Mezhprom v Pugachev

1. At this conference in November 2019 I spoke about the about the implications of the 2017 decision of Birss J. in the case of JSC Mezhdunarodny Promyshlnniy Bank (Mezhprom) v Pugachev, reported at 20 ITELR 908. In this talk I want to remind the audience what that important "trust-busting" decision was about, and why it matters.

2. I will then draw attention to the August 2020 decision in the Privy Council case of *Webb v Webb* [2020] UKPC 22, which essentially reached the same result, although without holding that the trusts in question were shams, and did so without reference to *Mezhprom*, for that reason an especially reassuring result.

3. Last I want to change subject almost completely, and draw attention to a recent decision of Fancourt J. in the case of *Byers v Samba Financial Group*, a case of some importance to parties and their lawyers bringing or defending knowing receipt claims when the trust assets in question were located in a jurisdiction which does not recognise the common law trust.

Mezhprom

4. What the case was about:

- Sergei Pugachev founded MB in 1992, and it became one of Russia's largest private banks. He is a former Russian senator and close associate of President Putin. [**Slide 2]**
- MB collapsed into insolvent liquidation in 2010. A criminal investigation against P was opened in 2011, and he fled Russia
- His life partner at the time was Alexandra Tolstoy, of that well-known family, whose grandfather had himself fled from Russia at the time of the revolution. They had 3 children together, although their relationship did not survive the difficulties in P's business life which have followed.
- In 2011 and 2013 P established 5 New Zealand law discretionary trusts, into which he predominantly settled settled some astonishingly expensive and fine real estate, including a massive house in ***[Chelsea/Battersea]*** – Old Battersea House, a chateau in France and a splendid seafront villa in the Caribbean island of St Barths for hire at $100k a week. ***[Here are some pictures – [Slides 4-7] – we could not find a picture of the villa itself, but I am told that this is what the view looks like. You get the idea. The assets in the trusts were said to be worth some $95m.]***
- P was not only the settlor, he was the Protector of the trusts, and the powers given to him as protector proved to be his downfall, and that of the purported discretionary beneficiaries
- The discretionary beneficiaries included AT, their 3 still infant children and P's 2 older sons, Victor and Alexander

- The trustees were 5 New Zealand trust companies, set up, and with the trust deeds drafted by a New Zealand solicitor, William Patterson. He was a director of the trust companies, and held to be their directing mind for the purposes of what followed.
- It is of some significance that these were NZ trusts governed by NZ law: these were creations under the law and jurisdiction of the usual off-shore systems (although it can fairly be said that many of those jurisdictions are effectively governed by English law, because of their common law roots.)

[Slide 8]

5. In 2015 the liquidators obtained a RUB 76 bn judgment against P (over US$1 billion), which they then took steps to enforce in England, obtaining a WFO and related disclosure orders along the way, resulting in disclosure of the existence of the trusts. In further developments **[Slide 8]**:

- The WFO was extended to cover the trust assets under the *Chabra* jurisdiction, on the basis that there was a good arguable case that the judgments against P could be enforced against those assets and there was a real risk of dissipation.
- Despite an order for delivery up of his passports, P left England (he had kept a French passport back)
- For that and other contempts he was sentenced to 2 years in prison by Rose J.

- In 2017 the trial of the issue as to whether the trust assets were indeed P's and amenable to enforcement by his creditors came on for trial. The parties were the Bank and its liquidators on one side, and the infant children and Ms Tolstoy as their litigation friend on the other.

The arguments [slide 9]

6. The Claimants put their case in 3 ways:

- First, that the trusts were "illusory". The Judge did not like that word. He preferred to describe the argument as concerning the "true effect of the trusts". It amounts to the same thing. The argument was that, on a proper construction of the trust deeds applying standard NZ/English law principles, P had simply failed to divest himself of his beneficial interests in the assets.

- Second, that even if as a matter of objective construction and "true effect" of the documents P had succeeded in transferring his interests into the discretionary trusts, the whole thing was a sham and designed to mislead. He had not subjectively intended to dispose of his beneficial interests, and Mr Patterson as the directing mind of the trust companies had shared that intention because he had no intention independent of P

- Third, that the transfers were to be set aside under Insolvency Act s.423 as undertaken for the purpose of defeating P's creditors.

7. The Judge's starting point was that discretionary trusts are particularly attractive for what he called "unscrupulous persons" who wish to hide their wealth and keep it out of the hands of creditors. The Judgement includes a detailed and interesting discussion about "discretionary trusts, protectors and fiduciaries". You will all be aware of what a discretionary trust is designed to achieve. What the judge has to say on the subject has been very well summarised in a 2018 article by the junior counsel in the case (Tim Akkouh and Christopher Lloyd) in the journal Trusts and Trustees:

- First, trust assets will not be held in the settlor's name. The asset can instead be vested in the name of an anonymous special purpose vehicle established to act as trustee. All the better if the trustee is a long way away: 'that just makes the job of searching a little bit harder' ([174]).
- Second, discretionary trusts have the additional feature that discretionary beneficiaries have no beneficial interest in the trust assets. This confers two advantages: if required to provide information as to *his* assets, a beneficiary will be able to decline to disclose that the trust assets or any interest in them belongs to

him ([175]); and assets held within a true discretionary trust are not amenable to execution if judgment is entered against one of a class of discretionary beneficiaries ([176]).

- But, third, there is a problem. As the Judge put it: Subject to the law on unwinding transactions to defraud creditors, if a person gives away their property to someone else then it is no longer theirs. But that is not what the unscrupulous person in the example wants to do at all. As far as they are concerned the property is theirs. The objective is not to lose control of it, the objective is to hide it and protect it from creditors.([179])
- Fourth, this is where the role of protector may come in: the settlor can grant himself wide powers as protector. He can, for instance, prevent the trustees from distributing the money to anyone but himself, and can remove recalcitrant trustees who fail to do his bidding and replace them with trustees willing to do what he wants.
- So, fifth, a discretionary trust may be seen as an effective shelter from attack. The trustee can, after the trust is established, go along with the settlor/protector's instructions, regarding him (and perhaps referring to him) as the 'client' or 'Ultimate Beneficial Owner (UBO)'. But as soon as the trust is challenged by creditors, the trust can be presented in a radically different way: the settlor/protector can be said to be subject to the full range of fiduciary obligations when exercising his powers.

- That is the Angora cat situation. Drawing on his IP background, Birss J. put it as follows:

  This, said the Judge, reminded him of the Angora cat problem encountered in patent law: when validity is challenged, the patentee says his patent is very small: the cat with its fur smoothed down, cuddly and sleepy. But when the patentee goes on the attack, the fur bristles, the cat is twice the size with teeth bared and eyes ablaze. ([438] citing from the decision of Jacob LJ in *European Central Bank v Document Security Systems* [2008] EWCA Civ 192 at paragraph 5)

8. But to return to Mr Pugachev's trust and the first way of putting the argument:
   - Under the trust deeds, Mr Pugachev as protector had very extensive powers. They included the power to:
     - Withhold consent to the trustees exercise of their powers to inverst and distribute the trusts assets
     - Withhold consent to the trustees' exercise of other powers, such as to remove beneficiaries and vary the terms of the trust
     - Appoint additional beneficiaries
     - Dismiss the trustees <u>with or without cause</u> and appoint replacements

They also provided that in the event of the Protector coming under a disability, then his protectorship would automatically end – the Protector automatically ceased to serve as such. Being under a disability included being subject to coercion, including coercion by operation of law, the idea being that would be triggered by a court order which required Mr P to do something that he did not want to, so that the trusts and trustees could at that point distance themselves from the suggestion that Mr P was in control. The Judge said about that:

… allows Mr Pugachev's effective complete control of the trusts to cease to exist the moment he is compelled to do something he does not want to do, like hand over the assets to a creditor. It is an attempt to make the trust judgment proof and should not be accepted. [275].

But the key thing in the Judge's view was not so much the existence of all these powers as the question of whether they were fiduciary or purely personal in nature. If they were truly fiduciary, so that Mr P was bound to exercise his powers in the interests of the beneficiaries as a class, that was one thing – but it was quite another if he was entitled to act entirely selfishly, solely in his own best interests – and that is how the Judge read the trust deed, focusing especially on the fact that

he could remove a trustee with or without cause, combined with his position as settlor and discretionary beneficiary.

So the Judge held that, applying the objective norms of documentary construction, the trust was illusory, because it was ineffective to alienate P's beneficial interest in the "trust" assets.

As to the "sham" case, the Judge again found that established.

Sham

The Judge dealt with this argument in accordance with standard English and NZ law principles. Whatever might be the intention and effect of the documents, objectively speaking, that did not represent either Mr P's or Mr Patterson's subjective true intentions. Mr Patterson, who gave evidence, was found to have no intention independently of the person who was telling him what to do – Mr Pugachev – and Mr Pugachev's actual intention was to retain personal control of the assets. *[Gray v Lewis]*

Insolvency Act 1986 s.423

The Judge also found, without difficulty and over a single page of a 90 page judgment, that the settlement of the assets into the trust was intended to prejudice the interests of creditors and defeat their claims, essentially by hiding Mr P's control of them and so liable to be set aside under s.423.

4 observations:

(i) The case was highly fact sensitive, as any other cases in this field will be. Much turns on the particular facts of the case. As the Judge said: If such extensive powers had been conferred on a third party as protector, with provisions barring that person from being a beneficiary, then I can see that a different result might follow but the fact it is a beneficiary on whom these powers are conferred militates against the idea of a limitation. One would expect a beneficiary ordinarily to be entitled to act in their own interests. Conversely if less extensive powers were conferred on a beneficiary/protector then again one might arrive at a different result but that is not this case.

(ii) The ◎true effect◎ analysis was unorthodox and could leave many similar structures open to scrutiny where a settlor retains some powers and control over trust assets.

(iii) The judgment also confirmed that even a professionally-administered trust could be held to be a sham where the trustee is ◎recklessly indifferent◎ to the settlor's sham intent.

(iv) The judgment may indicate changing judicial and societal attitudes to offshore structures. I do not know how the decision has been treated or applied in jurisdictions where the creation

> and defensibility of "discretionary" trusts is something approaching an industry, but one imagines a degree of alarm among the workers in that industry.

Webb v Webb

But in this case decided in August 2020 the PC reached an essentially identical result. It concerned trusts established by a husband, and the dispute arose in the context of matrimonial proceedings. One of the issues before the Privy Council was the validity of those express trusts known as the Arorangi Trust and the Webb Family Trust, though the Privy Council felt it sufficient to dispose of the issues by reference to the terms of the Arorangi Trust alone (since the points stood or fell together). The judge at first instance rejected the challenges to the Trusts. In the Court of Appeal they focussed on the question of whether, on an objective analysis of the powers reserved to Mr Webb in the trust deeds, Mr Webb had evinced an intention irrevocably to relinquish his beneficial interest in the trust property. They concluded that the deeds of trust failed to record an effective alienation since the powers retained by Mr Webb meant that any time he could have recovered and could still recover the property which he had settled on the trusts.

Lord Kitchin explained that there was no inconsistency between the finding of the first instance judge (upheld on appeal) that the trusts are

not shams, and were genuinely set up to create trusts primarily for the benefit of Mr Webb's children, and the conclusion that the attempts to create the trusts have failed or are defeasible, noting at [87] to [89] as follows (with bold emphasis added by me):

"87. Acceptance that Mr Webb intended to create trusts does not in any way preclude a finding that he reserved such broad powers to himself as settlor and beneficiary that he failed to make an effective disposition of the relevant property. Moreover, and as I have explained, the powers of clause 10 are conferred on Mr Webb as settlor, not in his capacity as Trustee or Consultant. These powers were therefore amply sufficient for Mr Webb to arrange matters in such a way that he alone would hold the trust property on trust for himself and no-one else, with the consequence that the legal and beneficial interest in all of that property would vest in him…

I will therefore confine myself to the substantive question whether Mr Webb's powers under each of the trust deeds were such that, in equity and in all of the circumstances of this case, he can be regarded as having had rights in the trust assets which were indistinguishable from ownership. In my view he plainly can. Mr Webb had the power at any time to secure the benefit of all of the trust property to himself and to do so regardless of the interests of the other beneficiaries . In my opinion, for the reasons set out at para 87 above, the Court of Appeal was plainly entitled to find as it did that the trust deeds failed to record an effective

alienation by Mr Webb of any of the trust property. The bundle of rights which he retained is indistinguishable from ownership.

On this question, the PC was unanimous, Lord Wilson dissenting in the result but on unrelated grounds. Importantly the Court included Lord Briggs and Lord Carnwath, two Judges steeped in trust law and the ways of the Chancery Division. *Mezhprom* was not cited in Lord Kitchin's judgment.

The case, although again of course turning on its own facts, certainly consolidates the "illusory" trust argument as a weapon in claimants' armoury. And now see also *Law Society v Dua* [2020] EWHC 3528 (Ch), in which both Mezhprom and Wbb are applied, although with different result.