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SHAM TRUSTS AND HOW TO EXPOSE THEM

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Trusts offer a number of advantages in the estate-planning context, from deferring taxes, to sheltering assets from creditors. However, if not properly constituted or carried out, a trust may be deemed void, and the intended advantages lost.

In order to create a valid *inter vivos* trust, there must be three certainties: a certainty of intention, a certainty of subject matter, and a certainty of objects. In other words, the person setting up the trust (the settlor) must intend to divest ownership of certain assets. As such, once the settlor transfers his or her assets to the trust, the assets are held for the benefit of the beneficiaries in accordance with the terms of the trust and will be controlled by the appointed trustee(s).

Sham Trusts

In a recent bankruptcy decision of *McGoey (Re)*¹, The Honourable Justice Penny nicely synthesizes the law on sham trusts. In considering the question, His Honour highlights three core points, being that (1) a trust is a sham if presented as something different than what the parties know it to be, (2) a finding of invalidity hinges on intention at the time the trust was created, and (3) the issue must be addressed considering all of the circumstances.

With respect to points (1) and (2) above, Justice Penny states:

[19] A sham is a transaction or instrument designed to give the appearance of creating legal rights or obligations that are different from what the party actually intended to create. In the context of a trust, a sham trust is usually created for a fraudulent, deceitful or illegal purpose, such as avoiding a creditor. However, deceit is a not a necessary element of a sham trust. The

trust need only be presented by the parties as being different from what they know it to be ...

[20] Whether a trust is invalid as the result of a sham depends on the intention that existed at the time that the alleged trust was made. Where the settlor did not in fact intend to part with the beneficial interest in trust property, but executed documents to that apparent effect, the trust is a sham. Absent clear and cogent evidence of an intention to create a valid trust, a trust may be set aside as a sham ...

[21] Where a purported trust does not represent the settlor's true intent (which is simply to create the appearance of a disposition of assets) there is no true intention to create a trust and one of the three certainties (certainty of intention) is missing. As a result, the purported trust is void ...

With respect to consideration of surrounding circumstances raised in point (3) above, Justice Penny reviews a non-exhaustive list of red flags ("badges of fraud") the common law has developed. These include:

[22] ...

(a) listing a trust property for sale without disclosing the existence of the trust;

(b) failing to notify a bank or mortgagee as to the existence of the trust and its effect on title;

(c) operating in a manner which disregards the proper operation of the trust;

(d) treating the property as one's own and only invoking the alleged trust when convenient to do so;

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- (e) using a property to secure financing (particularly where the trust is not disclosed);
- (f) the payment of all expenses for property by the settlor, while the alleged beneficiaries contribute nothing;
- (g) retaining personal control of an asset for one's own use;
- (h) encumbering an asset by using it as security for personal finances;
- (i) not registering a trust agreement on title; and
- (j) a general lack of documentation,

... It is also well established that another red flag is transactions at less than market value, made in the face of a hazardous undertaking or clear financial jeopardy. Such transactions are also suspect and cry out for a valid explanation.

Another indicator of fraud, such as a forged signature, would invalidate a trust. As such, in litigation it is not uncommon to engage handwriting experts to attest to the authenticity of a signature. Similarly, an inaccurate date of settlement may call the validity of a trust into question. In *McGoey (Re)*, this latter issue was before the Court, which aided in exposing the trusts as shams.


The Sham Exposed

Upon Mr. McGoey's assignment into bankruptcy, the trustee in bankruptcy sought to realize on the assets, seeking a declaration that Mr. McGoey's interest in two properties held jointly with his wife were assets of the estate and subject to creditor claims. Mr. McGoey and his wife argued that they held title to the properties in trust for their children and, thus, outside the reach of creditors. They asserted that the trust documentation was executed in 1995 for one property and in 2004 for the other.

Upon examination by a typography expert, it was revealed that the dates of execution of the documents were not accurate, as neither Cambria (the typeface on the 1995 document), nor Calibri (the typeface on the 2004 document), were available for use by the general public until 2007. The Court accepted the expert's evidence. However, the issue was not fully

resolved, since Mr. McGoey's financial predicament was not apparent until 2010. He and his wife may have lawfully created trusts for their children between 2007 and 2010.

Accordingly, the Judge turned his scrutiny to the other circumstances of the case. Several "badges of fraud" were found and are cited in the decision. Most notable was the fact that nothing distinguished the McGoey's use of the properties from that of an owner - they used the properties as they desired, encumbered them when they wanted and described themselves as the owners in legal papers. Accordingly, the Court concluded that the trusts were shams.

Although both the expert testimony and the surrounding circumstances contributed to the Court's ruling, it seems the evidence of the typography expert would have been definitive on the question had the factual timeline been different. With technological advances and, along with it anticipated ongoing creation of new fonts, we can expect to see increased use of such expert testimony in estates and trusts litigation. 

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