

TRUSTS AND PROTECTORS – SHAM TRUSTS – AN UPDATE

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In the case of *Mezhprom v Pugachev [2017]*, the English High Court set aside five discretionary trusts established by a Russian oligarch. This ground-breaking case has potentially introduced the concept of an “illusory trust”, which differs in important respects from a sham trust. The case serves as a reminder to Channel Islands’ trust and fiduciary practitioners that the validity of a trust may be compromised if extensive powers are granted to a protector/settlor. Appleby Guernsey’s Dispute Resolution and Private Client & Trusts teams review this important decision and the impact in the Channel Islands.

Background and the establishment of the trusts

Following the collapse of Mezhprom Bank (**Bank**) in 2010, the Bank and its liquidators pursued Mr Pugachev (**Pugachev**), the founder of the Bank, for the misappropriation of large sums of money.

Pugachev fled Russia and between 2011 and 2013 established five irrevocable discretionary trusts governed by New Zealand law (which for all relevant purposes is the same as English law). The combined value of the trusts was estimated at USD95m and there is evidence that Pugachev took advice as to how to defend his assets from claims by Russian creditors.

Pursuant to the terms of the trusts (which were substantially the same) Pugachev and his minor children were included as beneficiaries, Pugachev was the Protector and his adult son was the successor Protector.

Extensive powers were conferred on the Protector, including consent powers in relation to the trust period, the distribution of income and capital, investment of the trust fund, the removal of beneficiaries, the variation of the trust instrument and the release and revocation of any powers conferred upon the Trustee. Additionally, the

Protector had power to direct the Trustee to sell residential property, to add beneficiaries and to appoint and remove trustees *with or without cause*.

In the event of a Protector being "*Under a Disability*", the definition of which was broad and included, importantly, being under a disability due to "*coercion by operation of law*", that Protector would automatically and immediately cease to serve as a Protector.

The claims

The claimants pursued the assets of the trusts on the grounds that they belonged to Pugachev personally. Their case was put on three alternative bases:

1. "Illusory Trust" claim, i.e. that according to the terms of the trust deeds, properly construed, the trusts were not effective to divest Pugachev of his beneficial ownership of the assets placed into them;
2. "Sham Trust" claim, i.e. that the trust instruments were shams with the effect that they had no legal effect and the assets were not held on the terms as set out in the trust instruments;
3. A claim pursuant to s.423 of the Insolvency Act 1986, i.e. that if the trusts were effective to divest Pugachev of the assets, then the transfers of the assets into trust were carried out to prejudice the interests of the creditors.

Pugachev's minor children, who potentially stood to benefit from the trusts, defended the claims.

The findings of the Court

The Court found in favour of the claimants on all three grounds. In relation to the "*Illusory*" and "*Sham*" claims, the Court determined that these were not claims in the alternative but were, in fact, interrelated.

Illusory trusts

Although cases in other jurisdictions were cited in support of the term "illusory trusts", the Court declined to adopt this term, preferring instead to refer to the "*True Effect of the Trusts*" claim.

The Court concluded that when considering what powers a person actually has as a result of a trust deed, the court is entitled to construe the powers and duties as a whole and work out what is going on as a matter of substance.

The Court determined that the powers of the Protector were purely personal, thereby enabling Pugachev to exercise them freely for his own benefit without having to consider the interests of the other beneficiaries. This led to a finding that the true effects of the deeds were to allow Pugachev to retain ownership of the assets – effectively a bare trust in favour of Pugachev. That conclusion is distinct from a finding of sham, which is concerned with the *subjective intentions of the parties* to create a pretence to mislead.

Sham trusts

The Court highlighted the following points in relation to shams:

- a finding of sham requires careful analysis of the facts, including external evidence;
- the unilateral intentions of the settlor are insufficient to establish a sham;
- a sham requires a common intention;
- reckless indifference will be taken to constitute a common intention;
- a trust which is not initially a sham cannot become one; and
- a finding of sham is serious, especially for professional trustees.

Given that Pugachev's true intention was to retain ultimate control over the assets whilst creating the appearance that they did not belong to him, his true intention was effectively fulfilled and the trusts were not shams. Pugachev was the beneficial owner and kept control of the assets via his extensive personal powers as Protector. The trusts amounted to bare trusts for Pugachev.

However, if the deeds had conferred fiduciary powers on the Protector such that Pugachev was not considered the beneficial owner, the deeds would be shams on the premise that Pugachev used them to create a false impression as to his true intentions. On the topic of common intention, the Court found that the Trustee had no independent intention and simply went along recklessly with Pugachev's intention.

Conclusion

This case serves as a reminder to trustees that careful consideration should be given to the terms of a trust, especially in the context of granting or reserving powers. In particular, trustees and/or settlors may well wish to note the following:

- Excessive retention of powers may adversely affect the validity of a trust.
- If extensive powers are to be conferred, the holder of the power should be a third party and ideally that person should be barred from being a beneficiary; alternatively, where powers are to be conferred on a person who is both protector and beneficiary, the powers should be less extensive.
- A provision enabling a protector to remove a trustee "with or without cause" is significant and, all factors considered, may negate any ideas that the power is subject to a limitation of any kind (for instance, to act in the interests of the beneficiaries as a class).
- Careful consideration should be given to the inclusion of a provision which would cause the protector's office to cease if the protector is subject to coercion by operation of law. In the Pugachev judgment this provision added weight to the argument that Pugachev's powers could be exercised for his own selfish interests; if he were compelled by a court to do something that he did not want to do, such as hand over assets to a creditor, he could truly say to the court that his powers had ceased.
- Trustees should at all times be actively engaged in administering the trust under their management and should not simply perform a role akin to that of a corporate services provider. The actions of a trustee when it knows it is being watched will not count for much; actions when no-one is looking will carry more weight.

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