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# Let's chat

Sham arrangements – September 2022

With:

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*Information provided is general in nature; precise application depends on specific circumstances*



# The characters

- Prudence – the deceased
- Scott – the son
- Donna and Marla – the daughters not on great terms with Prudence
- Lotus Trust – a trust receiving the entirety of Prudence's estate
- Zalerina Pty Ltd – the trustee company of the Lotus Trust at the time of Prudence's death
- Orion Pty Ltd – a company that Prudence lent a significant amount to (which owns a commercial premise)
- Zeralda Pty Ltd – the trustee company of the Lotus Trust after a change of trustee post Prudence's death



# The history

- 2017/10/12 – Prudence met with lawyers and accountants to discuss her estate planning intentions
- 2017/11/29 – Prudence met with her lawyer to discuss her Will and ‘Secured Debt’ documents
  - Documents were signed
  - Secured Debt documents were signed but undated – lawyer explained *‘documents would not come into effect until dated’*
- 2018/04/18 – Prudence met lawyers to finalise work and Secured Debt documents dated
- 2019/09/21 – Prudence passes away
- 2020/01/29 – Probate for Prudence’s Will granted to Scott
- 2021/04/27 – Donna files an application seeking to remove Scott as executor of Prudence’s estate
  - Orders subsequently made for Scott to be removed as executor



# The Will

- Scott appointed as executor and trustee
- Shares in Zalerina gifted to Scott
- Balance of estate gifted to Lotus Trust
- Estate (approximately \$3million) comprised:
  - Shares in Orion
  - Loan to Orion
  - PPR
- NB: Donna and Marla to receive nothing



# Removal of Scott as executor

- Scott appointed as executor and trustee of Prudence
- Scott controlled Lotus Trust
- Argument that:
  - Scott had a clear interest in defending Secured Debt documents between Prudence and Lotus Trust
  - Question as to whether Scott would prefer own interests to the due administration of estate
  - Question whether Scott did not intend to any issue as to the enforceability of the Secured Debt document
  - Evidence of recorded conversation between Scott and Marla in which Scott displayed deep-seated animosity towards Donna and an intention to access estate's funds to fight any claim knowing that Donna would need to fund any legal fees herself



# Secured Debt arrangement

- 1) Statutory declaration whereby Prudence gifted an amount to Lotus Trust
- 2) Signing of a Bearer Promissory Note containing three parts:
  - A promise by Prudence to pay the bearer of the note the sum of \$3 million
  - A receipt given by Zalerina as trustee of the Lotus Trust recording it as having received the promissory note from Prudence as a gift
  - A further receipt given by Prudence recording her as having received the promissory note back from Zalerina as a loan and the note having been cancelled by her because of the merger of the right to be paid and the obligation to pay
- 3) Resolution by Zalerina as trustee of the Lotus Trust of Bearer Promissory Note and to execute a Loan Agreement and Mortgage document

# Secured Debt arrangement (cont)



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- 4) Loan agreement between Prudence and the Lotus Trust where by Prudence was loaned \$3million with security provided over the PPR and shares in Orion
- 5) Security deed signed by Prudence as grantor and the Lotus trust as secured party
- 6) Deed of assignment between Prudence and Lotus Trust where Prudence assigns the debt (\$877K) owed by Orion to Prudence, to the Lotus Trust
- It's a gift and loan back arrangement



# The Lotus Trust

- Scott was the principal of the Lotus Trust at the time when he was removed as executor
- As a result of being removed as executor, a different person was appointed who could have the ability to appoint a director of Zalerina (by acting as legal personal representative of the estate who owns the shares in Zalerina)
- Scott, as principal, changed the trustee of the Lotus Trust to Zerelda



# Attempted enforcement of Secured Debt arrangement



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- 2021/08/20 – After the change of trustee, a letter was sent from the Lotus Trust to the Administrator of Prudence's estate regarding the \$3million debt owed by the estate to Lotus Trust
- 2021/11/23 – Further letter for the written demand of repayment was sent
- 2021/12/03 – Letter sent stating that Lotus Trust had taken possession of the PPR pursuant to the terms of the mortgage
- 2022/01/27 – Lotus Trust commenced proceedings regarding the outstanding debt
- NB There was an outstanding case on whether the Secured Debt arrangement was enforceable on foot (position explained over following slides)



# Administrator position

- The sole purpose of the arrangement was to strip the estate of assets by permitting the Lotus Trust, at its discretion, to enforce the arrangement and to thereby preclude any successful application for family provision being brought by Donna and Marla.
- Scott had evinced an intention to effect Prudence's intentions as to her estate and the purpose of the arrangement, that being to preclude any successful application for family provision being brought by Donna and Marla.
- If Prudence entered into the arrangement for the purpose of stripping the estate of assets so as to preclude any successful application for family provision being brought by Donna and Marla then she would not have acted in good faith.
- If Scott sought to implement and give effect to the arrangement for that same purpose then he would not have acted in good faith.
- If the arrangement was entered into for that same purpose they would be void as contrary to the public policy underpinning Part IV of the Succession Act



# Scott's position

- Administrator's challenge to the enforceability of the arrangement was 'frivolous and vexatious and an abuse of the process' of the Court
- A positive allegation that from about October 2017 to her death, Prudence held the intention that her estate should pass to the Lotus Trust for the benefit of Scott and her grandchildren and the passing of her estate was done in a manner that was not capable of being challenged under the family provision application
- It was open to Prudence to give effect to her intention, but to do a transfer of assets would result in adverse tax and stamp duty.
- Prudence made her Will and entered into the arrangement so not to expose herself to any capital gains tax liability or stamp duty. This was her 'commercial purpose' for entering into the arrangement.



# Additional claims

- Donna argued the arrangement was a sham in circumstances where Prudence, and through the Lotus Trust, had no intention to give effect of the documents recording the arrangement.
- Marla adopted a similar position to Donna



# Additional claims from Scott

- With less than a week for the application being heard, Scott filed the following additional points for the first time:
  - The documents recording the arrangement were signed by Prudence on 29 November 2017, the same date as she executed her will, but were not dated or delivered on the date they were signed
  - Prudence's will and the documents recording the Transactions comprised the structure adopted to give effect to her intention
  - The documents recording the Transactions were kept in their signed but undated form by Cleary Hoare pending, among other things, Zalerina being appointed trustee of the Lotus Trust and the receipt of instructions from Prudence and Zalerina to date and deliver those documents
  - Prudence, in her personal capacity and in her capacity as sole director of Zalerina, gave instructions to date and deliver the documents on 18 April 2018
  - Pursuant to those instructions, Mr Hart dated and delivered the documents recording the Transactions, or caused those documents to be dated or delivered.



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# The core issue

- Was the secured debt arrangement (i.e. the gift and loan back arrangement) enforceable?



# Answer

- No
- This was due to the promissory note not being 'delivered' from the Lotus Trust to Prudence, and therefore the arrangement was not effected
  - Delivery under the Bills of Exchange Act 1909 requires the transfer of possession, actual or constructive, from one person to another
  - Recall the documents were signed in 2017 but only dated in 2018
  - Prudence did not hold the documents at the time of dating, the documents were held by her solicitor's
  - Prudence's solicitor believed Prudence's verbal understanding constituted delivery



# Other comments

- Court believes Administrator would succeed arguing invalidity as the enforcement of the arrangement would be contrary to public policy
- Noted:
  - This was not a case of Prudence having divested herself of all her assets before she died.
  - Based on evidence of solicitor, Court would not accept the arrangement involved a bona fide inter vivos gift of Prudence's assets.
  - Prudence had no intention of disposing of her property during her lifetime.
  - The documents which recorded the arrangement were executed contemporaneously with Prudence's Will and were only ever intended by her to take effect upon her death.
  - Prudence never intended that the Lotus Trust, which she controlled, would call on the promissory note or attempt to enforce the loan while she was alive. If that occurred, she would have been placed in the position of having to sell her assets to meet her obligations and she never intended to do so.
  - Evidence given by the accountant was also consistent with the conclusion that the arrangements were not intended to take effect during Prudence's lifetime.





# Court extract

*[76] Although the context of this proceeding is different, Barwick CJ's statement is apt to describe Prudence's conduct. **She entered into an illusory transaction whereby she appeared, contrary to the reality, to have parted with her property.** That conduct amounted to dealing with her property in a testamentary fashion. **The sole purpose of that conduct was to ensure that there was so little, if anything, left in the estate upon Prudence's death** that any family provision application under section 41 of the Succession Act by Donna and Marla would have no prospect of success. In those circumstances, the effect of enforcing the Transactions would be to "defeat or circumvent" **the public policy upon which s 41 of the Succession Act is based, and would thereby "be generally regarded as injurious to the public interest"**.*

*[77] In those circumstances, I am confident that the Administrator was almost certain to have succeeded on his application on the basis that enforcement of the Transactions would be contrary to public policy.*



# Sham comments

*[80] In this case, the Transactions meet that description of a “sham”. Contrary to the terms of the promissory note, Prudence never intended to pay the sum of \$3 million to the Lotus Trust. The Lotus Trust, being under Prudence’s control, had no intention of receiving (nor seeking to enforce the payment of) the \$3 million. Consequently, the Lotus Trust never had any expectation that it would have \$3 million (or Prudence’s property representing that amount) for it to be in a position to lend that amount or those assets back to Prudence. As already noted, the Transactions were only ever intended by her to take effect upon her death.*



# Takeaway points

- Gift and loan back arrangement invalid due to a technicality regarding the use of a promissory note
  - If using promissory notes, understand how to utilise them validly
- Case now provides a question on whether gift and loan back arrangements can be voided on 'public policy' or 'sham' grounds:
  - Use to get around family provision applications in doubt unless can show there was actual intent to divest asset during deceased's lifetime
    - Cash transfer?
    - Unrelated controller of lender?
  - Use for asset protection – yet to be considered
  - Use for internal family transactions – continues to apply

# Bankruptcy Act clawback provisions



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- Section 120(1) - A transfer of property by a person who later becomes a bankrupt (the transferor ) to another person (the transferee ) is void against the trustee in the transferor's bankruptcy if:
  - the transfer took place in the period beginning 5 years before the commencement of the bankruptcy and ending on the date of the bankruptcy; and
  - the transferee gave no consideration for the transfer or gave consideration of less value than the market value of the property.
- Section 120(3) - Despite subsection (1), a transfer is not void against the trustee if:
  - in the case of a transfer to a related entity of the transferor:
    - the transfer took place more than 4 years before the commencement of the bankruptcy; and
    - the transferee proves that, at the time of the transfer, the transferor was solvent; or
  - in any other case:
    - the transfer took place more than 2 years before the commencement of the bankruptcy; and
    - the transferee proves that, at the time of the transfer, the transferor was solvent.

# Bankruptcy Act clawback provisions



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- Section 121 - A transfer of property by a person who later becomes a bankrupt (the transferor ) to another person (the transferee ) is void against the trustee in the transferor's bankruptcy if:
  - the property would probably have become part of the transferor's estate or would probably have been available to creditors if the property had not been transferred; and
  - the transferor's main purpose in making the transfer was:
    - to prevent the transferred property from becoming divisible among the transferor's creditors; or
    - to hinder or delay the process of making property available for division among the transferor's creditors.
- Note:
  - The transferor's main purpose in making the transfer is taken to be the purpose described above if it can reasonably be inferred from all the circumstances that, at the time of the transfer, the transferor was, or was about to become, insolvent.
  - Transfers made for market value consideration and where the transferee could not have inferred the transferor's main purpose was the above or that the transferee would become insolvent, are not voided



# Statute barred debt

- Six-year limitation period applicable to debt – Limitation of Actions Act 1974 (Qld)
  - Actions cannot be brought after expiration of 6 years from the date on which the cause of action arose
- Where a right of action has accrued to recover a debt, and the person liable or accountable acknowledges the claim or makes a payment in respect, the right shall be deemed to have accrued on and not before the date of the acknowledgement or the last payment (section 35(3))
- Gift and loan backs – made without interest payable, so need to have written acknowledgement if not making a token repayment to acknowledge the debt



# Statute barred debt

- Chianti Pty Ltd v Leume Pty Ltd (2007) 35 WAR 488 at 514 [76], Buss JA (with whom Martin CJ and Pullin JA agreed) summarised the present state of the law as follows (regarding use of financial statements as written acknowledgement):

*“Numerous authorities have considered, in the context of acknowledgments of debt for the purposes of limitation statutes, whether a corporation’s financial statements can constitute an acknowledgement of debt. The authorities establish that financial statements (including the balance sheet and the notes to the accounts) can constitute an acknowledgment of debt, and that individual creditors comprised in the aggregate sums shown in the financial statements can be identified by extrinsic evidence, where the financial statements have been received by the creditor who sues in reliance on them.”*

- Would still recommend a token loan repayment to avoid doubt.



# Sham trusts?

- Sham trusts' and ascertaining intentions to create a trust' (2018) 12 Journal of Equity, Ying Khai Liew (Senior Lecturer in Law, University of Melbourne):
  - *'a Court holds that a trust instrument executed by a settlor (S) in favour of a beneficiary (B) is null and void on the basis that the 'true' intention all along has been that S's property would be dealt with in a wholly different manner; and instead, that legal effect should be given to that 'true' intention. Typically, S would attempt such an elaborate scheme with the intention of shielding his or her property from others – the taxman, creditors, a soon-to-be ex-spouse, etc – while simultaneously attempting to retain maximum control over the property; and the pejorative phrase 'sham trust' is employed to reflect the typical deception attending S's employment of such a scheme.'*





# Sham trusts?

- 'Sham Trusts', G.T. Pagone, Trusts Symposium, Society of Trust and Estate Practitioners, Adelaide, 9 March 2012:

- *For something to be a sham what must be established therefore, is the presence of an intention that what was created was not intended to have its legal effect. The shamming intention must be that the device not be effective according to its terms and that it not have the legal effect it is designed to appear to have. In Snook v London and West Riding Investments Ltd Diplock LJ said:*

*...[sham]...means acts done or documents executed by the parties...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.*

*The application of these observations requires, therefore, an inquiry into the actual intentions of the parties.*



# Evidence of a sham

- The difficulty to prove:
  - Evidence of shammer is usually to assert the sham to be genuine
- Objective evidence to the contrary
  - Inconsistent economic, business or financial outcome achieved
- Subjective intentions?



# Raftland Pty Ltd v ATO

- Concerned the finding of a trustee resolution to distribute money (in the millions) to another trust (holding \$4million losses) was a sham despite:
  - Parties needed resolution to have legal effect if ultimate taxation consequences were to be achieved; and
  - Parties took steps to secure control of beneficiary trust after the resolution (required to avoid commercial consequence if resolution did have the legal effect)
- Found a sham as the loss trust's family only were intended to receive \$250,000 for the 'acquisition' by the profit trust family of the loss making trust



# Proper documentation?

- If intentions can displace documentation, what's the point?
- Documents as a starting point
- Intentions are proper, documentation provides legal basis to defend
- Provides certainty to which parties agree
- Each party separately represented
- Even in the employment law space (recent cases of *Personal Contracting and Jamsek*), contract is king **unless a sham can be proved**

# Contact details

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