

When is a trust not a trust?

Summary

The latest judgment in the long-running Pugachev litigation highlights that a settlor cannot avail themselves of the benefits of putting assets in trust whilst at the same time in reality maintaining control over the assets through extensive non-fiduciary personal powers. The High Court has ruled that Sergei Pugachev, the Russian oligarch who was a settlor, “protector” and discretionary beneficiary of five discretionary trusts worth approximately US\$95 million, was the true owner of the trust assets in question and the Court should not give effect to the trust instruments.

Birss J made this finding based on:

1. the wide scope of the powers conferred on Mr Pugachev as the protector of the trusts, which he held were “*purely personal*” in nature. Mr Pugachev was not constrained by the terms of the trust instruments to act in the best interests of the discretionary beneficiaries as a class and could instead choose to exercise those powers selfishly in his own interests. In particular, the protector’s powers included being able to add or remove other discretionary beneficiaries (so Mr Pugachev could make himself the sole beneficiary), the power to veto the trustees’ decisions and the power to appoint and remove trustees, including removing them without cause. Birss J found that as a matter of construction, the true effect of the trust deeds was to leave Mr Pugachev in control of the trusts assets;
2. if that interpretation of the deeds was wrong, such that the protector’s powers were fiduciary in nature and did have the effect of divesting Mr Pugachev of his beneficial ownership, Birss J said that the trust instruments were a sham and of no effect because Mr Pugachev’s intention “*was not to cede control of his assets to someone else, it was to hide his control of them*”. The judge found that none of the other individuals involved in setting up the trusts had an intention independent of that.

Background

Mr Pugachev had been a prominent Russian businessman and politician and a sometime ally of President Putin. Mr Pugachev has two adult sons by his estranged wife and three young children by Ms Alexandra Tolstoy, a British citizen of Russian ancestry whom he met in Moscow.

Amongst Mr Pugachev’s assets was a bank called Mezhprom. The bank collapsed following the financial crisis. The bank’s liquidators, the Russian State Corporation Deposit Insurance Agency, claim that Mr Pugachev was embezzling the bank, leading eventually to its demise and in 2013 brought claims against Mr Pugachev in Russia seeking to recover losses claimed to amount to several billion dollars.

However, Mr Pugachev was by this time living in London with Ms Tolstoy and their children. The DIA therefore commenced proceedings in London in July 2014 with the aim of enforcing judgements obtained in Russia against Mr Pugachev’s assets here. Since then, there have been a series of applications and judgments relating to Mr Pugachev’s obligations to disclose his assets and relating to his disputed ownership of assets purportedly held in trust. In total, the Court has issued more than 170 orders relating to the litigation. In breach of a Court order, Mr Pugachev, who is also a French citizen, left London in 2015 during the course of this litigation and is now resident in the South of France. He did not take part in the hearing which is the subject of the Birss J Judgment. The only defendants who were represented at the hearing were his infant children, with Ms Tolstoy acting as their litigation friend. The Court, therefore, heard no evidence from Mr Pugachev as to his intentions in settling the trusts.

In 2011, and after leaving Russia following the commencement of criminal investigations concerning his involvement in the collapse of Mezhprom Bank, Mr Pugachev settled the first of five discretionary trusts.

Each of the trusts was slightly different but the named discretionary beneficiaries included variously Mr Pugachev, his two adult sons, Ms Tolstoy and her children with Mr Pugachev. Each of the trust instruments named Mr Pugachev as the “First Protector”, to be succeeded by his eldest son Victor, who would also have the power to act as protector if Mr Pugachev was “under a disability”. The trust deeds were drafted by a New Zealand solicitor and the trustees were newly incorporated New Zealand companies.

The Claimants’ case was that the beneficial interest in the trust assets belonged to Mr Pugachev, such that the Claimants could enforce their judgments against these assets. The Claimants advanced this claim in three ways:

1. The “Illusory Trust”/ “True Effect of the Trusts” claim- the trusts were not effective in divesting Mr Pugachev of his beneficial ownership of the trust assets. A key aspect of this argument was Mr Pugachev’s extensive role as protector, in addition to being the settlor and a discretionary beneficiary.
2. The Sham claim- the trust deeds were shams, therefore of no effect and the assets were not in fact held in the terms purported to be set out in the deeds.
3. Section 423 of the Insolvency Act 1986- alternatively, if claims one and two above fail and the trusts were effective at divesting Mr Pugachev of the trust assets, then the transfers of the assets into the trusts were carried out to prejudice the interests of his creditors (including the Claimants) and ought to be set aside.

It was noted that the correct approach to the interpretation of trust deeds is that as described in *Underhill & Hayton*, namely that the meaning of relevant words is to be considered in light of the following:

- i. natural and ordinary meaning;
- ii. overall purpose of the document;
- iii. any other provisions;
- iv. facts known and assumed by the parties at the time of execution; and
- v. common sense.

Subjective evidence as to the parties’ intentions is to be ignored.

The “Illusory Trust”/ “True Effect of the Trusts” claim

The overlap between a sham claim and an “illusory trust” (later described by Birss J as the “true effect of the trusts” claim) was considered. Birss J dealt at length with the New Zealand Supreme Court’s decision in *Clayton v Clayton* (a case involving allegations of a sham and an “illusory trust”), which overturned the Court of Appeal’s decision that there was no distinction between a sham and an illusory trust. The Supreme Court held that “*..a finding that a trust deed is not a sham does not seem to us to preclude a finding that the attempt to create a trust failed and that no valid trust has come into existence. That would lead to a finding that the trust is illusory..*”. Indeed, the Supreme Court observed that there were alternative lines of analysis concerning a trust’s validity given the extensive powers (in that case) held by the settlor.

Against that backdrop, Birss J said that the Supreme Court decision establishes that when considering the extent of powers a person has as a result of a trust deed, it is entitled to construe the powers and duties as a whole, in order to work out what is going on as a matter of substance. A finding that a settlor has retained the powers of ownership is not the same thing as a finding of a sham. Rather, “*the analysis is concerned with what the effect of the deed truly is. It is not concerned with the subjective intention of the parties to create a pretence to mislead*”.

Birss J considered Mr Pugachev’s extensive powers as protector and distinguished between “fiduciary” powers, i.e. those that must be exercised in the interests of the beneficiaries as a whole, and those that were “purely personal”, in the sense that they can be exercised in the protector’s own selfish interests. The task of determining the scope and nature of a power conferred in the deed is one of construction, and a relevant consideration will be whether the protector has other roles within the trust such as settlor, trustee and/or discretionary beneficiary. The question was for whose benefit the power had been given.

Mr Pugachev had the power to refuse consent to the trustees’ exercise any of their powers which would normally vest in a trustee and he could dismiss trustees “with or without cause”. He was irrevocably appointed as a retiring trustee’s agent to vest the trust fund in continuing or new trustees.

Birss J held that the rights conferred on Mr Pugachev could be exercised freely for his benefit. They were not constrained by consideration of the interests of the discretionary beneficiaries. In effect, the ability of the discretionary beneficiaries to receive any distribution from the trust would be in the hands of the protector. Conversely Mr Pugachev's powers would enable him to direct that the trustees treat him as the sole beneficiary if he so wished.

The true effect of the trust deeds was “*to leave Mr Pugachev in control of the trust assets*” [J455]. They did not “*divest Mr Pugachev of his beneficial ownership*” but rather allowed him to “*retain his beneficial ownership..*”.

The Sham Claim

The law on sham trusts is well established and Birss J noted that what may or may not be a sham are “*the acts or documents which purport to set up a trust*” (*Snook v London and West Riding Investments* [1967]). The parties to a trust deed must have intended subjectively to create different rights and obligations from those appearing in the trust document and they must have intended to give a false impression of those rights and obligations to third parties. There must be a common intention to sham (at the time the document is created). Given the trustees here were New Zealand companies, the necessary intentions were to be attributable to the relevant individuals controlling the trust companies.

Birss J's conclusion on the facts was that Mr Pugachev's intention was “*not to cede control of his assets to someone else, it was to hide his control of them. In other words Mr Pugachev intended to use the trusts as a pretence to mislead other people, by creating the appearance that the property did not belong to him..*”. The role of the protector was the means by which he did this. The judge found that no other individual involved in setting up the trusts had “*an intention independent of Mr Pugachev*”.

Given the finding on the “true effects of the trusts” claim (that the trusts did not divest Mr Pugachev of control), Birss J held that the trust instruments were not shams: rather they fulfilled his true intention which was not to lose control of the trust assets.

If, on the other hand, the interpretation of the “true effect of the trusts” was wrong and they did divest Mr Pugachev of his beneficial ownership, then the trust deeds would be a sham because “*the settlor intended to use them to create a false impression as to his true intentions and the trustees went along with that recklessly*”.

Section 423

Given Birss J's finding that the trust deeds were not effective at divesting Mr Pugachev of his beneficial interests, it was not necessary to consider this claim in detail. Birss J noted that the relevant principles are summarised in *JSC BTA Bank v Ablyazov* [2016] EWHC 3071. These were that it was for the Claimants to prove that Mr Pugachev's real and substantial purpose in relation to each of the trusts was to defeat creditors. That result being a by-product was not enough; purpose is not the same as result. Birss J found that in establishing the trusts, Mr Pugachev intended to create the appearance that the property did not belong to him when it really did. He intended to hide his control from persons who might make a claim against him in future.

Comment

Birss J held that “*whatever label is to be applied to this case*”, the court should not give effect to the trust instruments as that would result in the assets being regarded as outside Mr Pugachev's ultimate control when, in fact, they were not.

The decision on the “true effect of the trusts” claim paves the way for an arguably simpler way to analyse whether trust assets are available to the settlor's creditors. This is useful because it can be difficult to establish that trust documents are a sham given the requirement to establish the parties' subjective intentions.

The case is (1) *JSC Mezhdunarodniy Promyshlenniy Bank and (2) State Corporation “Deposit Insurance Agency” v Sergei Viktorovich Pugachev and others* [2017] EWHC 2426 (Ch).

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