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In-depth
Sham Trusts

Sunil Gadhia , Konrad Rodgers and Joe-han Ho*

Abstract

There is an increasing trend to attack discretionary trusts by deploying the developing doctrine of sham trusts. Surprisingly, there is relatively scarce literature on this doctrine. We seek to fill that gap by examining the doctrine's contours, unpacking its reasoning, and taking a hard look at some of its problematic aspects. We further draw on our experience to discuss best practices to defend against allegations of sham.

Introduction

Discretionary trusts occupy a central role in the private client sphere. They offer a flexible legal structure that can harness tax efficiencies, safeguard intergenerational wealth, and protect assets against speculative claims. This is why many wealthy individuals place their assets into discretionary trusts.

However, wealth attracts envy. As F Scott Fitzgerald famously wrote:

> Nothing is as obnoxious as other people's luck.

It is increasingly common to attack discretionary trusts (targeting the Settlor, Beneficiaries, or both) by deploying the developing English law doctrine of sham trusts.[1]

Surprisingly, there is relatively scarce literature on this doctrine. In this article, we draw upon our experience to outline the contours of the doctrine, unpack its reasoning, and share best practices to defend against unfair allegations of sham. We then examine the rule that a sham trust can become genuine, and take a hard look at an important and often under-analysed question: if there is a finding of sham, where does the 'trust' property go?[2]

If there is a finding of sham, where does the 'trust' property go?

'The discretionary trust' section of this article introduces the discretionary trust in the private client context. 'The sham trusts doctrine' section examines the contours of the sham trusts doctrine and unpacks its reasoning. The 'Best practices to avoid allegations of sham' section then sets out best practices to defend against allegations of sham. Finally, the 'Particular aspects of the sham trusts doctrine' section takes a close look at particular aspects of the sham trusts doctrine that have yet to be satisfactorily resolved.

* Sunil Gadhia, Partner; Konrad Rodgers, Associate; and Joe-han Ho, Associate, Cleary Gottlieb Steen & Hamilton LLP, City Place House, 55 Basinghall Street, London EC2V 5EH, UK. Tel: +44 20 7614 2264; Fax: +44 20 7600 1698; Website: www.cgsh.com; The authors would like to thank Dr Andrew Hayward, Lecturer at Durham Law School, for his helpful comments on previous drafts. The views expressed in this article are personal to the authors, and all errors, omissions, and opinions are their own.

1. The usual 'attackers' are the revenue, creditors, and statutory or disappointed heirs. However, the changing legal landscape may add to this list. For example, legislation now allows 'civil recovery' of the proceeds of crime even where there is no conviction. See Nicholas Le Poidevin, ''Sham and Trusts: A Practitioner's Perspective'' in Edwin Simpson and Miranda Stewart (eds), *Sham Transactions* (OUP 2013) 152–54.

2. For convenience, we do not put 'Settlor', 'Trustee', or 'trust' assets in quotation marks where there is a sham. It should be clear to the reader whether these words, when read in context, should be prefixed with 'putative'.

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The discretionary trust

The typical set-up of a discretionary trust

A discretionary trust is typically set up in the following manner:

- The Settlor's lawyers draft a detailed Trust Deed after consulting with the Settlor. The Trust Deed will set out the Beneficiaries (who are often the Settlor and his family) and it is common for the Settlor and/or the Trustee to have the power to add to or remove from the class of Beneficiaries at any time. The Settlor may also decide to reserve other powers in the Trust Deed,[3] such as the power to appoint a Protector,[4] and the power to replace the Trustee.[5]
- A confidential letter of wishes is prepared. This letter from the Settlor to the Trustee, which must be consistent with the terms of the trust, sets out the Settlor's hopes and wishes as to the operation of the trust. While the letter has no legal effect, the letter is often influential in guiding the Trustee's decisions.
- Professional trust companies are shortlisted as Trustee candidates. Many reputable accountancy firms, law firms, and international banks have subsidiaries that offer such specialist services. The Settlor's priority is to decide on a candidate that is reputable, reliable, and of the highest professional integrity. Many professional trust companies also have sister companies that can act as asset managers for the trust assets. This is often important to the Settlor, who may also consider the track record and investment philosophy of the asset manager.
- Once the trust deed is finalized, the letter of wishes prepared, and the professional trust company chosen, the trust is ready to be created. The assets are transferred to the Trustee and the Trust Deed is executed.[6] The trust is now operational. The Settlor drops out of the picture save for the powers reserved under the Trust Deed.

In practice, it is common to set up a pilot trust, ie a discretionary trust with nominal trust assets, and for the Settlor to contribute further property at a later stage. Further, where very substantial assets are involved, the Settlor may use a more complex structure to administer the assets. This typically features a dedicated family office at the apex overseeing a network of offshore companies, management committees, and sub-trusts or separate trusts catering to different branches of the Settlor's family.

The advantages of a discretionary trust

In the private client context, the discretionary trust is the legal structure of choice. Transferring ownership of assets to the Trustee reduces the Settlor's taxable assets. The Trustee may also place the trust assets in a low tax jurisdiction for further tax efficiencies.

However, the Settlor's divestment need not mean complete estrangement from the trust assets. The Settlor may retain some indirect control or influence by his letter of wishes and reserved powers. The Settlor may also include himself as a Beneficiary and thereby be entitled to be considered by the Trustee for a distribution.

The important legal distinction is that a Beneficiary has no right to demand trust assets. Rather, the

3. The range of reserved powers is broad and includes revocation clauses, spendthrift clauses, flee clauses (for instance, upon the Settlor's creditors commencing trust litigation, the trust assets, administration, and governing law are automatically transferred to a different jurisdiction), and anti-duress clauses (for instance, where the Settlor is under duress, such as being mandated by a court order, the Trustee may disregard the Settlor's instructions in exercise of his reserved powers).

4. The Protector is a person other than the Trustee who by the Trust Deed has powers or duties in the administration of the trust. In practice, this is the Settlor's trusted advisor or confidante, and his role as a safeguard over the Trustee's actions gives the Settlor comfort that the trust will be properly managed.

5. The weighty influence or retention of large powers by a settlor does not itself render the trust a sham. However, there are disadvantages to retaining excessive powers, including: (i) possible adverse tax consequences, (ii) susceptibility to the appointment of a receiver by way of equitable execution, and (iii) arguments (although controversial in English law) that the trust is a nominee or agency agreement. In theory, control may be diffused through a structure of Protectors, management committees, and offshore companies. However, such complexity may invite suspicion, and clients may find this difficult to understand or get comfortable with. Timothy J Bennett, "The Importance of Proper Offshore Administration" [1993] 4(3) ICCLR 93, 95.

6. There is no legal difficulty if this cannot be done simultaneously. Where the assets are transferred to the Trustee prior to the execution of the Trust Deed, the Trustee holds the assets on an automatic resulting trust. *Vandervell v IRC* [1967] 2 AC 291 (HL).

Beneficiary only has the right to demand loyalty from the Trustee, and to be periodically considered for a distribution. It is an essential feature of a discretionary trust that the Trustee must consider from time to time, acting independently and in its absolute discretion, whether to make a distribution of the trust assets.[7]

The corollary of this is that a Beneficiary does not own any of the trust assets *unless and until* a distribution is made to him. So, before a distribution is made, the Beneficiary does not own any trust assets that can be taxed or made available to creditors. These features of a discretionary trust have obvious advantages.

From a litigation risk perspective, this reduces the prospect of opportunistic litigation against the Settlor or Beneficiary, or at least improves their settlement leverage by making them less attractive as litigation targets.

To optimize tax efficiencies and safeguard inter-generational wealth, the Trustee may apply his discretion to decide which Beneficiary, and when, should receive trust assets (whether income and/or capital), and in what proportions. In this way, the Trustee can tailor the distributions to provide for the particular circumstances of each Beneficiary, and also make distributions with a view to minimizing the Beneficiary's potential income, inheritance, and other tax liabilities.

The Settlor's divestment of assets to the trust also facilitates inter-generational wealth. Upon the Settlor's death, for the divested assets, there is no publicity, delay, or expense of probate. The ownership of the family business (or conglomerate of business interests) may also be united in the Trustee, thus avoiding the risk of protracted litigation or fragmented ownership due to squabbling by the Settlor's issue.

'Good' and 'bad' discretionary trusts

One final point needs to be made. It is sometimes suggested that the very concept of a discretionary trust is morally suspect—especially when used in tax planning—and that its use 'helps rogues be rogues'.[8] There have also been industry murmurings that an estimated 50–80 per cent of discretionary trusts are shams.[9]

However, much of this suspicion arises from ignorance of the conceptual basis of a discretionary trust. Trusts are routinely misunderstood.

As for the use of discretionary trusts in tax planning, any allegation of 'abuse' here is a political point, not a legal point. As Lord Upjohn observed,

> [n]o commercial man in his senses is going to carry out commercial transactions except on the footing of paying the smallest amount of tax involved. [10]

Similarly, in the US, Judge Learned Hand explained that:

> [a]ny one may so arrange his affairs that his taxes shall be as low as possible . . . there is not even a patriotic duty to increase one's taxes. Taxes are enforced exactions, and not voluntary contributions.[11]

As for industry estimates that 50–80 per cent of discretionary trusts are shams, this is wildly misconceived. These estimates were arrived at by using a loose colloquial layperson definition of 'sham', and by *misunderstanding* the *legal* meaning of 'sham'.[12]

If the concern is that the *legal form* of discretionary trusts is being *abused*, then the solution is to examine whether the law draws the right line between permissible and prohibited uses of the discretionary trust. There are many specific legal doctrines—some more well-known than others—that prevent the discretionary trust from being abused.[13] Further, the modern English position is that Trustees should be neutral when a trust's validity is attacked. The defence should be left to the Beneficiaries, while the Trustee

7. *Gartside v IRC* [1968] AC 553 (HL).
8. David Hayton, "The Future of the Anglo-Saxon Trust in the Age of Transparency" [2015] 29(1) Tru LI 30, 32.
9. John Mowbray, "Shams, Pretences, Blackmail and Illusion: Part 2" [2000] 2 PCB, 105, 108.
10. *CIR v Brebner* [1967] 1 All ER 779, 784.
11. *Helvering v Gregory* [1934] 69 F2d 809, 2d Cir, affirmed 293 US 465 (1935).
12. Mowbray (n 9).
13. These doctrines are explained in'The sham trusts doctrine' section. There are also broad statutory rules such as s 423 of the Insolvency Act 1986 that can unwind trusts set up to defraud creditors.

stands ready to abide by any court orders.[14] This is a healthy contrast to the approach in some offshore jurisdictions, where Trustees are expected to vigorously contest any attacks on the validity of the trust.[15]

The sham trusts doctrine

Background and meaning of 'sham'

The sham trusts doctrine is of relatively recent vintage.[16] Despite some commentators doubting whether the doctrine exists,[17] or is distinct from the process of construction,[18] we believe it is fair to say—especially in light of the doctrine's discussion and application in recent cases—that it is a distinct and developing doctrine with tolerably clear boundaries.

The starting point for the legal meaning of 'sham' is the *dictum* of Lord Justice Diplock (as he then was) in *Snook*,[19] where 'sham' was held to mean:

> 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.[20]

While *Snook* was not a case involving a sham trust, Lord Justice Diplock's *dictum* has been applied to the sham trusts context in several cases.[21]

It is important to note that the *legal* definition of 'sham' is much narrower than its colloquial definition of some trick or fraud. In particular, the legal meaning of 'sham' is that the pretence is something that is capable of and purports to have legal consequences, and the parties intend that what is created does not have its purported legal effect.[22] An allegation of sham therefore requires careful legal analysis instead of a vague allegation of sharp practice.

The legal definition of 'sham' is much narrower than its colloquial definition of some trick or fraud

How to make a sham trust argument

Generally speaking, to make a sham trust argument, the party alleging sham must prove that, at the point of the trust's creation, there was a shared dishonest intention between the Settlor and the Trustee to give a false impression to third parties that a trust was created as per the terms of the Trust Deed, when no such trust was created, and in truth some other arrangement was intended. These points require careful elaboration.

The burden of proof

The party asserting sham bears the burden of proving the sham to the usual civil standard of the balance of probability.[23] This standard is flexible in its application:

> the more serious the allegation the less likely it is that the event occurred and, hence, the stronger should

14. *Alsop Wilkinson v Neary* [1996] 1 WLR 1220. Robert Hunter, "The Fraudulent Use of Trusts" (2013) 19 *Trusts & Trustees* 312, 314.
15. Paul Matthews, "The Sham Trust Argument, and How to Avoid it" [2007] 21(4) Tru LI 191, 200.
16. The word 'sham' first appeared in English law in 1691, and only moved towards its modern legal meaning after the 1850s. Mike Macnair, "Sham: Early Uses and Related and Unrelated Doctrines" in Edwin Simpson and Miranda Stewart (eds), *Sham Transactions* (OUP 2013) 30.
17. Paul McGrath QC, *Commercial Fraud in Civil Practice* (OUP 2014) para 17.06.
18. For a discussion of how the sham trusts doctrine is distinct from the process of construction, see Matthew Conaglen, "Sham Trusts" (2008) 67(1) CLJ 176, 179–183. See also Lynton Tucker, Nicholas Le Poidevin and James Brightwell (eds), *Lewin on Trusts* (19th edn, Sweet & Maxwell 2014), para 4-031. See also John McGhee (ed), *Snell's Equity* (33rd edn, Sweet & Maxwell 2014) para 22-071.
19. *Snook v London & West Riding Investments Ltd* [1967] 2 QB 786.
20. ibid, 802.
21. For example, *Hitch v Stone* [2001] EWCA Civ 63, [2001] STC 214; *Shalson v Russo* [2003] EWHC 1637 (Ch), [2005] Ch 281; *Painter v Hutchison* [2007] EWHC 758 (Ch).
22. Tony Pagone, "Sham Trusts Revisited" (2014) 20 *Trusts & Trustees* 1081, 1081–82.
23. *Mikeover Ltd v Brady* [1989] 3 All ER 618, 626.

> be the evidence before the court concludes that the allegation is established on the balance of probability.[24]

Any evidence that indicates the shamming parties' intentions at the point of the trust's creation is admissible.[25] This is so even if the evidence post-dates the trust's creation. So, the conduct of the shamming parties subsequent to the execution of the Trust Deed may allow an inference of collusion.

Asserting sham is always a grave accusation of dishonesty. It impugns the integrity of the Settlor (often an influential businessman) and the Trustee (invariably a reputable professional).[26] So, strong and persuasive evidence, commensurate to the gravity of the allegation, is required to assert and prove dishonesty.

Asserting sham is always a grave accusation of dishonesty

In line with these principles, Mr Justice Neuberger (as he then was) in *National Westminster Bank Plc v Jones* held that there was

> a *strong presumption, even in the case of an artificial transaction,* that the parties to what appear to be perfectly proper agreements on their face, *intend them to be effective . . . an allegation of sham carries with it a degree of dishonesty*, and *the court should be slow . . . to find dishonesty.*'[27] (emphasis added)

Therefore, there is a high threshold to meet for an allegation of sham trust to succeed. This is compounded by the nature of sham trust conspirators to conceal their dishonest arrangement. In practice, a party alleging sham is unlikely to find a 'smoking gun', and must rely on collating sufficient inferences to make out its case.

However, notwithstanding the difficulties faced by a party alleging sham, the current state of the law is soundly rooted in considerations of fairness and policy, and unlikely to change. The law strikes a delicate balance, and the wide experience of English judges in these matters plays an important role in holistically assessing the evidence.

The nature of a sham allegation

Subject to two exceptions explained below, a sham means that the trust was fraudulent from its inception. If a trust had been validly constituted, and only at some later stage did the Settlor conspire with the Trustee, this does not impugn the validity of the trust. Instead, it is *prima facie* a breach of trust; English law has no doctrine of 'emerging sham'.[28] Hence, the general rule that a genuine trust cannot become a sham. The High Court, in an *obiter* discussion of the doctrine, affirmed this,[29] and drew on the same principle to elaborate that, as a general rule, a sham trust can become genuine if new honest Trustees were later appointed.

The salient principle here is that a trust operates on the conscience of the legal owner and requires the Trustee to carry out the purposes for which the property was vested in him.[30] This principle goes to the heart of equity. A Trustee who voluntarily assumes office has his conscience impressed with a duty of loyalty to the Beneficiaries. This is an onerous duty which breach attracts serious consequences. As an experienced practitioner observed,

> it is the sanction [of breach of trust] that gives the whole trust arrangement much of its status as a

24. *Re H (Minors) (Sexual Abuse: Standard of Proof)* [1996] AC 563, 586 (Lord Nicholls). Keane and McKeown describe how 'in general the seriousness of an allegation is a function of the seriousness of its consequences'. Adrian Keane and Paul McKeown, *The Modern Law of Evidence* (10th edn, OUP 2014) 116–17.
25. *AG Securities v Vaughan* [1990] 1 AC 417, [475–476] (Lord Jauncey).
26. As previously discussed, the Trustee is often a specialist subsidiary of a reputable firm or bank. Where the Trustee is a company, its directors (which, for the purposes of imputing dishonesty, are the directing mind and will of the company) usually include distinguished partners or senior managers of the chosen firm.
27. *National Westminster Bank Plc v Jones* [2001] 1 BCLC 98, [46].
28. This is where a sham can develop over time if there is a departure from the Trust Deed and parties knowingly do nothing to alter the provisions of the documents. See Pagone (n 22) 1081, 1088–89. See also McGrath QC (n 17) para 17.31.
29. *A v A* [2007] EWHC 99 (Fam).
30. *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669, [705] (Lord Browne-Wilkinson).

serious legal mechanism. When parties take on liabilities, one assumes they mean business.[31]

A trust operates on the conscience of the legal owner

Where there was originally a validly constituted trust, for the law to instead allow a finding of sham is undesirable. First, it strips the Trustee's fiduciary duties of any content. Secondly, it allows the Trustee to rely on his own serious wrongdoing to collapse the trust. Thirdly, there is no juridical explanation as to how the (formerly valid) trust is collapsed. Fourthly, as a validly constituted trust is analogous to a perfected gift to the Beneficiaries (albeit one with restrictions depending on the trust's terms),[32] it is an expropriation of the Beneficiaries' interests under the trust. To add insult to injury and disrepute to the law, this expropriation may be—depending on the arrangement underneath the sham—for a dishonest Settlor's benefit.

These reasons also explain why a sham trust can become genuine. Once an honest Trustee is appointed and voluntarily assumes office, the Trustee's conscience is bound, and equity recognizes the trust. While there are some criticisms of this—which we address in the 'Particular aspects of the sham trusts doctrine' section—the High Court considered this proposition and concluded that:

> principle argues compellingly that in such circumstances there is, for the future, a valid and enforceable trust.[33]

We elaborate on this reasoning in the 'Particular aspects of the sham trusts doctrine' section.

There are two apparent exceptions to the general rule that a genuine trust cannot become a sham. The first exception is where all the Beneficiaries are *sui juris* and with the requisite dishonest intention join with the Trustee to create a sham.[34] The reasoning appears to be that the Beneficiaries exercise their *Saunders v Vautier* rights to collapse the trust.[35] Therefore, the sham is the pretence that the existing (but in reality, now terminated) trust continues; so the sham springs up *for the first time* at this point.[36] In our view, this is consistent with principle and, when properly characterized, it is not an exception at all. Rather, while it *appears* that a genuine trust has become a sham, the truth is that the genuine trust is collapsed by the Beneficiaries, and the role of the Beneficiaries in the newly created sham is really *qua* Settlors.

The second exception derives from the decision of *Hill v Spread Trustee Co Ltd*[37]—it appears that where the original Trustee is honest but does not take steps to administer the trust,[38] when the Trustee is then replaced with a dishonest Trustee, a finding of sham may still be found.[39]

In *Hill*, the initial Trustee held office only for a weekend, and simultaneously with executing the Trust Deed also executed a deed of retirement and appointment in favour of a subsequent Trustee (which had always been intended to take office). The court held that the intentions of the initial Trustee were irrelevant. The reasoning appears to be that the initial Trustee was never

31. Hunter (n 14) 312, 318.
32. Rimer J makes this analogy in *Shalson v Russo* [2003] EWHC 1637 (Ch) at [190]. Bernard Rudden's comments are also apposite: [a trust is] 'essentially a gift, projected on the plane of time and so subjected to a management regime'. Bernard Rudden, "John P. Dawson's Gifts and Promises" (1981) 44 Mod L Rev 610.
33. *A v A* (n 29) [45] (Munby J).
34. ibid [44] (Munby J).
35. ibid.
36. There may be difficulties with the statutory formalities of s 52(1) of the Law of Property Act 1925. If the Beneficiaries create the sham by directing the Trustees to hold the trust assets for some third party, the facts are similar to *Grey v IRC* [1960] AC 1 and there will be a formalities requirement. While it is for a future article to fully examine this, possible solutions are that (i) *Grey* was wrongly decided in light of the *Vandervell* cases, (ii) *Grey* can be distinguished, or (iii) the law imposes a constructive trust. The proper legal characterization may also impact upon the illegality and estoppel doctrines.
37. *Hill v Spread Trustee Co Ltd* [2005] BPIR 842.
38. Tucker and others (n 18) para 4-026.
39. It is unclear what steps the original Trustee must take for the trust to be validly constituted. We suggest that the original Trustee must have (i) had an intention to assume office, and also (ii) taken some material administrative or dispositive action regarding the trust.

intended to take any steps in the administration of the trust.[40]

While *Hill* was probably correctly decided, it was based on particular and unusual facts. The initial Trustee's role was *de minimis*—his role was fleeting, and it was always going to be (indeed, embedded at the trust's creation when the deed of retirement was also executed) the case that a new Trustee would be appointed.

The shared dishonest intention of the Settlor and the Trustee (and other third parties)

If the Settlor constitutes the trust by transferring assets to a Trustee, an allegation of sham requires an argument that both the Settlor and the Trustee shared a dishonest intention. This rule is now well established in English law.[41] The focus is on intention, and motive is generally irrelevant.[42] In this context, intention includes reckless indifference.[43] This coheres with the way intention is treated elsewhere in the law of trusts.[44] For example, in *Agip (Africa) Ltd v Jackson*,[45] Mr Justice Millett (as he then was) held that consciously assisting arrangements with an indifferent attitude towards the possibility that those arrangements are fraudulent is dishonest.[46]

If the Trust Deed provides for a Protector (or some other party with powers integral to the operation of the trust), it is unclear whether this party must be party to the sham. Le Poidevin suggests that such party must also share the dishonest intention, on the basis that the general rule requires all parties to the transaction to share the shamming intention.[47] We agree with this—by parity of the reasoning that a trust operates on the conscience of the legal owner, it also ought to operate on the conscience of parties with powers integral to the operation of the trust. *Insofar* that this is an extension of legal principle, it is a small extension that is reasoned and desirable.

We further recognize that there will be borderline situations where the Protector or other party may argue that its office is not fiduciary or is not sufficiently fundamental to the operation of the trust to attract this rule. No doubt the ambit of this rule will be developed in the case law.

The nature of the dishonest intention

The dishonest intention must be (i) to give a false impression to third parties (ii) that a trust was created as per the terms of the Trust Deed, when no such trust was created, and in truth some other arrangement was intended. While the jurisprudence has emphasized that the requisite intention comprises these two separate limbs,[48] this is unlikely to cause difficulties in a sham allegation. It is difficult to imagine why a Settlor would make the effort of executing a Trust Deed different from the true arrangement

40. Tucker and others (n 18) para 4-026. As a variant of this exception, Frank Hinks QC suggests that (although the evidential difficulties will be formidable) a sham may be found if a Settlor creates a trust with an innocent Trustee, but via reserved powers (to the Settlor or a Protector) replaces the innocent Trustee with a sham Trustee. The same principle applies, in that the innocent Trustee was a mere conduit in the conspiracy. Frank Hinks QC, "Sham Trusts" PLC database (accessed on 14 August 2015: http://uk.practicallaw.com/uk/6-383-2143).

41. *Pankhania v Chandegra* [2012] EWCA Civ 1438, [20] (Patten LJ). Paul Matthews argues that the courts developed this rule based on a misunderstanding of the jurisprudence. However, we believe that even if this is correct, the rule is now well-established in English law (and rightly so for the reasons explained in this article). Matthews (n 15) 191, 198.

42. The Settlor may have a collateral motive for creating the trust, which is nonetheless consistent with the non-sham intention that the law requires for a genuine trust to be created. Mr Justice Megarry (as he then was) in *Miles v Bull* [1969] 1 QB 258, [264] held that 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.' See also *Chase Manhattan Equities Ltd v Goodman* [1991] BCLC 897.

43. *A v A* (n 29) [52] (Munby J). But note the contours of this—as Le Poidevin explains: 'It cannot be enough if the settlor privately intends a sham and the trustees, where there are separate trustees, do not know or care what the settlor is doing, for that would be to defeat the trust by reference to the settlor's intention alone; the trustees must surely share at least the settlor's intention that the property of the apparent trust is not to be administered for the benefit of the apparent beneficiaries. Mere indifference to the trust instrument should not suffice.' Le Poidevin (n 1), para 8.18.

44. Conaglen (n 18) 176, 191–92.

45. *Agip (Africa) Ltd v Jackson* [1990] 1 Ch 265, [293], [295].

46. Conaglen (n 18).

47. Le Poidevin (n 1) para 8.28–8.29.

48. *Pankhania v Chandegra* (n 41), [20].

with the Trustee without positively intending to dishonestly deploy the Trust Deed in circumstances when it suited him.[49]

The effect of a finding of sham

If there is a finding of sham, the effect is that the trust is void.[50] The critical issue is then to determine the consequences. How were the trust assets held? This is not a matter of judicial discretion. Rather, the court must ascertain the true intentions of the Settlor, subject to the application of doctrines such as estoppel and illegality.[51]

Many commentators, as a starting point, state that the effect of a finding of sham is that the Trustee holds the trust property for the Settlor on a resulting trust. Matthew Conaglen states that where there is a sham,

> the most likely result is that the 'trust' property is held on automatic resulting trust for the shamming settlor.[52]

Similarly, Toby Graham and Joanna Poole conclude that 'there is a resulting trust for the settlor',[53] and Paul McGrath QC states that:

> the purported trustee holds the relevant assets on a resulting trust for and on behalf of the settler . . . [t]his view is consistent with the approach to an express trust failing for want of certainty.[54]

It is true that in most sham trust situations, the Trustee holds the property to the Settlor's order. However, while this is the same *outcome* as a resulting trust (ie that the Settlor holds the beneficial interest), the *legal characterization* is not necessarily a resulting trust.[55] In the 'Particular aspects of the sham trusts doctrine' section, we argue that the better legal characterization is an express trust.[56]

More importantly, the suggestion that there is usually a resulting trust must not obscure the possibility of a different agreement underneath the sham. It is this analysis that determines who owns the trust assets. The Trustee may hold the trust assets as donee (ie absolutely), bailee (ie with bare possessory rights), or trustee on some other trust. The sham trusts doctrine does not deal with these possibilities, and it is left to general property law to determine the proprietary consequences.

The position of the Trustee and third parties also needs to be considered. The Trustee may have to make restitution (with interest) of all trust fees received as there was never a right to charge these fees.[57] There may also be difficulties for the Trustee to seek a *quantum meruit* given that the Trustee had a dishonest intention and knowledge of the sham.

Third parties who are prejudiced through their dealings with the Trustee may also benefit from an estoppel,[58] although it is difficult to see how in practice their position will be improved by an estoppel.[59] *Insofar* as their dealings were as equity's darling, they took free of any equitable claims, and for advisors to the Trustee, a personal claim against the Trustee to be paid should still lie.[60]

Proving a sham trust is difficult, and often the first step in protracted litigation. The real issue is then to

49. Le Poidevin (n 1) para 8.10.
50. McGhee (n 18) para 22-070.
51. For a brief explanation of these doctrines in the sham trusts context, see Le Poidevin (n 1) para 8.35–8.37.
52. Matthew Conaglen, "Sham and Trusts" Legal Studies Research Paper No 14/99, November 2014, para 10.61.
53. Toby Graham and Joanna Poole, "Switching Assets from One Shadowy Hand to Another': Piercing the Veil of Company and Trust" (2010) 16 *Trusts & Trustees* 705, 716.
54. McGrath QC (n 17), para 17.02. Graham and Poole, ibid, fn 4.
55. It is true that absent evidence of any agreement underneath the sham, the court will find a resulting trust. However, even absent *direct* evidence, the court is at liberty to (and in many situations *should*) infer that the true arrangement was that Trustee would hold the assets to the Settlor's order.
56. Frank Hinks QC recognized this point, although he argues that there is normally no difference between the transaction taking effect in accordance with the true intention and the transaction being void with a resulting trust for the settlor. Hinks QC (n 40).
57. David Harris, "No Such Thing as a Sham Trust?" [2004] 2 PCB 95, 96.
58. *Hitch v Stone* (n 21).
59. Le Poidevin (n 1) para 8.37.
60. ibid.

determine the effects of the finding of sham—where should the trust assets go? This is a factual and legal minefield, but the rewards for an aggressive litigant can be enormous.

This is a factual and legal minefield, but the rewards for an aggressive litigant can be enormous

Doctrines that are similar—but conceptually different—to the sham trusts doctrine

In our writings elsewhere,[61] we adopted a taxonomy of (i) sham trust, and (ii) all other doctrines that render the particular discretionary trust form legally defective or vulnerable. The literature uses various terms such as 'total sham', 'partial sham', 'formal sham', and 'illusory trusts'. These are not, however, terms of art.

The lack of a uniform taxonomy sometimes means that the sham trusts doctrine is mistaken for other similar doctrines. It is important not to fall into this trap, for these other doctrines have different conceptual bases and require different elements to be made out. Such awareness is important to be able to properly advise a client, and may affect all stages of the litigation strategy. Below, we briefly delineate two scenarios that do not, on a proper analysis, engage the sham trusts doctrine.

The first scenario is where the Settlor intended a trust, but the trust fails for some reason. This may be because on a proper construction of the Trust Deed:

- The Settlor holds the trust assets absolutely. In other words, the Trustee holds the assets only as bailee. This may be where the Settlor never had an intention to transfer legal ownership of the trust assets at all.[62]
- The trust assets are a gift to the Trustee.[63] For example, the Trust Deed may have a very wide exemption clause that immunizes the Trustee regardless of what happens to the trust assets. It is arguable there is no 'irreducible core of obligations owed by trustees to the beneficiaries',[64] and the Trustee is a donee because 'an uncontrollable power of disposition would be ownership, and not trust'.[65]
- The trust is testamentary, and non-compliant with statutory formalities. For example, the Trustee may hold the property upon trust as directed by the Settlor during his lifetime, and upon his death for the Settlor's children.[66]

The second scenario is where the Settlor retains such extensive reserved powers in a valid trust that he may terminate the trust at will (by a power of revocation or by exercising a power of appointment). Here, the trust may be susceptible to an application under section 37(1) of the Senior Courts Act 1981 to appoint a receiver by way of equitable execution, and for a court order to make distributions to the Settlor's creditors.[67] This argument succeeded in the Privy Council case of *Tasarruf*.[68]

Tasarruf caused concern in the industry particularly as the Settlor's reserved powers were on the bank's standard form. However, a properly structured discretionary trust can avoid this danger. It seems that very extensive reserved powers are usually required before the court will appoint a statutory receiver. Nevertheless, this is an area worth monitoring closely.

61. Sunil Gadhia, Konrad Rodgers and Joe-han Ho, 'Setting Up a Trust under English Law' [2015] 7(43) Legal Insight 20 (Russian language publication).
62. Matthews (n 15) 191, 196.
63. Conaglen (n 18) 176, 197. This construction is subject to the court reading down the exemption clause, or alternatively finding that there is a sham with an underlying agreement.
64. *Armitage v Nurse* [1998] Ch 241, 253 (CA).
65. *Morice v Bishop of Durham* (1804) 9 Ves 399, 405.
66. Michael Mitchell and Bruce Judelson, "Defective Trusts under English and United States Law" [2003] PCB 23, 24–25.
67. This is not an attack on the validity of the trust. Under English law, a trust with full powers of revocation is a validly constituted trust. Rather, this is a statutory route where Parliament allows the Settlor's creditors to look beyond the legal form of the discretionary trust.
68. *Tasarruf Mevduati Sigorta Fonu v Merrill Lynch Bank and Trust Company (Cayman) Ltd & Ors* [2011] UKPC 17. See Tony Molloy QC, "The Vulnerability of Asset Protection Trusts Revocable by the Settlor: 'Equity's Tenderness for Creditors' and the Privy Council's judgment in Tasarruf Mevduati Sigorta Fonu" (2011) 17 *Trusts & Trustees* 784. See also Stephen Moverley Smith and Alexander Pelling, "Tasarruf Mevduati Sigorta Fonu (TMSF) v Merrill Lynch Bank & Trust Co (Cayman) Ltd: How the Game has Changed for Creditors" [2012] 4 PCB 143.

Best practices to avoid allegations of sham

Best practices

In any allegation of sham trust, a party alleging sham is unlikely to find a 'smoking gun', and must rely on collating sufficient inferences to make out its case. The court's difficulty is in drawing the appropriate inferences from the evidence. Even if arguably suspicious situations may, when taken discretely, admit of innocent (eg even if negligent or bad practice, not bad faith) explanations, is a collection of such situations sufficient for the party alleging sham to discharge the legal burden of proof?

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Each case is genuinely fact-sensitive. This is where the advantages of the English litigation process come to the fore. The availability of disclosure, the nature of cross-examination, and the huge experience of English judges (as serving judges, and previously, decades as counsel), can be very helpful in a proper adjudication of sham trust disputes. English judges are fully aware of commercial realities, and are equally astute to assess the evidence holistically.

In terms of commercial realities, judges are aware that sloppy trusts administration is unfortunately common, and that what may at first blush appear to be 'murky' may really be a sophisticated client legitimately structuring its affairs in complex ways.[69]

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In truth, it is common (and legitimate) for the Settlor and Trustee to liaise closely. Nor is it inherently suspicious for the Trustee to grant decisions requested by the Settlor.[70] It is also entirely proper for the Trustee to pay considerable deference to the wishes of the Settlor when exercising its discretions.[71]

In assessing the evidence holistically, the heart of the inquiry is very much whether the Trustee exercised an independent mind. Whether the Trustee occasionally disagreed with distribution requests is a factor, but is not determinative. Similarly, whether or not a Trustee has a track record of always agreeing with a Settlor's or Beneficiary's wishes is not determinative. Such conduct may yet be consistent with the Trustee having an independent mind.

The fact that the court may be urged to make adverse inferences means that it is all the more incumbent on lawyers to ensure that best practices are followed. A well-administered trust avoids giving a party alleging sham an opportunity to seek to draw inferences from a Trustee's careless conduct.

The key is to make transparently clear that (i) the Settlor and the Trustee are honest, and *seen to be* honest, and (ii) the Trustee is independent, and *seen to be* independent. In practice, while careless administration should not lead to a finding of sham, reducing its incidence by following best practices can significantly reduce litigation risk.

In our experience, the Settlor should adopt the following best practices to guard against unfair allegations of sham:

- Record the reasons why the trust is being set up. If particular tax reasons were influential, record these

69. In *R v Allen* [2000] QB 744, the Court of Appeal affirmed that there was nothing sinister in a 'Red Cross' trust. There was nothing unusual in a power to include an unlimited class of Beneficiaries, and that the trust assets included bearer shares was not indicative of sham. In *Hill v Spread Trustee Co Ltd* (n 37), the High Court also held that Settlor's intention to retain 'influence, perhaps even a decisive influence, on the administrative decisions' did not render the trust a sham.' We have also previously mentioned Mr Justice Neuberger's (as he then was) dicta in *National Westminster Bank Plc v Jones* as to how artificial transactions are not treated by the courts as *inherently* suspicious, although it may nonetheless constitute relevant evidence to be assessed holistically.

70. *Charman v Charman* [2006] 2 FLR 422 (CA).

71. Le Poidevin (n 1) para 8.14.

with legal and tax advisors. These should be contemporaneous and show the genesis and development of the Settlor's ideas.
- Internally document why a particular Trustee candidate was chosen. The selection process must avoid enquiries that may be later mischaracterized as gauging the Trustee candidate's attitude to requests from the Settlor (ie to choose compliant candidates).
- Record all communications between the Settlor, his lawyers, and any external lawyers regarding the drafting and revision of the Trust Deed.
- Ensure that the letter of wishes is consistent with the terms of the trust.

In addition, in choosing the law governing the Trust Deed and the location of the trust assets, the Settlor should be aware of the risk that a party alleging sham may seek to draw adverse inferences in certain circumstances. For example, where alternative jurisdictions would meet the Settlor's objectives (such as a low tax base), but the Settlor choses a jurisdiction with 'asset protection' legislation, a party alleging sham may seek to draw adverse inferences as to the Settlor's intentions.[72]

The Trustee should also adopt the following best practices:

- Keep a meticulous record of all documentation relating to the trust. In particular, preserve minutes and correspondence that demonstrate careful consideration of distribution decisions. If legal advice was taken, it should be recorded.
- Do not refer to the Settlor as the 'client' or 'customer'. Once the trust is operational, the Trustee owes no duties to the Settlor.
- If requested to make a distribution, ensure that sufficient information is provided by (or reasonable enquiries made with) the relevant stakeholders so that independent judgment can and is exercised. The Trustee must also ensure that it has sufficient time to deliberate any decisions.
- If there is a change of Trustee, both the retiring and new Trustees should ensure that all relevant records are preserved and kept. Records must not be 'lost in transition'.
- Never stage 'dummy' decisions where the Settlor's requests are deliberately rejected. If lawyers or advisors suggest this, this should be firmly rejected.

Never stage 'dummy' decisions where the Settlor's requests are deliberately rejected

Care must be taken to avoid giving any impression (such as through the use of loose language) that the Settlor retains control over the trust assets, or that the Trustee is prone to do what the Settlor says. In terms of record-keeping, the Settlor and the Trustee are well-advised to preserve all relevant records as simply and accurately as possible. The key is candour—for example, if the Trustee consulted the Settlor and/or the Beneficiaries at any point, this should be recorded. Without more, there is nothing suspicious that these parties contributed their views.

The letter of wishes

We also draw special attention to the letter of wishes, and the importance of properly explaining its role to the client. If the client's real intention is that the letter of wishes must be precisely followed—and the language used is accordingly mandatory—then there is a grave risk that the Trust Deed is overridden and a sham to that extent.[73]

We also agree with Paul Matthews that a letter of wishes should not have prior recitations, only to conclude with language along the lines of 'It is my wish that in my lifetime you have regard to my wishes.'[74] This only serves to invite the suspicion that the discretions conferred on the Trustee are a sham, and the real trust intended is a bare trust for the Settlor.

72. Matthews (n 15) 191, 199.
73. Paul Matthews, "The Black Hole Trust - Uses, Abuses and Possible Reforms: Part 1" [2002] 1 PCB, 42, 50–51.
74. ibid.

Particular aspects of the sham trusts doctrine

A sham trust can become genuine

We previously explained the general rule that a sham trust can become genuine by the appointment of an honest Trustee. There is a difficulty with this rule, but we believe that this difficulty is not insurmountable.

The difficulty is how to explain the *creation of a trust for the first time* by the later appointment of an honest Trustee, given that the Settlor never had an intention to create the trust. The core objection here is that upon the application of the sham trusts doctrine to create a trust for the first time, the law creates an express trust in circumstances where the Settlor incontrovertibly had a positive intention for there 'not' to be a trust according to the Trust Deed. In other words, there is notice of what the Settlor positively does 'not' want, and yet the law finds exactly the opposite legal effect, in the name of a legal device designed to further the Settlor's agency.

Le Poidevin seeks to avoid this difficulty by suggesting an explanation consistent with the trust as a facilitative device that gives the Settlor's intentions primacy. He suggests that the solution is to examine whether the power to change Trustees:

> is as much a sham as the rest of it. If it is, then the appointment of new trustees may have to be disregarded. But if not . . . the arrangement may perhaps be treated as equivalent to a Quistclose trust, i.e. a trust for the settlor but coupled with a power in the appointor to apply the assets on the terms of the trust instrument by appointing new trustees.[75]

However, with the greatest respect, this explanation is not entirely convincing. In a typical sham trusts situation, it is difficult to see how the Settlor dishonestly intended to convey a false impression to the world, yet honestly intended a genuine power to change Trustees. Further, this would entail serious evidential difficulties for a party alleging sham, with the attendant legal uncertainty for the status of the trust, and potentially wide knock-on effects on proprietary rights and commercial arrangements.

In addition, Le Poidevin's explanation is not in line with that of the High Court. According to Mr Justice Munby,

> even if the earlier trustee was party to a sham, a new trustee cannot become an unknowing party to the sham. Once the new trustee becomes legal owner of the trust property, provided he exercises his powers and fulfils his duties in accordance with the terms of the trust instrument, the trust cannot be regarded as a sham, no matter what may have passed before.[76]

Nowhere does Mr Justice Munby suggest that the legal effect turned on an assessment of the power to change the Trustee.

We suggest that the better explanation is to recognize that the law balances (i) frustrating the Settlor's intentions against (ii) rightfully protecting the honest Trustee and ensuring legal certainty in dispositions of property (and, as mentioned earlier, with potentially wide knock-on effects on proprietary rights and commercial arrangements). The law is betwixt the devil and the deep blue sea, and it chooses to aid the righteous, even if this is at the expense of straining the fabric of the law of trusts. In aiding the righteous, the law looks to the guiding principle that a trust operates on the conscience of the legal owner and requires the Trustee to carry out the purposes for which the property was vested in him.[77]

So the explanation goes like this. At the sham's inception, despite the objective presence of the three certainties, the court *declines* to give the trust declaration its usual effect in law on the basis that the Trustee's conscience is not impressed with a duty of loyalty to the Beneficiaries. The court declines to resort to equitable maxims to find a valid trust because the presumption that the parties intend their arrangements to be effective

75. Le Poidevin (n 1) para 8.23.
76. *A v A* (n 29) [47] (Munby J).
77. *Westdeutsche Landesbank Girozentrale v Islington LBC* (n 30).

is rebutted. Instead, the court recognizes the factual reality that the Trustee, by his conspiracy with the Settlor, rejects the assumption of fiduciary duties.

However, upon the entry of a subsequent honest Trustee, the court allows the trust declaration to have its usual effect in law and the trust is constituted for the first time. The three certainties are objectively present, and the honest Trustee voluntarily assumes office with his conscience impressed with a duty of loyalty to the Beneficiaries. This solution promotes legal certainty in the validity of trusts, prevents a shamming Settlor profiting from his own wrongdoing, and avoids innocent Trustees unwittingly being saddled with a sham trust.

The effect of a finding of sham: where do the trust assets go?

In *Carman v Yates*,[78] Mr Justice Charles held that where there was a sham trust, but underneath that was some other genuine arrangement,

> the court has to grapple with what the effect of the true arrangements are in law and equity by reference to the principles that would govern litigation between the participants in the sham as to their respective interests. This involves ascertaining their agreement and intentions and may be complicated by (i) the point that the purpose of, or motive for, the pretence or sham is to defraud creditors (and is thus tainted by illegality), and (ii) questions relating to the presumption of advancement and resulting, constructive and implied trusts.[79]

So, if a sham trust is found, the court still has to look to what the underlying arrangement is (if any), and apply general property law to determine the proprietary consequences.

In practice, this analysis is crucial to determining who owns the trust assets. This point is often obscured because the usual understanding between the shamming parties is that the Trustee will hold the property to the Settlor's order. However, practitioners must be alive to the possibility that a *different, valid, trust* exists *underneath* the sham front of the Trust Deed. Indeed, in certain circumstances, a party may wish to argue that the trust property is not held for the Settlor, but rather held for some other third party. In *A v A*,[80] the wife argued that the trust was a sham, but the difficulty was that the Settlors were the husband's father and brother. The wife was therefore forced to argue that the real underlying agreement was that the Trustee held the trust assets not for the Settlors, but for the husband.[81]

Practitioners must be alive to the possibility that a different, valid, trust *exists* underneath *the sham front of the Trust Deed*

So, if there is a finding of sham, where do the trust assets go? As explained above, there are three possibilities: the Trustee may hold the trust assets as donee (ie absolutely), bailee (ie with bare possessory rights), or trustee on some other trust. If the third possibility applies, the question then is what type of trust it is.

The automatic resulting trust explanation

As we discussed earlier, Matthew Conaglen and Paul McGrath QC have both suggested that the Trustee

78. *Carman v Yates* [2004] EWHC 3448 (Ch).
79. ibid [173].
80. *A v A* (n 29) [32] (Munby J).
81. While counsel's submission failed, we believe that this argument is in principle available. Le Poidevin agrees, stating that while authority is lacking, 'there seems nothing to stop the beneficiaries of the trust really intended from enforcing it. The only difference between their case and the ordinary case of creation of an oral trust is that the settlor has also brought into being a misleading document. It is difficult to see why that circumstance should impinge on the ability of those beneficiaries to enforce it.' Le Poidevin (n 1) para 8.31. See also ibid, para 8.07.

holds the trust assets on an automatic resulting trust.[82] However, it is not altogether clear *why* this is so.

We suppose that the explanation goes something like this[83]: (i) the Settlor transfers the trust assets to the Trustee without specifying any trusts (ie so an automatic resulting trust arises), and (ii) the parties then proceed to conspire to set up the sham and execute the Trust Deed (ie so the underlying legal relationship is unchanged as the Trust Deed is of no effect).[84]

However, we respectfully query if this is correct. At stage (i), there is an automatic resulting trust, but only because there is a gap in the ownership of the assets. By the time stage (ii) comes about, this gap is filled in. Indeed, the sham arrangement very likely means that there is *some other agreement* underneath the ostensible Trust Deed. Even if this is left unsaid, the strong inference in the circumstances is that the parties understood that the trust assets would be held to the Settlor's order. As Lewin on Trusts puts it,

> The parties will in the nature of things usually have some side intent or there would be no point in their entering into a document they mean to disregard.'[85]

This looks very much like an express trust, in which case there would be no room for an automatic resulting trust to operate.

The presumed resulting trust explanation

Could the Trustee instead hold the trust assets on a presumed resulting trust? Robert Hunter suggests that this is (or was) a popular argument,[86] while Matthew Conaglen discusses the presumption of advancement in the context of sham trusts.[87] Mr Justice Charles similarly adverts to such presumptions in his *dictum* cited earlier. However, we find this legal characterization difficult to understand.

The reason for this is that the presumed resulting trust is,

> a longstop, to be used only where the evidence is not sufficient to determine a case and all reasonable inferences have first been drawn from the surrounding circumstances.[88]

But again, a sham arrangement very likely means that there is *some other agreement* underneath the ostensible Trust Deed. Indeed, that is often the *raison d'être* of entering into a sham conspiracy in the first place. There should not be a need for presumptions to operate.

A sham arrangement very likely means that there is some other agreement *underneath the ostensible Trust Deed*

The constructive trust and express trust explanations

Could the Trustee instead hold the trust assets on a constructive trust or an express trust? Both possibilities are in principle available. We suggest that the express trust characterization is preferable. All the ingredients for an express trust are present, and to apply an express trust analysis is logical, intuitive, and promotes legal certainty. There is much explanatory force to this. Nevertheless, it is open to the court to decide on either characterization,

82. To be fair to the learned authors, this may have been on the assumption of certain facts, such as the sham being proved and no other evidence being available. However, as we argue above, even absent *direct* evidence, the court is at liberty to (and in many situations *should*) infer that the true arrangement was that Trustee would hold the assets to the Settlor's order.

83. We assume here that the Trustee is a professional trust company.

84. A variant of this may be that (i) the court is persuaded that there is a sham trust, (ii) the professional Trustee has legal title to the trust assets, but (iii) no evidence is adduced to show where the beneficial interest lies, and so (iv) the court fills in the gap in ownership by imposing an automatic resulting trust.

85. Tucker and others (n 18) para 4-021.

86. Hunter (n 14) 312, fn 11.

87. Conaglen (n 18) 176, 199.

88. James Penner, "Lord Millett's Analysis" in William Swadling (ed), *The Quistclose Trust: Critical Essays* (Hart Publishing 2004), 61.

and this may well be driven by the particular facts of the case.[89]

Conclusion

The private client sphere grows with every passing year. Wealthy and savvy clients use ever more sophisticated ways to manage their wealth. As increasing amounts of assets are placed into trusts, and as trust structures become more intricate, the sham trusts doctrine becomes an ever more popular avenue to attack trusts. The litigation stakes are very high indeed. There can be no doubt that, as the case law develops, the contours of the sham trusts doctrine will slowly emerge from the mist.

Sunil Gadhia *(Partner),* ***Konrad Rodgers*** *(Associate), and* ***Joe-han Ho*** *(Associate), Cleary Gottlieb Steen & Hamilton LLP, London, specialize in dispute resolution, including high-value litigation with international trusts aspects. E-mail: sgadhia@cgsh.com; krodgers@cgsh.com; jhho@cgsh.com*

89. If a constructive trust is imposed, there may be difficult questions regarding whether this is some variant of a remedial constructive trust, and if so, the extent to which this is or should be part of English law.