TRUST LAW

How a trust might become an 'emerging sham'

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I was asked by a colleague the other day about a trust that most non-lawyers would call a sham.

A trust that started off as genuine with the trustees all being involved in decision-making had been hijacked by one of them. He bought properties without informing his co-trustees, took trust money, failed to produce financial statements for the trust, failed to keep records of trust assets and liabilities and was generally completely unaccountable.

Under our law at present, the trust would not have been a sham since the trustees would all have said at the outset that they genuinely intended to create a trust. The Court of Appeal said in *OA v Wilson* [2007] NZCA 122 that "unless the appearance of a sham can be traced back to the creation of the trust, the trust remains valid".

The trust my colleague described involved similar facts to those of *Vervoort v Forrest* [2016] NZCA 375 where the Court of Appeal rejected a claim that the trust had developed into an 'emerging sham'.

If the doctrine of 'sham' were to apply to such a trust, it would have to be via the 'doctrine' – if it exists – of 'emerging sham'.

The doctrine of emerging sham is controversial and I consider that for all practical purposes it doesn't exist. If a trust starts off with its trustees all intending that the trust would be genuine, and if the trust subsequently went off the rails and was hijacked by a trustee, the courts would say the appropriate remedy was for a beneficiary to sue the trustee for breaches of various obligations and not to plead that the trust was a sham.

Most conventional trusts in New Zealand are discretionary family trusts and a discretionary beneficiary with no fixed entitlement to a distribution will not be willing to spend money on High Court litigation of that nature, meaning that the hijacking trustee will carry on flouting the law and plundering the trust's assets.

The courts, as guardians of trusts, ought never to allow this state of affairs to exist. In the *Raftland* case [2008] HCA 21, Kirby J of the High Court of Australia delivered what is almost certainly the most comprehensive judgment in the Commonwealth on sham trusts. He sensibly called for courts to adopt "a broader and more robust approach to the identification of sham".

He referred with approval to a decision of the New Zealand Court of Appeal in *Marac Finance v Virtue* [1981] 1 NZLR 586 in which Richardson J said there were two situations where "a document may be brushed aside if and to the extent that it is a sham". One of the circumstances is "where the document was bona fide in inception but the parties have departed from their initial agreement and yet have allowed its shadow to mask their new arrangement".

In recent times the leading case on shams in New Zealand is the Supreme Court's decision in *Ben Nevis v CIR* [2009] 2 NZLR 289. In that case, Blanchard and Wilson JJ said, "a document which originally records the true common intention of the parties may become a sham if the parties later agree to change their arrangement but leave the original document standing and continue to represent it as an accurate reflection of their arrangement".

The Court of Appeal also acknowledged in *Vervoort v Forrest* that a trust that started off as genuine "becomes a sham because there has been a deliberate change in the trust arrangement so that it no longer has any of the characteristics of a trust, and the use of the trust name has become a deliberate pretence of a trust arrangement".

There is therefore high authority in New Zealand for the fact that a trust that was genuine at the outset can cease to be genuine and become a sham as time goes on.

Justice Kirby said in *Raftland* that "sham can develop over time if there is a departure from the original agreement and the parties knowingly do nothing to alter the provisions of their document as a consequence".

A finding that a trust that once was genuine has ceased to be so ought not to be concerning.

What is problematic is the requirement that "the parties to the trust" must have departed from the initial agreement. By 'the parties' I assume the court is speaking of all the trustees and office holders.

I suspect that if professional trustees have been side-lined by a hijacking trustee, they would say they still intend the trust to be genuine but have been wrongly excluded from trust management and decision-making by the hijacking trustee.

In these circumstances I consider that a concerned beneficiary should contact the other trustees and try to obtain the information and assistance the hijacking trustee ought to be providing but which is being withheld.

If the other trustees are unwilling to do this, or are unwilling to do so satisfactorily, then it would not be unreasonable to say the trustees are no longer willing to comply with the terms of the original deed of trust and are operating a sham.

In this way, a trust that started off as genuine can cease to be genuine and the trustees be held to be party to an 'emerging sham'. ■

Anthony Grant is an Auckland barrister specialising in trusts and estates ■