ILLUSORY TRUSTS AND SHAM TRUSTS

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Last week the English High Court handed down a significant judgment in which it found that five discretionary trusts settled by Russian oligarch, Sergei Pugachev (also known as "Putin's banker"), were bare trusts for his benefit.

Background

Mr Pugachev was the co-founder of the Russian bank, Mezhprom Bank. In 2010 Mezhprom Bank collapsed and Mr Pugachev fled Russia for London.

The Deposit Insurance Agency was appointed as liquidator of Mezhprom Bank and has been pursuing Mr Pugachev for the last four years to recover funds for creditors. In 2016 the DIA and Mezhprom Bank obtained a significant judgment against Mr Pugachev. The proceedings before the High Court related to the enforcement of that judgment against the assets of trusts which Mr Pugachev settled.

Between 2011 and 2013 Mr Pugachev settled around $95 million worth of assets on five New Zealand based discretionary trusts. The Trust assets included two properties in London and a luxury holiday home in the Caribbean valued at c. US$40 million.

Mr Pugachev was named as both a discretionary beneficiary and the protector of each of the five trusts. As protector, he had extensive powers. These included, the right to request information from the trustee and the ability to refuse to consent to the trustees' exercise of their powers thereby allowing him to control the trustees decision making. He was also able to dismiss the trustees "with or without cause" and he had the power, on removal of the trustees, to exercise a power of attorney to ensure the transfer of the trust property to newly appointed trustees.

In the High Court proceedings the DIA and Mezhprom Bank sought an order requiring the trust assets be vested in them. Their case was put on three bases of which the first two are of particular relevance. The first basis was referred to by the Claimants as the "Illusory Trusts" claim but which Mr Justice Birss referred to as the "True Effect of the Trusts" claim. By this the Claimants argued that on a proper construction of the trusts deeds, the trusts were not effective in divesting Mr Pugachev of his beneficial ownerships of the trust assets. In support of this claim, the Claimants relied heavily on the fact that Mr Pugachev was both the settlor, a discretionary beneficiary and the protector with extensive powers of the trusts. The second basis was referred to as the "Sham" claim. The Claimants argued that the trusts, or strictly the trusts deeds, were shams and therefore the trusts had no effect.

Judgment

The High Court found in favour of the Claimants on both heads of claim finding that the five discretionary trusts were bare trusts for Mr Pugachev's benefit.

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The True Effect of the Trusts Claim

Mr Justice Birss held that Mr Pugachev's powers as a protector of the trusts were purely personal powers as opposed to fiduciary powers. By this he explained that Mr Pugachev was able to exercise his powers selfishly and in his own best interests, as opposed to exercising his powers solely for the benefit of the discretionary beneficiaries. In reaching this conclusion Mr Justice Birss placed considerable emphasis on the fact Mr Pugachev was also the settlor and one of the named discretionary beneficiaries. It was noted in the judgment that had the protector's powers been held by a third party a different result might have followed.

The Sham Claim

Before considering the Claimants argument that the trusts were shams, Mr Justice Birss reviewed the established case law on sham trusts. From that review he noted that, a trust is a sham if there is a common intention of all parties to the trust deed to give third parties or the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations which the parties intended to create.

Mr Justice Birss found that Mr Pugachev had at all material times regarded all the assets in the trusts as belonging to him and that he intended to retain ultimate control. He had been able to retain this control through the extensive powers reserved to him as protector. In relation to the trustees of the five trusts, as they were companies it was necessary to look at the natural persons who controlled those companies. Mr Justice Birss found that the lawyer who had sat on the board of the corporate trustees and had been involved in the preparation of the trust deeds had done nothing to indicate to Mr Pugachev that he would be relinquishing control of the assets of the trust. As an example, Mr Justice Birss stated he would have expected Mr Pugachev to have been advised that his powers as a protector were fiduciary and fettered to an extent. Mr Justice Birss concluded that the lawyer had no intention independent from Mr Pugachev.

This case is a significant ruling which arguably provides support for an additional head of claim for a creditor wishing to attack assets of a trust. Until now, a creditor's primary means of attack had been to allege a trust is a sham, which requires the claimant to show a common intention of all parties to retain control and ownership of the trust assets. Creditors may now look to the terms of the trust's constituting instrument to assess whether a settlor has effective control and ownership of the trust assets. This case is therefore a clear reminder that care must be taken when reserving powers to a settlor or carving out trustee powers to a settlor protector. Tip the balance too far and the assets of the trust may become vulnerable to arguments as to the trust's "True Effect".

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