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HIGH COURT RULES AGAINST RUSSIAN OLIGARCH IN TRUSTS CASE – THE ROLE OF THE PROTECTOR AND SHAM TRUSTS DISCUSSED

JSC Mezhdunarodniy Promyshlenniy Bank v Pugachev [2017] EWHC 2426 (Ch)

Introduction

In a judgment handed down on 11 October 2017 in *JSC Mezhdunarodniy Promyshlenniy Bank v Pugachev* [2017] EWHC 2426 (Ch), the English High Court (Birss J) found that Mr Sergei Pugachev, a Russian oligarch, retained beneficial ownership of the assets involved in five discretionary trusts constituted under the law of New Zealand worth approximately \$95 million at the time of settlement and thus the trust assets were not beyond the reach of creditors. Birss J found that if the analysis that Mr Pugachev retained sole beneficial interest in the assets were incorrect, the trusts would be considered sham trusts to which the court would not give effect.

Background

The first claimant, a bank founded by Mr Pugachev called Mezhprom Bank, went into insolvent liquidation in Russia in 2010; its liquidator is the second claimant. Together the claimants were seeking to enforce a judgment debt in excess of \$1 billion owed to them by Mr Pugachev. In 2011, Mr Pugachev fled Russia, as his relationship with the government had deteriorated. At the time, he was in a relationship with Ms Alexandra Tolstoy with whom he had two children, though over time that relationship had broken down.

Five trusts were established under the law of New Zealand concerning different real properties. The trusts established were discretionary trusts in which Mr Pugachev, Ms Tolstoy, their children and Mr Pugachev's sons from a prior relationship, Victor and Alexander, were named as discretionary beneficiaries. Although established as discretionary trusts run by trustees, the trusts had a role for a "Protector", who had the powers of vetoing actions taken by the trustees, notably distribution of income or capital of the trust funds, of rewriting the terms of the deeds, and of dismissing and replacing trustees for any reason or no reason. Mr Pugachev was named First Protector; his son Victor would be named Second Protector on his resignation or disability.

The trust instruments were drafted by one Mr Patterson, who served as trustee of the trusts. Mr Patterson was an experienced solicitor who appeared to be aware of Mr Pugachev's settlement of the trust property, of the apparent non-fiduciary character of the Protector, and of the consequences of the terms of the trust document. Furthermore, in his testimony Mr Patterson claimed he played a substantial role in the management of the trust assets.

Judgment

Birss J held that the sole beneficial ownership of the trust property was held by Mr Pugachev and thus was within the reach of his creditors.

As a preliminary matter, Birss J found the trusts had been established by Mr Pugachev as settlor. Birss J then found that the Protector was not in a fiduciary role, but rather possessed 'personal' powers, i.e., powers he could exercise selfishly. The Protector's powers to veto all major decisions a trustee might make, to appoint new Discretionary Beneficiaries, to appoint his successor, and to remove trustees without cause all leave scope for the finding that the Protector is in a fiduciary role. However, Mr Pugachev's being named a discretionary beneficiary, to whom all trust assets could be directed, was critical in finding that the Protector role of these particular trusts was not fiduciary in character. The fact that Mr Pugachev was also the settlor reinforced this conclusion. Therefore, the terms of the trusts do not divest Mr Pugachev of the beneficial ownership he had of the trusts transferred into them; in substance the deeds allow Mr Pugachev to retain his beneficial ownership of the assets.

Birss J also held that if he were wrong as to his construction of the trust instrument and the powers of the Protector, the sham doctrine would apply. A sham trust is one intended by the parties 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 (if any) which the parties actually intend to create. All parties must have a common intention that the documents create this appearance, and reckless indifference will be taken to constitute a common intention. A trust which is not initially a sham cannot become one.

Birss J then engaged in a detailed factual analysis of the creation and operation of these trusts. At all material times Mr Pugachev regarded all the assets in these trusts as belonging to him and intended to retain ultimate control. The point of the trusts was not to cede control of his assets to someone else, but rather to hide his control of them; even if the ultimate purpose of the trust was to benefit his family, it would only be on his say so. Furthermore, his intentions should be imputed to the trustee companies, as Mr Pugachev had a nominee on the board of three of the four of those companies; those nominees took his instructions at all times. Furthermore, Mr Patterson, found to be the directing mind and will of each of the trustee companies for all major decisions, did not in fact exercise an independent intention; he did not play the role he claimed he did. Birss J found, on the basis of Mr Patterson's design of the trust documents and the large role the Protector plays in the trusts, that whatever his intentions, Mr Patterson did not in fact infer that Mr Pugachev wanted to relinquish control of his assets; at best Mr Patterson was reckless as to the settlor's true intentions. Because of this, a common intention could be found, and the sham doctrine could be applied.

Concluding Remarks

This case demonstrates that a court will look to the substantive elements of a trust document concerning ultimate beneficial ownership and control to see whether the trust accomplishes what it purports to accomplish. Though cleverly designed, this trust did not create a discretionary trust based on the exercise of fiduciary duties. Rather, it maintained the firm control of the settlor to his own benefit.