WHAT IS (AND WHAT IS NOT) A SHAM

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The purpose of this article is to review the law of sham; to explain (if not to reconcile) some dicta in this area; and to draw conclusions for trust drafting.

Definition of Sham

The leading case is Snook v London & West Riding Investments:

"It is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create".

[1967] 2 QB at 801(Diplock LJ)

Put more shortly, a sham exists where the parties say one thing intending another: Donald v Baldwyn [1953] NZLR 313, 321, per F B Adams J, cited by Bingham LJ, AG Securities v Vaughan [1990] 1 AC 417.

"Sham" is not a concept of tax law, or trust law, but of the general law. None of the leading cases are tax cases or trust cases.

All parties to the sham documentation must be aware of sham

"But one thing, I think, is clear in legal principle, morality and the authorities ... that for acts or documents to be a "sham," with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a "shammer" affect the rights of a party whom he deceived."

(Diplock again at p 802.)

What matters is intention of parties at time of execution of documentation

It is fundamental law that a settlement (as any gift) is irrevocable once validly made (unless there is a power of revocation): it cannot be revoked by subsequent conduct. The relevance of subsequent conduct is that it may

shed light on the intention at the time of the settlement and show that it was not validly made. There may be other explanations of conduct.

The following are not proof of sham:

(1) Ulterior Purposes

(2) Dishonesty

(3) Artificiality

(4) Sloppiness of execution

(5) General disapproval of the Court

“A transaction is no sham merely because it is carried out with a particular purpose or object. If what is done is genuinely done, it does not remain undone merely because there was an ulterior purpose in doing it.”

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

Midland Bank v Green concerned a sale at undervalue whose purpose was to defeat the rights of an option holder:

"That the ulterior motive for the transaction was to defeat Geoffrey's option, that the price was exceedingly low - perhaps only 1/80th of the true value of the farm in 1967 - and that the normal step of a written contract preceding the conveyance did not take place - all these factors undoubtedly existed. Nevertheless, ... the conveyance did and was intended to convey the estate from Walter to Evelyne. It was not a "sham" and cannot in my view be converted into a sham because of the motive or reason for the transaction, namely, because the parties wished to take advantage of the provisions of section 13 (2)."

"Real and lawful intentions cannot be dismissed as shams merely because they are disliked. ... the court cannot say that a licence is a sham for the reason that the court thinks the parties ought to have intended a tenancy."

Donald v Baldwyn [1953] NZLR 313, 321, (cited Somma v Hazelhurst).

"In a case involving a complex and artificial tax avoidance scheme, where the scheme documentation is sloppily executed, where the evidence of the taxpayer and of his legal adviser (the deviser of the scheme) is found to be unreliable, and where their dealings with the Revenue have been less than straightforward, there must be a strong temptation for any tribunal to, in effect, throw up its hands and cry "Sham!". But in the instant case - and as long as the Snook definition of sham remains the accepted definition - that temptation has, in my judgment, to be resisted."

Hitch v Stone [1999] STC 431 at p 466:

“It is conceded that the present schemes are not shams in that narrow sense. They are, however, ‘paper transactions’ without any objective economic reality.”

(Ramsay v IRC 54 TC 176) (emphasis added)

“Sham” in Trust Cases

In the well-known case Rahman v Chase Bank [1991] JLR 103, Butterworth’s Offshore Cases Vol 1, p 433, Royal Court, a trust was held to be a sham on very strong facts:

1. Settlor running the trust:

(a) Bank (Nominee) account contract provided that “the Bank may make or change investments upon receipt of instructions given by Mr Rahman”.

(b) Investment adviser appointed by Mr Rahman on terms agreed by Mr Rahman.

(c) Withdrawals from trust account without knowledge of the trustees or reference to them.

(d) Investment policy: correspondence between investment managers and Mr Rahman bypass the trustees.

2. Settlor considered the funds as his own: he referred to the trust as "his Will". He made payments out of the trust find telling recipients it was "his" money.

3. Inappropriate confidentiality: reversionary beneficiaries were not informed of their interests.

4. Inconsistent appointments: an appointment was prepared (and possibly executed) which revoked previous appointments which were declared to be "irrevocable".

R v Dimsey & Allen [1999] STC 846 is another example.

"Sham" in Tax Cases

Sham is a straightforward but limited doctrine, which does not help the Revenue to defeat properly carried out tax avoidance schemes.

“Now it will be readily perceived that the participants in virtually every tax avoidance scheme have not the slightest incentive to produce a sham. The strategies depend for their effectiveness on the steps taken being real. ... Given that there is no difficulty in taking the artificial steps, there is no point whatsoever in not taking them but in merely pretending to take them. Indeed, there is every point in taking them; as otherwise the scheme certainly will not work and will depend for its de facto effectiveness on a criminal fraud which is totally unnecessary and the discovery of which will normally give rise not only to the tax, which continues to be due, being in fact collected but also the perpetrator being indicted on serious charges.”

(Tax Avoidance and The Law (1997) Key Haven Publications, p. 27, Robert Venables, QC)

So the context of a tax avoidance scheme is irrelevant to sham, or else makes a finding of “sham” more difficult! For another example of Revenue failure in a sham argument see: Ingram v IRC [1985] STC 835.

For an example of Revenue success in a sham argument, see Dickenson v Gross 11 TC 614. This concerned a partnership deed “perfectly good according to its tenor;” the difficulty being that it was ignored in practice. No books were kept, and the partnership income was not distributed in accordance with the partnership deed. Rowlatt J held that there was no partnership:-

“Many people think that by putting a bit of paper in the drawer they can make an Income Tax partnership, and they go on treating the undertaking

as though it were still the sole uncontrolled property of the one person, the father, instead of a partnership."

"Nearly a Sham"

Note, strictly, an arrangement is either a sham or is not. There is no halfway house. Yet we see in tax cases:

"Very close to a sham"

Colours (formerly Spectrum Ltd) v IRC [19981 STI at 721.

"Mr Walker's scheme, which trembled on the brink of a sham, employed the devices which proved ineffective in Ramsay [1979] STC 582 and Furniss v Dawson[1984] STC 153"

(Lord Templeman, dissenting in Fitzwilliam v IRC 67 TC at 754.)

The thinking behind such dicta may be, that the Court was very tempted to find a sham, but (applying the law correctly) finds that it was not. Or that the higher Court would like to make that finding but it is a matter of fact and it is unable to overturn facts found by the court below.

"The Revenue Should Have Argued 'Sham'"

“A series of transactions so unusual and so close to the death of the testator almost inevitably suggests that there might have been grounds for attacking the transactions as a sham or as lacking bona fides or as ineffective under the principles enunciated by the House of Lords in W T Ramsay Ltd v IRC [1981] STC 174, [1982] AC 300. That, however, has not been suggested by the respondent at any stage of the proceedings and their Lordships must, therefore, approach the matter in the same way as the courts below, that is to say as a genuine, arm’s length transaction which had the effect of transforming the testator’s property in Hong Kong into a single chose in action represented by the promissory note .... As has already been stated, no challenge has been raised to the bona fides of the transaction, so that their Lordships have been compelled, as were the courts below, to treat it in the same way as an arm’s length transaction. Lest, however, it should be thought that the door has been opened to making estate duty in Hong Kong a voluntary imposition, their Lordships would add that it would be unwise to assume that the genuineness of similar transactions in the future will necessarily be beyond challenge.”

Kwok Chi Leung Karl (Executor of Lamson Kwok) v Commissioner of Estate Duty [1988] STC 728.

“I might myself have had some difficulty in accepting the genuineness of all of the transactions involved had that been put in issue before me as a tribunal of fact. In particular, the idea that the appointment in step 4 could have constituted a valid exercise by genuine trustees of a fiduciary power would have taken some swallowing when placed alongside the admitted fact that it formed part of a prearranged scheme, as would the proposition that any serious person would have paid 40,600 for the dubious benefits of obtaining the fruits of such an obviously impugnable appointment. The scheme seems to have been devised with scant regard for fundamental principles of trust law. With such matters I am not, however, concerned. The Revenue accepts, and the Special Commissioner found, that the

transactions were not shams. I am not a tribunal of fact in relation to such matters and the Revenue has not sought to suggest otherwise."

DTE Financial Services Ltd v Wilson [1999] STC 1060

No doubt one could assemble dicta from other cases along these lines. In these cases the Judges' attention was not drawn to the cases on "sham". On the basis of the authorities set out above, the Revenue might have succeeded on "sham" but it would have been an uphill struggle. (Such cases bring to mind the "the golden rule" for judges in relation to obiter dicta, namely, that "Silence is always an option: " Reg. v Comr. of Police of the Metropolis, Ex parte Blackburn [1968] 2 QB 157.)

Comparison with Related Doctrines

It is well settled that there may be a partnership agreement despite a clause saying "there is not a partnership"; or an employment contract despite a clause saying "this is a contract of services which shall not constitute X an employee". In relation to whether there is an interest in possession it has been said that what is decisive is the substance of the provision and not the clothes or label which it wears. This may be called the label doctrine - that labels assigned by parties are not decisive.

A document may also be invalid under the rules of non est factum; a deed of appointment may be void under the rules known as "fraud on a power."

A transaction may be ineffective for tax by virtue of Furniss v Dawson.

The sham doctrine is related to (but not the same as) all these doctrines, but they may overlap. Note how the wilder obiter dicta in Kwok, and DTE, cited above, scatter these doctrines in a somewhat "elephant gun" approach.

Another Doctrine Wrongly Called "Sham"

"The word "sham" has perhaps not always been used in that clear sense. In Gilford Motor Co. Ltd. v Horne [1933] Ch. 935 the plaintiff company employed Mr Horne as its managing director under a contract containing a post-contract non-solicitation clause. At the end of his contract, Mr Horne set up a company, J M Horne & Co. Ltd., to carry on a competing business. An injunction was granted against Mr. Horne and the company. In the Court of Appeal Lord Hanworth MR said, at pp. 961-962, that the company was a mere cloak or sham, a mere device for enabling Mr. Horne to breach his contract, and that accordingly an injunction should be issued against both defendants. It was plainly necessary to determine whether, on the proper construction of the contract, the acts of the company put Mr. Horne in breach of his obligations. In order to give commercial efficacy- to the relevant clause, consistent with the way in which it would have been understood by reasonable businessmen, it was necessary to construe it as wide enough to encompass the activities of a company set up for the sole purpose of attempting to defeat the contractual restrictions which Mr. Horne had accepted. If an injunction lay against Mr. Horne, it was proper that an injunction should lie also against the company which was knowingly assisting him. The granting of an injunction against the

company was necessary because the company was, as Lord Hanworth MR affirmed, at p. 955, a separate entity from Mr Horne.

"That case was followed in Jones v Lipman [19621 1 WLR 832, where a vendor of land attempted to avoid being compelled to convey the land to the purchaser by forming a limited company and conveying the land to the company. Russell J, citing Gilford Motor Co Ltd v Horne [1933] Ch. 935, ordered specific performance against both the vendor and the company. Lord Cooke in his Hamlyn Lecture, at p. 17, made the following comment about the decision:

"Since the company was in the vendor's control, there was no difficulty in granting a decree of specific performance against him. Describing the company as a creation of the vendor, a device, sham and mask, the judge also decreed specific performance directly against it. Those epithets, however, do not appear to have been needed to justify the remedy. No particular difficulty should arise in holding that a company or any other purchaser acquiring property with actual notice that the transaction is a fraud on a prior purchaser takes subject to the latter's equity. In truth the very granting of the remedy against the company brings out that it was not a sham."

See Yukong Line Ltd v Rendsburg Investments Corpn. (No. 2) Toulson J. [1998] 1 WLR. 294.

How to Avoid A Sham Trust

Administration

The essence is to ensure the settlor understands he is creating a trust, and intends to create a trust, and to cease to be the beneficial owner of the trust property. This is not primarily a matter of trust drafting. The drafting of marketing literature is relevant to sham, because this may shed light on the settlor's intentions. The drafting of correspondence by the settlor will certainly shed light on his intentions, his correspondence can hardly be vetted by his lawyers; so the only course is to instruct or educate him in the nature of a trust. Again, the quality of trust administration is relevant to sham: the Court may draw an inference from inappropriate trust administration that the settlor did not intend to create a trust: see above. The risk of sham is, obviously, greatest where the settlor is a beneficiary (also though to a lesser extent where he receives trust funds on behalf of his minor children). In such cases additional care should be given to conducting administration in a manner producing a full and genuine paper record of decisions made by the trustees on at least an annual basis.

Drafting

The trust draftsman cannot draft his way out of a sham. However he can help draft his way into one, by producing trust documentation which records untruths; which fails accurately to record the true intention of the settlor; or which is unnecessarily artificial.

The greater the gap between the reality and the documentation, the higher and stronger the possible inference of "sham".

Nominee Settlors

It is the custom in some offshore jurisdictions to arrange for a lawyer or trustee company to settle an initial nominal trust fund. This may be referred to as a nominee settlor; though others may use unkinder words such as dummy or stooge. The real settlor then adds a more substantial trust fund. It goes without saying that the person who provides trust property directly or indirectly will be the "Settlor" for tax purposes and likewise for insolvency & matrimonial law purposes. This style of drafting may have the pernicious result of leading a court to infer an intention to mislead the reader into thinking that the nominee settlor is the only and real settlor. (Though the true and more innocent explanation may be that the parties are seeking confidentiality and mistakenly believe that every trust deed needs a named settlor; or that this is done for no reason whatsoever). One wonders how often the nominee settlor actually provides the initial trust fund - though fortunately this hardly matters.

The draftsman should not name beneficiaries in trust deeds whom there is no intention to benefit; and should name the actual intended beneficiaries; or at least if they are not named in the trust deed, their names must be added by an appropriate appointment before they receive benefits.

If the settlor requires powers of control over the trustees, this should be appropriately dealt with in the trust instrument. Some commentators have suggested that such control (especially power to dismiss trustees) makes the trust likely to be dismissed as a sham. The author does not agree. Of course a trust conferring on the settlor a power to dismiss may be held to be a sham. So may a trust without such an express power. The question in each case is whether the settlor intended to create a trust: if he had the requisite intention there is no sham. If the settlor in fact controls the trust without authority in the trust deed for doing so, this is in principle some evidence of sham (the cogency of such evidence depending on the factual background). Whereas if the trustee confers powers of control on the settlor typically appointing the settlor as "Protector" an inference of "sham" in these circumstances is actually weakened or neutralised.

Sham as defence to claim for breach of trust

If a trust is a sham, it is a sham for all purposes. So if beneficiaries sue trustees for breach of trust, it will be a defence that the trust is a sham. However - especially if the trustees were the original trustees, and parties to the trust deed - the defence that the trust which they executed is a sham is at first sight an unattractive one which might fail in practice even though it can succeed in theory. Further, evidence that the trustees treated the trust as a sham will tend to confirm any allegations of breach of trust, if the defence of sham is not made out.

If the trust has a valid trustee exclusion clause the duty of the trustees is limited. The clause "exempts the trustee from liability for loss or damage to the trust property no matter how indolent, imprudent, lacking in diligence, negligent or wilful he may have been, so long as he has not acted dishonestly". In these circumstances a trustee may be in a position to mitigate the embarrassment of claiming his trust is a sham by arguing firstly that the trust administration reached the relatively low level necessary for a valid trust with an exclusion clause; but if it did not, then the trust was a sham.

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