The limits of sham trusts: Whether a trust's terms matter

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As attention surrounding the use of trusts in asset protection strategies has increased in recent years, so have questions surrounding the validity of such trusts. Central to this has been an attempted expansion of the sham doctrine from its traditional limits. These limits are that sham only considers the terms of arrangements as a point of comparison with a contrary shamming intention: that is, has the arrangement been used as a façade for the parties' true arrangement? Yet recent caselaw has advanced a view that an arrangement's terms matter in a more substantive way by themselves disclosing a shamming intention. This article challenges that view, asserting that sham should only be understood in its traditional sense for sound doctrinal reasons; and that expanding the sham doctrine in such a way conflates sham with improper motives for creating trusts and would introduce into the law value-judgments regarding what is, and what is not, an appropriate use of trusts.

I Introduction

To label a trust as a sham is to challenge its validity on the basis that the settlor and trustee have conspired with each other to use an otherwise validly created trust as a façade for some other arrangement.[1] Central to such a finding is that the settlor and trustee harboured an intention from the outset that the trust was to function as a sham: that is, there is no such thing as an emerging sham trust.[2] Further, a challenge of sham is based on extrinsic evidence of the trust parties' — the settlor and trustee's — true arrangement with each other.[3] Thus, key to sham, and what differentiates it from challenges to a trust's validity based on failing to, for example, meet the required certainty of intention, is that the trust is otherwise validly constituted and is being challenged on the basis of intentions evidenced elsewhere. This reflects the nature of sham as an independent private law doctrine that operates upon trusts, contracts, etc. while not forming a part of their constitutive rules.

This understanding of sham, however, leads to questions regarding the line between what is a sham trust and what is a valid one. Clearly, a trust which has been created as a façade for something else would be a sham, but the issue

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1 *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786, 802; [1967] 1 All ER 518, 528; *Street v Mountford* [1985] AC 809, 825–26; [1985] 2 All ER 289, 299; *Midland Bank plc v Wyatt* [1997] 1 BCLC 242, 215–52; *Scott v Federal Comr of Taxation (Cth) [No 2]* (1966) 40 ALJR 265, 279; *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd* [2004] HCA 55; (2004) 218 CLR 471, 486–87 [46]; *Raftland Pty Ltd v Federal Comr of Taxation* [2008] HCA 21; (2008) 238 CLR 516, 531–32 [35].

2 *Hitch v Stone* [2001] EWCA Civ 63 (CA); STC 214, [68]; *A v A* [2007] 2 FLR 467, 481–82 [42]–[44]; *Official Assignee v Wilson* [2008] 3 NZLR 45, [57]; *Lewis v Condon* [2013] NSWCA 204; (2013) 85 NSWLR 99, 116–17 [80]–[82].

3 *Snook* (n 1); *Hitch* (n 2) [63]; *A v A* (n 2) 479 [34]; *JSC Mezhdunarodniy Promyshlenniy Bank v Pugachev* [2017] EWHC 2426 (Ch) [150].

is not so clear if the trust has been created with the intention of using it to protect assets. Does the sham label apply to trusts where the settlor has retained or reserved strong powers with respect to the management and/or control of the trust property? To what extent is the nature of the trust's terms in such circumstances informative of whether the trust is a sham? These are questions that have been raised by recent case law, most notably *JSC Mezhdunarodniy Promyshlenniy Bank v Pugachev*,[4] concerning sham trusts, but have yet to be satisfactorily answered. Such questions go to the issue of the limits of the sham doctrine: the border between what is a valid and invalid trust for the purposes of sham.

Accordingly, this article will address these questions. It will apply the understanding of sham as a bilateral doctrine that requires two or more parties to have intended to use the trust as a façade. It will show that, given the sham doctrine's focus on extrinsic evidence of the trust parties' intentions, the terms of the trust are only relevant as a point of comparison. As a result, whether the shaming intention exists is not shown by the terms of the trust in question; indeed, it cannot be. The point of sham, whether it operates in the trust or contract context, is that the parties properly created a functioning legal relationship, and extrinsic evidence of their intentions is being used to challenge that. This means that references to the trust's terms should only be relevant insofar as serving as a benchmark against which to assess the trust parties' true intentions: did they deviate from those terms or not? As such, whether or not a settlor possesses strong powers with respect to the trust property should be irrelevant for determining whether the trust is a sham. This also indicates that trusts which provide for such powers by their terms, should not have those terms used in determining whether or not a trust is a sham. Provided that they are valid trust terms, a trustee or settlor/protector acting according to them should not be indicative of sham; in fact, it should argue strongly against it.

II The bilateral nature of sham

It has long been understood that the sham doctrine is bilateral in nature. This is unarguable in the contractual context where two or more parties are required in order for the arrangement itself to be valid.[5] In the trust context, however, the position has been more open to question. This is because trusts may be created unilaterally by declaration. Further, even where trusts are created bilaterally through transfer, the trust's terms are solely determined with reference to the settlor's intention.[6] This has led numerous scholars, and the courts, to opine on the possibility of sham operating unilaterally in the trust context. For instance, Conaglen has argued that a unilateral sham trust 'is plausible where the trust has been declared wholly unilaterally over the settlor's own assets, without the involvement of any separate trustee. In this

4 *Pugachev* (n 3).

5 Eg, *Snook* (n 1); *Equuscorp Pty Ltd* (n 1).

6 *Gosper v Sawyer* (1985) 160 CLR 548, 568–69; Sinéad Agnew and Simon Douglas, 'Self-Declarations of Trust' (2019) 135 LQR 67, 84. See also Derwent Coshott, 'The Sham Doctrine and Intention: Addressing the Bilateral Nature of Sham Trusts' (2022) 138 LQR 114, 116–18.

(relatively rare) situation, the only relevant intention is that of the settlor as he is also the trustee'.[7] Statements to similar effect have been made in the English High Court and the New Zealand Court of Appeal.[8]

The focus on the settlor's intention when creating a trust has also led scholars such as Palmer, Douglas and McFarlane, and Liew to contend that there is no sham doctrine operating in the trust context; rather, when a court finds that a trust is a sham, this simply represents the settlor not having the requisite intention to create a trust.[9] This, in their view, renders the sham doctrine unnecessary since a unilateral shamming intention — the intention not to create a trust — simply falls within the trust's certainty of intention rules.[10]

However, more recent scholarship has argued against both views, showing instead that the sham doctrine is: 1) a distinct doctrine which operates upon trusts and other private law arrangements; and 2) requires more than one person in order to function.[11] This is because, if the common intention requirement that is necessary in bilaterally created trusts were discarded in unilaterally created trusts, this would permit evidence of a settlor's entirely secret and unknowable intentions to undo the creation of a trust.[12] This would enable sham to be used as a means to circumvent the certainty of intention rules if settlors simply decided that they no longer wished for a trust to stand, based solely on evidence of secret intentions that could be proved to have existed at the time that the trust was created.[13] Further, if sham were permitted to operate unilaterally, then given that even in bilaterally created trusts the settlor's intention is all that we look towards, it would have to follow that the trustee's intentions are irrelevant here as well.[14] As such, the caselaw on sham in bilaterally created trusts would have to be regarded as entirely incorrect; and this would enable sham to serve as a form of escape hatch for settlors who wish to have the means to undo trusts whenever they see fit.[15]

Accordingly, for sham to function in a coherent manner, it must operate bilaterally. Given that, in the trust creation process, the trustee's intentions are

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7 Matthew Conaglen, 'Sham Trusts' (2008) 67 CLJ 176, 189. See also, Matthew Conaglen, 'Trusts and Intention' in Edwin Simpson and Miranda Stewart (eds), *Sham Transactions* (OUP 2013) 132.

8 *Painter v Hutchison* [2007] EWHC 758 (Ch) [115]; *Re Murphy* [2021] EWHC 278 (Ch); *Official Assignee* (n 2) [51].

9 Jessica Palmer, 'Dealing with the Emerging Popularity of Sham Trusts' [2007] NZLR 81; Simon Douglas and Ben McFarlane, 'Sham Trusts' in Heather Conway and Robin Hickey (eds), *Modern Studies in Property Law: Volume 9* (Hart Publishing 2017) 237; Ying Khai Liew, '"Sham Trusts" and Ascertaining Intentions to Create a Trust' (2018) 12 JOE 237. See also Nicholas Le Poidevin, 'Trusts: A Practitioner's Perspective' in Edwin Simpson and Miranda Stewart (eds), *Sham Transactions* (OUP 2013) 144–45; Alvin See, 'Revisiting Sham Trusts: Common Intention, Estoppel and Illegality' [2018] Conv 31; BoHao Li, 'There is No Such Thing as a Sham Trust' (2013) 44 VUWLR 115.

10 Coshott (n 6) 115, 126–29.

11 ibid.

12 ibid 122–23.

13 ibid 125.

14 ibid122–23.

15 Eg, consider the position in Australia regarding the certainty of intention following *Comr of Stamp Duties (Qld) v Jolliffe* (1920) 28 CLR 178, up until the High Court of Australia corrected the state of the law in *Byrnes v Kendle* [2011] HCA 26; (2011) 243 CLR 253.

irrelevant to establishing the certainty of intention, this means that the sham doctrine must operate upon the bilateral arrangement between the trust parties: the transaction that consists of the transfer of the trust property to the trustee, as this is where the trustee's intentions are relevant.[16] Consequently, the sham doctrine looks to evidence that is extrinsic to this transaction, which is a fundamental pre-requisite to the trust's validity, in order to challenge it.[17] This also shows that the sham doctrine is distinct from the arrangement which is being challenged, given that evidence extrinsic to the creation of the arrangement is being invoked to undermine it.[18] The point of sham is that under the constitutive rules of the arrangement in question, an arrangement has been validly created.[19] As such, sham is being invoked to challenge this; in the same way that extrinsic evidence is used to challenge arrangements under, for example, the doctrines of non est factum duress, unconscionable conduct, and undue influence.[20] Thus, in the trust context, the certainty of intention rules remain intact; and sham is invoked only on the basis of facts which show that the trust parties had the intention to use the otherwise validly created trust as a façade for their true arrangement.

III The line between sham and validity

Understanding the sham doctrine as bilateral in nature, and something which operates separately from, but upon, trusts, enables issues surrounding trusts where powers have been 'reserved' to settlors under the trust's terms to be clarified and better addressed. These most notably include situations where the settlor is given powers with respect to the trust property, often as a so-called trust protector, but can include any situation where the settlor 'retains' some form of management or control over the property. However, if these are explicitly provided for in a trust's terms why should these be regarded as indicative of sham?

The question arises due to caselaw stating that they can be. Most notably is *Pugachev*.[21] The case concerned five discretionary trusts which had been settled by Mr Sergei Pugachev. The trusts contained approximately US$95 million worth of assets. Mr Pugachev, and members of his family, were named as the beneficiaries of the trusts; and Mr Pugachev himself was also

16 Coshott (n 6) 116–21.

17 ibid 129–30.

18 ibid 123–26.

19 ibid 120.

20 Eg, *Saunders v Anglia Building Society* [1971] AC 1004, 1020, 1034; *Petelin v Cullen* (1975) 132 CLR 355, 359–60 (non est factum); *Barton v Armstrong* [1973] UKPC 27, [1976] AC 104 (duress); *Lloyds Bank Ltd v Bundy* [1975] QB 326, [1974] 3 All ER 757; *National Westminster Bank v Morgan* [1985] AC 686; *Barclays Bank Plc v O'Brien* [1994] 1 AC 180; *Louth v Diprose* (1992) 175 CLR 621 (undue influence); *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447 (unconscionable conduct); *Thorne v Kennedy* [2017] HCA 49; (2017) 263 CLR 85 (unconscionable conduct and undue influence); Marcus Moore, 'Why does Lord Denning's Lead Balloon Intrigue us Still? The Prospects of Finding a Unifying Principle for Duress, Undue Influence and Unconscionability' (2018) 134 LQR 257, 260–62; Coshott (n 6) 125.

21 *Pugachev* (n 3).

provided with significant powers as 'Protector' of the trusts.[22] These included the trustee needing to seek the Protector's consent regarding: the distribution of income and capital; investments concerning any of the trust property; declaring that a person will cease to be a discretionary beneficiary; and varying the trust deed.[23] The Protector also had the power to direct the trustee to sell any residential property which formed part of the trusts,[24] appoint new discretionary beneficiaries, in addition to being able to remove and appoint trustees.[25]

Mr Pugachev was the founder of Mezphrom Bank, and was described by the judge, Birss J, as a Russian oligarch.[26] Mezphrom entered into insolvent liquidation in 2010, and together with its liquidator, the Deposit Insurance Agency, commenced proceedings against Mr Pugachev claiming that he owed over US$1 billion to Mezphrom due to misappropriation of funds.[27] The claimants, in an effort to gain access to the value represented by the five trusts, argued that the trusts were shams, based on: 1) the significant protector powers held by Mr Pugachev; and 2) that the trustee, a company under the control of Mr William Patterson, conducted itself in such a way as to effectively allow Mr Pugachev and his associates to give direct instructions relating to the trusts' property, while exercising little effective control as trustee itself.[28]

Birss J, in finding that the trusts were void, appeared to agree that these factors combined were determinative regarding whether a shamming intention existed. His Lordship found that Mr Pugachev exercised his Protector powers in such a way which indicated that he regarded himself as the true owner of the property, and that the trustee went along with this from the outset (and was summarily later replaced when it would not).[29] As Birss J remarked:

> I find that at all material times he [Mr Pugachev] regarded all the assets in these trusts as belonging to him and intended to retain ultimate control. The point of the trusts was not to cede control of his assets to someone else, it was to hide his control of them. In other words Mr Pugachev intended to use the trusts as a pretence to mislead other people, by creating the appearance that the property did not belong to him when really it did. The role of Protector was the means by which control was to be exercised. The position of Victor [Mr Pugachev's son] as a potential Protector was part of the pretence. Victor was acting on his father's instructions.[30]

Thus, key was the intention to retain control, which was facilitated and agreed with by the trustee.[31] The trusts were shams due their terms purporting to represent that Mr Pugachev was not the beneficial owner of the trusts' property when, in actuality, he was.[32]

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22 ibid [15].
23 ibid [115].
24 ibid.
25 ibid [116].
26 ibid [3].
27 ibid [3], [9].
28 ibid [382].
29 ibid [417]–[421].
30 ibid [424].
31 ibid [427]–[435].
32 ibid [442].

However, as Birss J also observed, Mr Pugachev and the trustee did act in such a way that was consistent with the trusts' terms: 'Overall however while the operation of the trusts is consistent with their being genuine discretionary trusts for the class of Discretionary Beneficiaries as a whole, it does not allow one to distinguish between that and Mr Pugachev retaining beneficial control of the underlying assets.'[33] The retention of beneficial control, or beneficial ownership, of the assets was determinative for declaring that the trusts were void, and this depended on whether the trust's terms truly reflected this reality. If they did not, then the trusts could be regarded as shams. What mattered was whether, in the view of Birss J, 'the Protector's relevant powers are fiduciary'.[34] If they were not, then the trusts reflected Mr Pugachev's true intentions and it could not be said that the trusts were shams; but if they were, then this did not reflect his true intentions, nor how he conducted himself, and thus the trusts were shams.[35]

The issue was put by his Lordship in terms of the 'Angora cat problem': 'In some circumstances a ... [person] can argue for a narrow interpretation of a document while defending it in one context but then argue for a different wide interpretation when asserting it in another context.'[36] Here, Birss J believed that the trusts' terms were drafted in such a purposeful way so that, in a case such as this, the Protector's powers could be argued as being fiduciary in character, and thus 'confined and narrow'; whereas in other circumstances, such as when Mr Pugachev required 'collateral for a bank loan, a completely different stance could be taken in relation to the very same instrument. Mr Pugachev could be presented as the owner of the trust assets.'[37] This later situation was, as his Lordship put it, the 'true effect of the trusts',[38] which meant that they were illusory, insofar as 'according to the terms of the deeds, properly construed and on a proper application of the law to them, the trusts were not effective to divest Mr Pugachev of his beneficial ownership of the assets put into them'.[39] However, while this finding was sufficient to void the

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33 ibid [408].

34 ibid [437]. For problems relating to this particular conclusion, see Timothy Sherwin, 'When is a Trust Not a Trust? When the Courts Do Not Want it to be' (2021) 6 PCB 238.

35 *Pugachev* (n 3) [436], [437]. Note that Paul Matthews puts the kind of distinction that Birss J makes in terms of a 'sham in law' and a 'sham in fact', The former equating to illusory trusts, with the latter equating to sham as properly understood: Paul Matthews, 'The Sham Trust Argument and How to Avoid it' (2007) 21 TLI 191, 196–97.

36 *Pugachev* (n 3) [438].

37 ibid [440].

38 ibid [71], [169].

39 ibid [71].

trusts,[40] insofar as Birss J held that this was Mr Pugachev's true intention, as his Lordship went on to remark:

> I do not believe this characteristic of the deeds in this case is accidental. Whether 'sham' is a perfect description is not clear but it does not matter. ... in my judgment the combination of circumstances here means that the court should not give an effect to these instruments that would result in the assets being regarded as outside Mr Pugachev's ultimate control. The whole scheme was set up to facilitate a pretence about ownership (or rather its absence) should the need arise.[41]

In other words, the indeterminate nature of the Protector's obligations — were they fiduciary or not — was a conscious choice of Mr Pugachev and the trustee so as to enable Mr Pugachev to conveniently represent when he was, or was not, the beneficial owner of the assets. This was, in the court's view, a shamming intention and could, as a matter of principle, give rise to a sham claim.

It is important as this stage to discuss his Lordship's use of the term beneficial owner as this is key to his findings. Birss J appears to define beneficial owner as meaning that Mr Pugachev, through his powers as Protector, still retained control over the trusts' property. But, as noted, this alone was not indicative of sham if those powers were not fiduciary. What mattered was evidence of communications between Patterson, when establishing the trusts, and associates of Mr Pugachev that referred to the latter as the 'UBO' or 'ultimate beneficial owner'.[42] As Birss J remarked, 'Of course the idea that Mr Pugachev is the "UBO" of the assets is the claimants' case in a nutshell and is flatly contrary to Mr Patterson's position that as a Discretionary Beneficiary Mr Pugachev has no proprietary interest in the trust assets'.[43]

However, Birss J appears to have misunderstood in what sense the term, UBO, was being used. This is apparent by his Lordship's discussion of a letter concerning the OPK trust, which was another trust settled by Mr Pugachev, whose terms were used as a template for the five discretionary trusts.[44] The letter was an opinion drafted by Patterson's law firm 'concerning the ownership and controlling structure' of the trust.[45] Relevantly, the letter stated that 'the protector has ultimate control of the trust'.[46] Patterson admitted when giving evidence that the 'same opinion would apply to the trusts in this case' but went on to contextualise this by stating that:

> We were running into this problem of banks wanting to know who the ultimate beneficial owners were, even though it was just a nonsense. ... It was apparently required because there had to be some statement that the protector had ultimate control and he may well have.[47]

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40 ibid [436].
41 ibid [441]–[442].
42 ibid [338].
43 ibid [338].
44 ibid [342].
45 ibid [342].
46 ibid [343].
47 ibid [344].

This, for Birss J, was indicative that Patterson, and by extension the trustee, did not regard Mr Pugachev's Protector powers as fiduciary in nature, and that the trusts' property still belonged to Mr Pugachev: 'the protector (Mr Pugachev) retained ultimate control'.[48]

Yet the requirement that Patterson was referring to means nothing in the doctrinal context of trust law, nor under the sham doctrine; rather, it refers to obligations under the Financial Action Task Force (FATF) Recommendations, which require financial service providers, such as banks, to collect information on who are the beneficial owners and ultimate beneficial owners of trust structures.[49] Due to the nature of how the Recommendations define ownership and control, although persons, who would not be regarded as beneficial owners under the English or New Zealand law of trusts, would be regarded as such under the FATF Recommendations. This is due to the nature of the FATF Recommendations being concerned with identifying the proceeds of illicit activities from a functional and economic perspective, which legal and equitable ownership structures do not necessarily reflect. For example, in the FATF Recommendations 'General Glossary' section, 'Beneficial Owner', it states that: 'Beneficial owner refers to the natural person(s) who ultimately owns or controls a customer.'[50] Here, customer refers to, amongst other legal structures and entities, a trust. Further, 'Trustee' is defined by the FATF Recommendations as follows: 'The terms trust and trustee should be understood as described in and consistent with Article 2 of the Hague Convention on the law applicable to trusts and their recognition.'[51] Art 2 is footnoted to the text of this definition:

> For the purposes of this Convention, the term "trust" refers to the legal relationships created – inter-vivos or on death – by a person, the settlor, when assets have been placed *under the control* of a trustee for the benefit of a beneficiary or for a specified purpose.[52]

Thus, the concept of control is key, as it seeks to avoid the conceptual issues surrounding the recognition of the existence of equitable title under European (civil law) systems, to which such a concept is an anathema.[53] As such, the

48 ibid [346].

49 The Financial Action Task Force (FATF), *International Standards on Combatting Money Laundering and the Financing of Terrorism and Proliferation: The FATF Recommendations* (February 2012, updated March 2022) Recommendations 10, 24, 25 (beneficial owner), 22, 119 ('Beneficial Owner').

50 ibid 119. See also Organisation for Economic Co-operation and Development, *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* (2001) 14, where it is stated that '"control" means effective control by an individual or a group of individuals over a corporate vehicle. Thus, with respect to the types of corporate vehicles [which include trusts] examined in this Report, the relevant inquiry will be who exercises effective control (rather than legal control) over the corporate vehicle.' This is referred to in FATF, *Review of the FATF Forty Recommendations: Consultation Paper* (2002) ii, 54.

51 FATF, *International Standards on Combatting Money Laundering and the Financing of Terrorism and Proliferation* (n 49) 132.

52 *Convention on the Law Applicable to Trusts and Their Recognition* (1985) (emphasis added).

53 Maurizio Lupoi, *Trusts: A Comparative Study* (CUP 2000) 336. See also how the FATF treats trusts as contracts in certain instances, thus eschewing a proper consideration of property, and what ownership legally means in the trust context: FATF, *Misuse of Corporate*

terms 'ultimate beneficial ownership' and 'control' are treated synonymously in order to identify who is a functional, effective, beneficiary of a trust, which is a distinct and broader question than whether such a person is beneficially entitled under trust law.[54] Therefore, identifying a person as a beneficial owner, or having control, for the purposes of complying with the FATF Recommendations cannot and should not be conflated with the same concepts under trust law or the sham doctrine.

This weakens the basis on which Birss J held that the trusts could be shams; since, if the references to UBO and beneficial ownership were in reference to different definitions and standards than those which apply under trust law itself, then for the purposes of trust law and the sham doctrine, Mr Pugachev and the trustee may not have held a shamming intention. Indeed, Mr Pugachev's potential status as the UBO actually stands against sham, since his identification as such depended on the trusts' terms.[55] Another example is the statement that 'we have a document that reflects his current desires' in reference to the trust itself, thereby further indicating that the objective terms of the trusts reflected Mr Pugachev's true intentions: that is, there was no subjective intention — as required under the traditional understanding of sham — that the trusts should not take effect according to their terms.[56]

That brings the assessment of sham back to the trusts' terms, and how Mr Pugachev and the trustee conducted themselves in relation to them. Is a trust to be regarded as a sham because Mr Pugachev, in some circumstances, represented himself as the owner of the assets; or because the trustee largely went along with what Mr Pugachev wanted? As Birss J observed, the behaviour of all parties was consistent with the trusts' terms. But those terms did not allow one to distinguish between that and Mr Pugachev retaining beneficial control.[57] If Mr Pugachev's retention of beneficial control was key, then the question is whether the trusts' terms reflected this or not? Only if they did not could they have been properly regarded as shams.

This means that the basis on which sham was posited in *Pugachev* was erroneous. It depended upon whether the true effect of the trusts, which was to give Mr Pugachev control over the trusts' property for his own interests, was actually reflected by the terms of the trusts themselves. If, on their proper construction, his Protector powers were fiduciary (or could be represented as such to third parties) then, in the court's view, this was not reflected by how Mr Pugachev conduct himself, and the trusts could be shams. But that cannot be correct since one would have to prove that the trust parties subjectively believed that those terms were definitely fiduciary in character in order to set-up a contrary shamming intention. This was shown by references to UBO and beneficial ownership, but when properly contextualised that is better understood as referring to obligations under the FATF Recommendations; not as indicating any belief about the trust's terms. Without that, all one is left with

Vehicles, Including Trust and Company Service Providers (2006) 13.

54 For issues regarding the conflation and confusion surrounding ownership and control in the trust context, see: FATF & Egmont Group, *Concealment of Beneficial Ownership* (2018) 16, where the terms are conflated, as compared with at 25, where they are discussed separately.

55 *Pugachev* (n 3) [403]–[406], [409], [429], [437].

56 ibid [367].

57 ibid [408].

is that sham will exist if a trust's terms are vague enough as to lead to differing views on whether or not a protector's powers are fiduciary, and the protector proceeds to act in a way that is not in line with them being as such; apparently, whether or not, on their true construction, the terms are actually fiduciary in nature.[58]

Pugachev was followed more recently by Sims QC in *The Law Society v Dua*.[59] The facts concerned proceedings taken by the Law Society against Mrs Dua on a judgment debt with regard to real property that she jointly owned with her husband. However, Mrs Dua asserted that 'she had divested herself of any beneficial or equitable interest in the properties' through the creation of a trust with her husband in 2004; thus purporting to put them out of the Law Society's reach.[60] The evidence showed that the trust had been validly created — it was not a sham in the conventional sense of there being some other secret arrangement behind it — and thus sham could not be established on the basis of the trust not reflecting the true intentions of Mr and Mrs Dua. However, the Law Society pursued the sham claim on the basis outlined above in *Pugachev*: that being, where extensive powers over the management and control of the property have been reserved to the settlor of a trust that it might properly be described as a sham.[61] This is on the basis that, as Sims QC held: 'the test may be ... summarised as to whether or not the powers are so broad that what was intended to be a trust was not in fact a trust'.[62]

Sims QC chose to put this in terms of the trust being illusory, as distinct from sham, and held that Birss J had been careful to distinguish the two from each other.[63] However, while this is correct in how Birss J discussed the differences between sham and illusory trusts — or the true effect of the trusts, to use his language — this is not accurate with respect to the conclusion his Lordship reached regarding what a significant reservation of powers in a settlor as protector meant. As Birss J clearly articulated, due to the express reservations of significant powers in Mr Pugachev as Protector, with no fiduciary obligations attached despite being able to represent otherwise when desired, the trusts were shams.[64] An illusory trust, on the other hand, involves a trust in which the settlor has, on an objective basis, purported to create a trust which is void for failing to meet one of the mandatory rules of trust law.[65] For

58 A further problem in this regard is why the Protector acting in a way contrary to a fiduciary obligation is not simply in breach of that obligation, rather than the trust being a sham, where the trust is set-up in such a way that renders the fiduciary character of such obligations as vague. Does it need to be proved that there was an intention that such vagary exists, or can it simply be imputed based on an ex post construction of the trust's terms? More on this will be discussed below.

59 [2020] EWHC 3528 (Ch).

60 ibid [16].

61 ibid [139]–[140].

62 ibid [142].

63 ibid [143]. On the illusory trust point see *Webb v Webb* [2020] UKPC 22; Mark Bennett, 'The Illusory Trust Doctrine: Formal or Substantive?' (2020) 51 VUWLR 193; Charles Strachan, 'Whither the "Illusory Trust"?' (2021) 137 LQR 206.

64 *Pugachev* (n 3) [437].

65 *Clayton v Clayton* [2016] NZSC 29; [2016] 1 NZLR 551, [119], [123]; *Pugachev* (n 3) [155]–[172]; *Tasarruf Mevduati Sigorta Fonu v Merril Lynch Bank and Trust Co (Cayman)*

example, a settlor who is also trustee, but whose fiduciary obligations have been so excluded by the terms of the trust so as to breach the irreducible core.[66] The point of *Pugachev* is that an illusory trust could amount to a sham on the basis that a trust's terms were intended, or designed, to mislead regarding its illusory nature, thus inherently entangling the two. The problem is the ex post nature of such a finding; combined with the trust functioning, and being intended to function, according to its terms.

Regardless, Sims QC declined to find that the trust was a sham in the *Pugachev* sense, on the basis that the powers reserved to Mr and Mrs Dua were not anywhere near as extensive as those in *Pugachev*. While Mr and Mrs Dua retained the power to add to the class of beneficiaries, thus enabling them to add themselves if desired, as Sims QC remarked:

> It was central to the reasoning of Birss J in *Pugachev* that the powers conferred on Mr Pugachev as protector could be exercised freely, for his own personal benefit and without any effective fetter or limitation. It was also noted that he could remove trustees without cause. Neither of those features are present in this case.[67]

Accordingly, on the basis of *Dua*, being able to benefit from the property at some time in the future, while not presently being a beneficiary, was insufficient to establish either an illusory trust or a sham in the *Pugachev* sense. As Sims QC put it, key was whether 'the powers reserved to Mr and Mrs Dua are tantamount to beneficial ownership'.[68] This would require that, inter alia, 'the powers vested in Mr and Mrs Dua as trustees [were] free from a fiduciary responsibility, fetter or limitation' as in *Pugachev*. Here, there was nothing in the trust's terms indicating that such powers, and thus such an intention, was present.[69]

The position taken on sham as held in *Pugachev* and *Dua* can be contrasted with *ND v SD*.[70] The case involved a dispute between a divorced couple concerning the existence of a trust established by the husband in favour of the couple's two daughters. The trust contained the vast bulk of the wealth built up through the family business over two decades. The wife's case was that the trust was a sham, so as to enable her to access the 'some £50 million' which was contained within it.[71] As Roberts J put it, 'In terms of a practical outcome for this couple, the stakes are very high.'[72] Accordingly, the wife argued that the trust was designed to put forth the appearance that this wealth was not the husband's beneficially, while enabling him to retain control and, therefore, beneficially — in substantive terms — ownership.

Ltd [2011] UKPC 17; [2012] 1 WLR 1721; *Webb* (n 63) [77]–[79]. See the discussion on the distinction between illusory trusts and shams in Samuel Yee Ching Leung, '"Illusory Trusts", Shams, and Reservations of Powers' (2021) 35 Tru LI 160.

66 *Armitage v Nurse* [1998] Ch 241, cited in *Pugachev* (n 3) [164], *Clayton* (n 65) [124].

67 *Dua* (n 59) [156].

68 ibid [157].

69 ibid.

70 [2017] EWHC 1507 (Fam).

71 ibid [2].

72 ibid.

Interestingly, a Mr P (as he was identified in the judgment) was called as a joint expert on the law of the country in which the trust was established. In relation to sham trusts, he set out a number of principles, amongst which was that:

> If it can be shown from either the nature or the amount of powers reserved to the settlor that the transfer cannot be said to have occurred because the intention of the parties [i.e. the settlor and the trustee] was for the settlor to remain effective legal owner and control the assets, the trust may be held void ab initio as a sham. The issue is in identifying the point at which the settlor has retained so much control that it can hardly be said that she or he has relinquished any proprietary interest to the trustees at all. In making such an assessment it is necessary to consider not only the number, but also the nature of the powers cumulatively that may infer a sham trust and the facts surrounding it. So a settlor's power to replace the trustees may alone trigger a sham risk whereas retaining the power to add to the class of beneficiaries and change the governing law may be permissible.[73]

This echoes what Birss J held in *Pugachev*: that a settlor retaining a sufficiently high degree of control could be regarded as not having actually relinquished beneficial ownership, thus rendering the trust a sham.

However, Roberts J did not appear to agree that the conferral of such powers on a settlor necessarily represented that a shamming intention was present. As her Ladyship stated:

> here, in order to establish the sham relied upon by the wife, Mr Amos [counsel for the wife] must establish that not only did *the husband* have a dishonest intent in that he regarded the 2007 Trust Deed as being no more than a 'paper' which created no legal rights or obligations as between himself, the trustee and the purported beneficiaries (the children); he must also establish that Y Trustees Limited either shared that dishonest intent or was recklessly indifferent to the fact that it was entering into a document which on its face purported to impose on it, qua trustee, onerous fiduciary obligations towards the beneficiaries and the trust property which it had no intentions of honouring.[74]

Accordingly, what did the evidence show of the husband's and the trustee's intentions at the time that the trust was created?

The answer is that there was a genuine intention to create a trust in favour of the daughters. Further, and importantly, that 'The Trust Deed itself was drafted in sufficiently wide terms to enable [the husband] to continue running the business without interference from the trustees' was not necessarily indicative of sham.[75] In other words, a settlor having a large degree of control over the trust property through the terms of the trust was not determinative of sham. The sham question, rather, is one directed towards whether those terms reflected the genuine arrangement between the settlor and trustee, and whether there was an intention to use the trust's terms as a façade to hide their true arrangement. Thus, with reference to the leading cases, Roberts J held that:

> In this context it is important to distinguish between *motive* as distinct from *intention*. It is plain from *National Westminster Bank v Jones* to which I have already referred that even an artificial transaction which is put in place for the purpose of

73 ibid [178].
74 ibid [191].
75 ibid [212].

> asset protection will not necessarily be cast aside as a sham and of no legal effect if all the parties to that transaction genuinely *intended* the agreements incorporated into the document in which they appear to take effect. It is sufficient for these purposes that the parties intended their agreements to be given effect in the form in which they are recorded, and the courts will not enquire into their motives for so intending. It is an established legal principle undisturbed by anything which has been said in the more modern authorities to which I have referred that 'if what is done is genuinely done, it does not remain undone merely because there was an ulterior purpose in doing it': see Megarry J (as he then was) in *Miles v Bull* [1969] 1 QB 258 at 264. As Munby J made clear in *A v A*, in order to establish that the 2007 Trust was a sham, the wife must establish on the balance of probabilities that each of the husband and ... [the trustee] *intended* that the trust assets would be held on terms other than those set out in the 2007 Trust Deed and that each of them intended to give a false impression of the position to third parties.[76]

Her Ladyship did not find that such an intention existed on the facts before her; but most importantly, this also meant that she did not find a settlor having control over the assets which make-up the trust is indicative of sham if such control is provided for by the trust's terms.

This represents the correct position. The sham doctrine is concerned with whether an arrangement has been entered into with the intention that it should be used as a façade for something else. Its inherent nature is concerned with deception regarding the objective existence of the arrangement. In *Pugachev*, the closest the trusts came to this was the Angora Cat issue concerning whether the nature of Mr Pugachev's Protector powers were fiduciary or not. Determining that the powers were not fiduciary, but that Mr Pugachev intended that they should appear vague enough that they could be, together with those powers giving Mr Pugachev a large degree of control over the property, was decisive. But this is the tail wagging the dog: it depends on an ex post construction of the settlor's objective intention — what the terms of the trust mean — and arguing that because the settlor's ex ante subjective belief was different that the trust was a sham; without showing that the settlor had a very definite and distinct belief that the objective terms of the trust should mean something different than the true arrangement between the parties.[77] Indeed, taken alone, it is doubtful that such would have resulted in a sham finding in *Pugachev* in the absence of the judge's conclusion that Mr Pugachev intended to maintain sufficient control over the trusts' property that he could be treated as the ultimate beneficial owner. But if this was evident from the trust's terms, and legally effective, then where is the intention that those terms should be broadly misleading enough to be considered a sham?

It is useful in this context to consider one of the leading Australian cases on the position of sham and settlors retaining powers over the trust property: *Lewis v Condon*.[78] The case concerned a trust which was established by Ms Lewis for the purchase of real property. The rationale for doing so was that

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76 ibid [240].

77 As noted above, in the absence of such an intention, it makes more sense that any deviation from the trust's terms by a protector should be regarded as a breach of trust, rather than as an intention travelling back in time to indicate a shamming intention.

78 *Lewis* (n 2).

Ms Lewis was involved in complex proceedings in the Family Court of Australia against her ex-husband, desiring to 'keep [the property] away' from her own name until such time as the court proceedings were finalised.[79] She would then arrange for the property to be transferred back to her.[80] To this end, a discretionary trust was established over the property in favour of Ms Lewis, her daughters and grandchildren; with Ms Lewis also naming herself as 'appointor' with the power to replace the trustee at will so as to enable her to carry out the scheme.[81]

In the years following there were various changes made to the trust, the effect of which was to replace Ms Lewis as appointor with one her daughters; to remove Ms Lewis as a beneficiary of the trust, and to replace the trustee with Ms Lewis herself. She subsequently entered into a series of loans, secured over the trust property, which she defaulted on. Mr Condon, her trustee in bankruptcy, took proceedings alleging that the trust was a sham — that is, it was entered into the intention of concealing that Ms Lewis remained the real owner of the property — and, accordingly, that the trust property should be available to Ms Lewis' creditors.

In the New South Wales Court of Appeal, it was held that the trust was not a sham; despite Ms Lewis' clear intentions regarding it from the beginning. Leeming JA (with whom McColl JA and Sackville AJA agreed) held that while the trust was established with the intention of keeping assets out of Ms Lewis' name, but within her control, it was not established with the intention that it should not have its apparent effect nor any legal consequence.[82] His Honour drew on decisions from throughout the common law world, including Lord Wilberforce in *WT Ramsay Ltd v IRC* that, 'to say that a document or transaction is a "sham" means that while professing to be one thing, it is in fact something different'.[83] The key for any court, therefore, is to look beyond the 'primary material' to all the other 'material factors' that demonstrate a quite different intention of the parties to the trust than disclosed by its terms.[84] Leeming JA held that this required a sham was not established by the objective terms of the trust, but by the subjective intentions of the parties.[85] His Honour further went on to cite Robertson and O'Regan JJ of the New Zealand Court of Appeal in *Official Assignee v Wilson* that, 'A court will 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.'[86] In other words, a premium is placed on the words, and thus the terms, of the trust deed itself; and evidence of sham is something distinct from this.

Essential to the court's judgment, and relevant to this discussion, was the distinction between sham trusts and trusts that are created for improper

79 ibid [13].
80 ibid.
81 ibid [8].
82 ibid [55]–[57], [59].
83 [1982] AC 300, 323, cited in *Lewis* (n 2) 112 [59].
84 ibid 112 [61].
85 ibid 112 [63].
86 *Official Assignee* (n 2) [52], cited in *Lewis* (n 2) 113 [64].

purposes.[87] The latter includes, for example, transfers of property for the purposes of defrauding creditors, or with the main purpose of defeating or delaying creditors. Under legislation these are treated as voidable, rather than void, transactions and thus are legally effective unless and until a court orders otherwise.[88] However, this distinction also means that transactions entered into simply with an ulterior purpose are not open to the label of sham. Citing *Miles v Bull*, and reflecting what was later stated by Roberts J in *ND* as noted above, '[i]f what is done is genuinely done, it does not remain undone merely because there was an ulterior purpose in doing it'.[89] Accordingly, Leeming JA stated:

> The proposition that not every transaction entered into for a legally improper motive is a sham must also be correct in principle. There is a clear distinction between a settlement of property in favour of (say) a spouse intended to operate in its terms, but made with the intent of defrauding creditors, and a sham declaration of trust in favour of a spouse never intended to give rise to the ordinary incidents of a trust. Both are entered into for an improper purpose, but the legal meaning of the former accords with the language of the declaration (although it is apt to be set aside pursuant to statute), while the legal meaning of the latter is that there is no trust at all. The limited notion of what constitutes a sham does not swallow up the large class of other transactions entered into for a purpose regarded as improper by the law. In short, every case of shamming intent involves a finding of intentional deception as to the effect of a document, but not every case of improper purpose is a sham.[90]

As a result, the court held that Ms Lewis simply wished to establish a trust so that, for the purposes of the family court proceedings, she did not have legal title to the property.[91] But the trust operated according to its terms: if the court proceedings were finalised when Ms Lewis originally hoped, then she could have requested that the trustee convey the property to her. If it refused to do so, she could have exercised her power of appointment to remove it and appoint one that would.[92] This intention could not be rebutted by evidence of subsequent events. Indeed, evidence of later events were wholly consistent with this conclusion, as those actions involved Ms Lewis acting in accordance with the terms of the trust.

Lewis therefore stands against the view advanced in *Pugachev*, and reflects the position taken more recently in cases such as *ND*. A sham must have no legal consequence or not its apparent legal consequence. This means that, with regard to transactions entered into to defeat creditors, for example, a transaction which is legally effective as to its terms cannot be a sham. This is why legislative provisions such as s 423 of the Insolvency Act 1986 (UK), s 37A of the Conveyancing Act 1919 (NSW) and s 121 of the Bankruptcy Act 1966 (Cth), exist: to render transactions voidable that would otherwise have the effect of taking property legally out of the reach of creditors. To

87 ibid 113 [65], 114 [69].
88 Eg, Insolvency Act 1986 (UK), s 423; Conveyancing Act 1919 (NSW), s 37A; Bankruptcy Act 1966 (Cth), s 121.
89 [1969] 1 QB 258, 264, cited in *Lewis* (n 2) 114 [69].
90 ibid 114 [70]–[71].
91 ibid 114 [72].
92 ibid 115–16 [75]–[76].

regard sham as encompassing such situations is to transform the doctrine into something quite different than what it is.

Accordingly, the idea that the sham doctrine takes account of the terms of the arrangement in question — in these cases, trusts — is erroneous; other than when examining those terms in order to ascertain whether or not the true intentions of the trust parties is at variance with them. As *Lewis* illustrates, an improper motive for using a trust, such as in asset protection strategies where the intentions are to defeat or avoid actual or potential creditors does not, and should not, be regarded as a shamming intention. Indeed, the intention present in such cases is to actually utilise the terms of the trust itself as the device to divest oneself of legal and equitable title, while retaining, in terms evoking the FATF Recommendations, ultimate beneficial ownership and control. This is distinct from the settlor possessing any legal or equitable interest in property, which is the point; and thus, is also distinct from the operation of the sham doctrine since the trust's terms do actually reflect the trust parties' true intentions.

Consequently, the attempted expansion of sham, as represented by *Pugachev*, is doctrinally problematic for the operation of the sham doctrine. This is because, as currently understood under sham, there is a clear dividing line between the terms of the arrangement in question — the objective intention — and the true intention of the parties regarding it — the subjective, secret or shamming intention. The line is that drawn between what is and what is not extrinsic evidence. Clearly, for a sham claim to be successfully made there must be evidence attending the creation of the arrangement in question which goes to show that, despite whatever the terms of the arrangement are, it was not intended to take effect.[93] Thus, with respect to a trust, the necessary evidence consists of: 1) a validly created and otherwise functioning trust (that is, it cannot be illusory); and 2) an intention on the part of the trust parties that the trust does not take effect according to those terms.[94] Therefore, like extrinsic evidence in a contractual context, the sham doctrine requires evidence of intentions that were present at the creation of the trust, but were not incorporated into, or reflected by, the trust's actual terms. Further, for the purposes of sham, the extrinsic evidence of such intentions must be to use the arrangement as a façade for something else which is not disclosed by those terms. As such, if those terms do reflect what the parties subjectively intended, then sham will not be available.

However, if the terms of the trust itself could be indicative of sham because they were, to use the language in *Lewis*, for an improper motive, then this introduces into the sham doctrine the idea of courts being able to make value judgments on what is or is not an appropriate use of a private arrangement. Apart from the above-mentioned legislation regarding transactions made with the purpose of defrauding or defeating creditors, the law has been quite circumscribed when interfering with private arrangements on such bases. For example, under the general law, what are known as the public policy restraints do permit courts to declare as void private arrangements — contracts, trusts, and most often wills — that seek to restrain or impermissibly interfere with

93 Coshott (n 6) 120–21.
94 See above nn 1–3.

marriages, or would encourage some forms of public or moral misconduct.[95] But these are extremely limited and not without controversy in their scope and application; with courts frequently commenting on how such matters are best left for legislatures to determine.[96] What *Pugachev* represents is the possible introduction into the sham doctrine of such value judgments; especially when there is no line defined therein of what constitutes an impermissible level of settlor/protector control, and there is an inherent value judgment being made as to why that control is present.[97]

The sham doctrine has never had within it such value judgments. It is a straightforward doctrine insofar as it asks a simple question: did the parties to the arrangement intend for it to be used as a façade for their true arrangement; or, do the terms of the arrangement not reflect the true arrangement between them? In *Pugachev*, it was clear that the terms of the trusts did reflect what Mr Pugachev wanted, while the references to ultimate beneficial ownership in the context of providing information to banks was not with reference to a shamming intention. At best, Mr Pugachev possessed an improper motive, to use the language in *Lewis*, but this does not equate to sham, nor should it.

IV Conclusions

This article has argued in favour of retaining the traditional understanding of sham as a doctrine which looks beyond the terms of private law arrangements to extrinsic evidence of the parties' intentions to use such arrangements as facades for their true arrangements with each other. To that end, it has argued against the purported change in the law as represented by *Pugachev*, which sought to incorporate into the sham doctrine considerations of whether a shamming intention was present in the terms of the arrangement in question. By this is not meant a consideration of those terms as a point of comparison with whatever intention is disclosed by extrinsic evidence of the parties' intentions; rather, what is meant is making judgments that the nature of those terms themselves could give rise to the arrangement being declared a sham. This is contrary to how the sham doctrine has traditionally operated, and contrary to the rationale of the doctrine itself, which is to simply determine whether the objective terms of the arrangement under examination represent the true arrangement between the parties. Further, and quite more problematically, it conflates the sham doctrine with the idea of improper motives for entering into trust arrangements, which are already dealt with under legislation in the context of bankruptcy/insolvency. Introducing this kind of value-judgment making power into sham would impermissibly

95 Eg, *Upfill v Wright* [1911] 1 KB 506 (immorality); *Fender v St John-Mildmay* [1938] AC 1; [1937] 3 All ER 402; *Re Fentem* [1950] 2 All ER 1073 (marriage); *Re Sandbrook* [1912] 2 Ch 471 (separation of parents and children); *Egerton v Earl of Brownlow* (1853) 4 HL Cas 1; 10 ER 359 (conduct injurious to public life).

96 *Wilkinson v Osborne* (1915) 21 CLR 89, 96–97; *Multiservice Bookbinding Ltd v Marden* [1979] Ch 84, 104; [1978] 2 All ER 489, 497.

97 Jack Davies, 'New Developments in Settlor Reserved Powers' [2018] Conv 175, 183.

transform the doctrine into a kind of new public policy restraint, and is therefore the kind of development better left to legislatures under a separate and new statutory regime that can properly define and delimit the nature of such powers.