

legal update

YOUR UPDATE OF
RECENT CHANCERY &
COMMERCIAL LAW

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Leigh Sagar

Don't mention the tax

A personal injury claim brought by Mr Derek Pitt following a serious road accident was compromised on terms that included the payment of a lump sum and monthly payments. These funds were settled by his wife, who was his court-appointed receiver, following the receipt of professional advice and the approval of the Court of Protection. It was later discovered that the transfer of the funds into the settlement gave rise to a substantial inheritance tax liability, which could easily have been avoided if the terms of the trust had been different. A claim was brought against the advisers, but this claim was stayed and an application was made to the court for declarations that the settlement and the initial transfer of funds were void, or were voidable and ought to be set aside.

The claim, known as *Pitt v Holt* [2011] STC 809, has reached the Court of Appeal. There were two alternative bases for the claim: first, that Mrs Pitt, as receiver, had failed to take into consideration relevant matters (the tax effects of establishing the trust), under the principle then known as the *Hastings-Bass* rule (*Re Hastings-Bass* [1975] Ch 25); and, secondly, that she had made a mistake.

The decision on the *Hastings-Bass* rule has received much more attention from commentators, but that aspect of the case is not discussed in this article, which concentrates on simple mistake.

In *Pitt*, Lloyd LJ set out what must be established to invoke the equitable jurisdiction to set aside a voluntary transaction for mistake:

- > it must be established that there has been a mistake;
- > the mistake must have been sufficiently serious; and
- > it must have been a mistake of a relevant type.

Mistake

This is generally self-evident and involves identifying the relevant mistake that must be subjected to the other two tests.

In *Re Walton's Settlement* [1922] 2 Ch 509, a beneficiary of a settlement had a power to revoke the settlement and did so, having been advised that the trust fund would fall into her estate. The fund actually reverted to the estate of the settlor. There was a mistake because the legal effect of what was done was different from what had been intended. Similarly, in *Gibbon v Mitchell* [1990] 1 WLR 1304, a life tenant was advised that by surrendering his life interest, the capital interests of his children would be accelerated. Unfortunately, he had a protected interest and what he did brought into place a discretionary trust, again the result of a mistake about the effect of the transaction.

Other mistakes will do. In *Lady Hood of Avalon v Mackinnon* [1909] 1 Ch 476, Lady Hood had power under a settlement to appoint capital to her two daughters. She appointed half of the fund to her elder daughter and, 15 years later, having forgotten about the earlier appointment, she made further appointments to both daughters, believing she was achieving equality. She sought to set aside the later appointment to the elder daughter and succeeded. There the mistake was forgetting "the existence of a pre-existing fact" (see 482), and assuming that the fact had never happened. Similarly in the New Zealand case of *University of Canterbury v Attorney General* [1995] NZLR 78, a donor made a substantial gift of shares to a university, believing that his gift was needed to increase the amounts of

scholarships. In fact it was not due to a shortage of funds that more valuable scholarships were not being awarded, but for some other reason, and it was held that the donor's belief was a fundamental or basic mistake of fact, of such importance in the context of the transaction that it would be just to order the return of the assets.

In *Pitt*, it was found that there had been a mistake on Mrs Pitt's part, as she had been advised that there were no adverse tax consequences of the transaction.

Seriousness

Next, the mistake must have been serious enough. In *Ogilvie v Littleboy* (1897) 13 TLR 399, the donor executed a number of deeds for the purpose of devoting a large part of her fortune to charity. She later regretted doing so and sought to set aside the deeds. Her application was rejected. Lindley LJ said (at 400):

"Gifts cannot be revoked, nor can deeds of gift be set aside, simply because the donors wish they had not made them and would like to have back the property given ..."

In the absence of all circumstances of suspicion a donor can only obtain back property which he has given away by showing that he was under some mistake of so serious a character as to render it unjust on the part of the donee to retain the property given to him."

This identifies how the court views the effects of mistake on the conscience of the recipient (see Lloyd LJ in *Pitt*, at para [203]), highlighting the need to protect him in his possession and enjoyment of the property given by applying a high test of the gravity of the mistake. As the donees are volunteers, however, once it is ascertained that there was a sufficiently grave mistake, they cannot conscionably insist on their legal rights (see Millett J in *Gibbon v Mitchell* [1990] 1 WLR 1304, at 1310). In *Pitt*, the gravity test was satisfied.

Article continued >



... no mistake about its terms or effect ... but the tax consequences were unexpected



Types of mistake

The court in *Pitt* held that the mistake could be about the effect of the legal transaction (*Gibbon v Mitchell*) or about some existing fact which was basic to it (*Lady Hood*). But the court would not set aside the transaction if the mistake was only about its “consequences” rather than its effect. The consequences of the transaction generally mean its consequences for tax.

In *Wolff v Wolff* [2004] WTLR 1349, the settlors (husband and wife) executed documents, which they did not understand, for an inheritance tax saving scheme. The scheme involved granting a reversionary lease of their home, to take effect 20 years later. The settlors then discovered that, if they were still alive at that time (and they were young enough for that to be likely), they would be able to remain in their home only by paying rent, or with the consent of the beneficiaries. They applied to set aside the lease, and succeeded. It was held that they had been mistaken about the legal effect of the transaction. If they had understood the lease and had been happy to grant it but it had turned out that the transaction resulted in an imposition of tax, rather than a saving, they probably would not have succeeded in setting it aside.

In *Pitt*, the claim to set aside the trust failed on this ground. Mrs Pitt created the trust intentionally, based on the advice that she had been given. There was no mistake about its terms or effect, as a matter of trust law, but the tax consequences were unexpected. Lloyd LJ said (at para [217]), “... in principle I regard the treatment for tax purposes of a transaction, or of any person or property as a result of it, as a consequence, not an effect”.

The Court of Appeal’s decision in *Pitt* will not be the last word: the Supreme Court has given permission to appeal.

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Charles Holbech

Trusts and divorce

Trusts (and companies) are often relevant in the context of a claim for ancillary relief on divorce. This article highlights some common situations.

Sham trusts

A spouse, say H, may have settled assets of substantial value, perhaps on discretionary trusts of which H and other members of his family are beneficiaries. On an ancillary relief application, W may contend that the trust is a “sham” and that, in reality, the trust assets belong beneficially to H.

The classic definition of a sham is that of Diplock LJ in *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786, at 802:

“... 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 rights and obligations (if any) which the parties intended to create”.

There would be a sham if H set up the trust, pretending to the outside world that it was a genuine trust, when in reality beneficial ownership had been retained by H. The trustees must also share H’s intention to deceive, or at least be prepared to go along with his intention, neither knowing nor caring what they agreed.

Evidence that H effectively controlled the trust or that the trustees acted on H’s instructions may give rise to an inference that the parties’ objective intentions were to create a bogus trust. However, there will be no sham if:

- > the trustees exercised their independent judgment, even if in practice they gave great weight to H’s wishes; or
- > the trustees intended at the outset to run a genuine trust, but subsequently, and in breach of trust, acted blindly on H’s instructions.

Minwalla v Minwalla (2004) 7 ITELR 457 is an example of a case where a trust was held to be a sham in the context of a matrimonial dispute. H had set up a Jersey trust, which held the shares in two companies, one of which owned the matrimonial home. The court held that H’s purpose has been to set up a screen to shield his resources from unwelcome scrutiny and investigation, partly for tax purposes, but also in order to shield his resources from matrimonial claims. His real intention had been that the assets of the trust and companies would remain his. The trustees were willing to go along with all of H’s actions and did not attempt at any stage to rein him in. H was held to be the true owner of the company shares.

Piercing the corporate veil

It may be that property is owned by a company owned and controlled by H, or by a trust which is the alter ego of H. It will be of little benefit to W to obtain a declaration that H is the true owner of the company shares, particularly where the company is incorporated off-shore. Assume that the company owns property (such as the matrimonial home) in England: W would much prefer to obtain a declaration that H is the beneficial owner of the property, and an order that H transfer (or cause to be transferred) the property to her. It will be costly and difficult to enforce an order of the English court for the transfer of shares in an off-shore company, registering the share transfer off-shore, and then taking steps to divident out the property to W or to wind up the company.

But an order for a transfer of the property, nominally owned by a company, and not by H, involves “piercing the corporate veil”. This has become considerably more difficult following the decision of Munby J in *Hashem v Shayif* [2009] 1 FLR 115. In *Hashem* W failed to establish that H



... interest under a trust as part of his financial resources ...



owned and controlled the company or that there had been “impropriety” by H. Munby J held that the court would pierce the corporate veil only if the owner or controller had personally committed some prior, independent wrong, giving rise to a liability which he was seeking to avoid by hiding behind the company structure, e.g. where he had committed a breach of covenant not to carry on a business, and then carried on that business through a company. In *Hashem* the most that could be said was that H wrongfully claimed in the divorce proceedings that the properties, owned by the company, were not owned by him, invoking the fundamental principle of company law that a one-man company is a legal entity distinct from its owner (*Salomon v Salomon* [1987] AC 22).

In *Kremen v Agrest* [2011] Fam Law 568 Mostyn J commented that it certainly came as some surprise to those who practised in ancillary relief cases to discover that a positive finding of impropriety was needed in order to pierce the corporate veil. The understanding had been for years that where the company was wholly owned by one party, or where minority shareholdings could realistically be disregarded, then a direct order could be made against the underlying asset. Mostyn J did, however, find that there was “impropriety” on the facts of *Kremen*, seemingly on the basis that H had ensured that the matrimonial home was held by an offshore company so that his ex-wife would not be able to prove that he was solvent in ancillary relief proceedings.

Trust as a financial resource

The family court may alternatively take into account H’s interest under a trust as part of his financial resources, without treating it as a sham or piercing a corporate veil. The test is: if H were to request the trustees to advance the whole (or part) of the capital of the trust to him, whether the trustees would be likely to do so (*Thomas v Thomas* [1995] 2 FLR 668), or whether H has “immediate access to the trust funds”. In *Charman v Charman* (No 2) [2007] 1 FLR 593 H was the

settlor of a Bermudian discretionary trust, of which he and others, including W, were potential beneficiaries. There was a letter of wishes by H that he wished to have the “fullest possible access” to the trust fund. Not surprisingly, the assets of the trust (worth £68 million) were held to be part of H’s resources.

Nuptial settlements

The court also has jurisdiction to make an order varying for the benefit of the parties to the marriage and the children of the family or either for any of them any ante-nuptial or post-nuptial settlement made on the parties to the marriage, and to extinguish or reduce the interest of either of the parties to the settlement (s 24(1) of the Matrimonial Causes Act 1973).

For a settlement to be nuptial there must be a connection between the settlement and the marriage. The settlement has to be upon the husband or wife, or both, in their character as spouses, and with reference to their present or future married state. A settlement may cease to be nuptial, e.g. if both spouses are irrevocably removed as beneficiaries, and cease otherwise to benefit from the trust. The trustees might also transfer the trust fund to a non-nuptial trust, if they have power to do so.

Charles Holbech specialises in all aspects of trust, property and land law, with a mix of litigious and advisory work and associated professional negligence claims. He has extensive experience in trust drafting, the use of trusts in tax planning and matters relating to trust administration.

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Thomas Fletcher

Are we “all in this together”?

Where fiduciary duties are owed by an insolvent party and its directors, when will the beneficiary of those duties enjoy proprietary rights and so come ahead of other creditors? In *Sinclair Investments (UK) Ltd v Versailles Trade Finance Ltd* [2011] EWCA Civ 347, the Court of Appeal was asked to consider two particular situations: first, where a fiduciary makes an unauthorised profit by breaching his duties and, secondly, where there has been inextricable mixing of a fund including trust moneys. In its judgment, the court took a robust approach both to the authorities and, in consequence, to the defaulting fiduciary.

The facts

The business of the Versailles Group was conducted through Versailles Trade Finance Ltd (VTFL). VTFL’s holding company, VGP, was effectively owned by one of its directors, Mr Cushnie. Finance was obtained from two sources:

- > Investors, who paid money to an investment company (TPL) controlled by Cushnie and an associate; and
- > Loans from two banks.

The Group’s business should have been to provide transaction-based finance, a form of factoring. Since it was a fraudulent scam, however, the sums advanced were instead used in various illegitimate ways. One of the effects was to inflate VTFL’s turnover artificially so as to boost share prices. Cushnie took advantage of this in late 1999 to sell part of his shares in VGP for £28.69 million, almost £10 million of which was applied towards buying a property in Kensington.

Article continued >



...when will the beneficiary of ...
duties enjoy proprietary rights ...?



The scam unravelled in early 2000. The banks appointed joint administrative receivers over VGP and VTFL. TPL was ordered to be wound up and its claims were ultimately assigned to Sinclair. The traders were left owed £22.6 million and the banks some £70.5 million.

The proprietary claims

The contest was between Sinclair (asserting claims assigned from TPL) on the one hand and VTFL and the banks on the other. Sinclair asserted two proprietary claims. The first was to the proceeds of sale of the Kensington property, which had been sold under a settlement agreement between the administrative receivers and Cushnie, the proceeds being held by the administrative receivers. The second was to distributions made by the administrative receivers from VTFL's funds to the banks, much of which had derived from TPL's money entrusted to VTFL under a management agreement.

Two arguments were advanced both at first instance and before the Court of Appeal, both designed to put Sinclair ahead of unsecured creditors:

- > As to the proceeds of sale, Cushnie had breached his fiduciary duties to TPL by misusing the traders' funds and had made an unauthorised gain (the share proceeds). Although that gain did not comprise the trader's funds, there was a proprietary right on the basis that there was a close causal connection between the misuse and the unauthorised gain. TPL, and hence Sinclair, could therefore claim in equity the traceable proceeds of the gain.
- > As to the distributions, VTFL had breached its fiduciary duties to TPL by mixing traders' funds with the Group's own funds. TPL, and hence Sinclair, was entitled to the remainder of that mixed fund, which could be traced into the hands of the banks.

At first instance ([2010] EWHC 1614 (Ch)), Lewison J, *inter alia*, held:

- > The first argument failed. Sinclair enjoyed a mere personal claim.
- > The second argument succeeded in part. Sinclair had a proprietary claim over the remainder of the mixed fund, albeit limited to the time when the banks (and VTFL) first had notice of that claim.

The Court of Appeal's decision

The leading judgment was given by Lord Neuberger MR.

The proceeds of sale

Lord Neuberger MR's judgment turned on the debate whether bribes or secret commissions to agents or employees are beneficially owned by their principals or employers and the long-standing conflict on that point between the Court of Appeal's decision in *Lister & Co v Stubbs* (1890) LR 45 Ch D 1 and the Privy Council's judgment in *A-G for Hong Kong v Reid* [1994] 1 AC 324. Faced with that choice, Lord Neuberger MR preferred *Lister* for a number of reasons:

- > There was not the necessary body of domestic authority demonstrating that *Lister* was unreliable;
- > *Reid* was inconsistent with the neglected decision of the House of Lords in *Tyrrell v Bank of London* (1862) 10 H L Cas 26;
- > *Lister* considered the potentially unfair consequences to other creditors; and
- > There was a real case for saying *Reid* was unsound on the basis that a bribe paid to a fiduciary "could not possibly be said to be an asset which the fiduciary was under a duty to take for the beneficiary".

The cross-appeal was therefore dismissed and Lewison J's judgment was upheld.

The distributions

A cross-appeal as to the distributions was also dismissed, so that Sinclair was able to assert a proprietary right in respect of certain of them. The defendants had argued, basing themselves on the principle of *Taylor v Plumer*, that any proprietary claim to the mixed fund was defeated because the traders' funds had been inextricably mixed with the Group's own funds.

Lord Neuberger MR rejected this argument on the basis that the onus of distinguishing funds held on trust from the fiduciary's own funds lay on the defaulting fiduciary. To the extent that the joint receivers could not so distinguish VTFL's own funds, Sinclair enjoyed a proprietary interest in the mixed fund. On the facts, however, Sinclair was limited in the extent to which it could trace that fund into the banks' hands: it could do so only from the date at which the banks had notice of the proprietary claim.

The outcome

Sinclair is a welcome decision in clarifying the position on proprietary rights, particularly in an insolvency context. There remains the possibility, as counsel for Sinclair submitted, that the Supreme Court may take a different view on the vexed question of *Lister* and *Reid*. At least for the moment, however, there is some certainty about the circumstances in which a creditor may be saved from the lot of other victims of scams run by the likes of Versailles.

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