



DIVORCED FROM REALITY: PUGACHEV, WEBB, AND ILLUSORY TRUSTS IN DIVORCE PROCEEDINGS

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Executive summary

Illusory trusts are (for now) a reality, even if the term itself is not widely recognised by the courts. The concept gained widespread coverage following the first instance decision of *JSC Mezhdunarodniy Promyshlenniy Bank v Pugachev* [2017] EWHC 2426 (Ch). Since then, its relevance to divorce proceedings came into sharp focus in the Cook Islands' Court of Appeal decision of *Webb v Webb* [2017] CKCA 4. *Webb* was then appealed to the Privy Council, whose judgment is eagerly awaited.

Therefore, we should shortly receive persuasive guidance from the Privy Council on the existence and scope of illusory trusts. Until then, existing case law suggests that the illusory trust concept is an attractive weapon in the armoury of applicant spouses seeking to attack trusts in financial remedy proceedings, and a growing concern for those seeking to “divorce-proof” assets using trusts.

Pugachev and illusory trusts

Pugachev concerned five New Zealand discretionary trusts settled by Sergei Pugachev between 2011 and 2013. Pugachev was also a beneficiary of the trusts (together with his family members) and the protector. As protector, he had wide-ranging powers, including the ability to veto trustee decisions.

Mezhprombank was a Russian bank formed by Pugachev that entered liquidation in 2010. Pugachev was accused of misappropriating huge sums from the bank, resulting in the bank and its liquidator obtaining judgments against him. They then sought to enforce those judgments against the trust assets through the English courts. The claimants' case included an argument that the trusts were “illusory” on the basis that the trust instruments did not divest Pugachev of beneficial ownership of the trust assets, given Pugachev's extensive protector powers and the fact that he was a beneficiary.

The judge noted that he did not find the term ‘illusory trust’ to be a helpful one. Nonetheless, he found for the claimants on the substance of this point and held that the trustees in fact held the assets on bare trusts for Pugachev rather than on the terms of the trust instruments. Therefore, the trusts provided no protection from Pugachev's creditors and their assets were available to the claimants to satisfy the judgments.

The court's determination that the protector's powers in the trust instruments were personal rather than fiduciary was crucial to its finding that Pugachev had not divested himself of beneficial ownership of the assets:

- if the powers had been fiduciary, Pugachev would have been obliged to exercise them in the interests of all beneficiaries and so may have divested himself of beneficial ownership; but
- as the powers were held to be

personal, Pugachev could exercise them for his personal benefit without considering the interests of other beneficiaries.

Webb and illusory trusts in divorce proceedings

The judgment in *Pugachev* was swiftly followed by the Cook Islands decision in *Webb*, which deals with trusts in the context of divorce proceedings.

Two trusts had been settled by the respondent spouse, Mr Webb. The applicant, Mrs Webb, argued that the trust assets should be considered matrimonial property and subject to division between the parties, because she said the trusts that purported to hold them were invalid (as they were effectively illusory trusts, although this term is not used in the judgment). Having been unsuccessful in the High Court, Mrs Webb succeeded before the Cook Islands' Court of Appeal.

The key issue in *Webb* was similar to that in *Pugachev* - whether, on an objective analysis of the settlor's reserved powers in the trust deeds, Mr Webb had demonstrated an intention irrevocably to relinquish beneficial interest in the trust assets.

The Court of Appeal tested this by reviewing the reserved powers and asking what would happen if the settlor tried to recover the property apparently settled on trust. They considered that:

- if this would: (i) require agreement from a truly independent person,

or (ii) be subject to an enforceable fiduciary duty on his part, the trust would be a valid trust; but

- if the trust instrument reserved an uncontrolled power for the settlor to recover the assets, the settlor would not have divested himself of beneficial ownership, and the trust would be invalid (i.e., effectively an illusory trust).

In the Webb trusts, Mr Webb was the settlor, trustee and a discretionary beneficiary. These roles together afforded him many powers, including an ability to:

- appoint a consultant to advise the trustee. The consultant had powers relating to investment, removing and replacing trustees, and veto powers on the acceleration of final vesting and variations to the trust deed. Mr Webb appointed himself as consultant;
- exercise his powers and discretions even if his interests or duties might conflict with his duty to the trust or any beneficiary;
- distribute capital or income to any beneficiary (including himself). He could also resetttle the trust or vary its terms (the latter with the consultant's consent, i.e., his own consent), to vest all trust property upon any beneficiary (again, including himself). Any resultant breach of fiduciary duty would be negated by the above conflicts clause;
- replace beneficiaries, including nominating himself as the sole beneficiary; and
- retain a high level of control as consultant even if he resigned as trustee. The consultant's power to remove and replace trustees was exercisable "at his absolute discretion and without giving reasons therefore". The Court determined that this power was non-fiduciary, allowed Mr Webb to dispose of uncooperative trustees, and added to "the picture of a settlor who has never intended to alienate his beneficial interest for the purpose of the law of trusts".

After considering the above, the Court of Appeal concluded that Mr Webb had not alienated his beneficial interest in the trust assets, as his powers meant he could recover the property he had purported to settle on trust at any time. The trusts were therefore deemed to

be invalid, and the Court of Appeal ordered that a leasehold interest in the matrimonial home allegedly held on trust should instead vest in Mrs Webb.

Mr Webb appealed to the Privy Council, which heard the case in January 2020 (<https://www.jcpc.uk/cases/jcpc-2019-0013.html>). Judgment is eagerly anticipated, as it should provide persuasive authority from the highest court on the existence and scope of the illusory trust principle.

Considerations

Subject to any changes following the Privy Council's judgment in Webb, determinations as to whether trusts are invalid on "illusory" grounds will be made on a case-by-case basis, based on the terms of the trust instrument in question. These are therefore important issues for applicant spouses seeking to attack trusts and those seeking to "divorce-proof" trust assets.

For applicant spouses:

1. The illusory trust principle provides another method for challenging trusts and may be easier to prove than the usual alternative of demonstrating that a trust is a "sham". The latter is notoriously difficult (and expensive) to establish, as it requires factual evidence of a joint shamming intention of the settlor and trustee. In contrast, establishing the existence of an illusory trust may be more straightforward (and cheaper), as this depends only upon an objective reading of the trust instrument.
2. Normal enforcement considerations will apply. Applicant spouses should consider the trust's governing law and the location and nature of its assets before determining whether an attack is feasible.
3. If a trust holds substantial assets and might be vulnerable to being deemed "illusory", this may provide a useful negotiating tool for applicants seeking an early and attractive settlement without the need for significant court intervention.

For those divorce-proofing assets:

1. The trust terms are crucial to determining whether a trust is vulnerable to attack. To reduce the risks, settlors should be encouraged to reduce any control that they retain over the trust

assets. In particular, they should consider:

- a. minimising the number and type of any reserved powers that they have;
 - b. particularly limiting the number and type of any personal powers that they have. Whether a power is personal or fiduciary can be a matter of interpretation, but it will be still helpful for trust instruments to state expressly where a power is intended to be fiduciary;
 - c. avoiding including any settlor powers to revoke the trust or a general power of appointment over the assets, as these powers in particular might point to invalidity; and
 - d. avoiding the settlor also serving as trustee and/or protector, particularly if they are also a beneficiary.
2. Jurisdictional considerations are key and settlors should consider carefully where to establish their trusts:
 - c. illusory trusts are less likely to be found when they are governed by the laws of jurisdictions with wide-ranging reserved powers legislation. The trusts in both Pugachev and Webb were governed by laws without such legislation; and
 - d. the existence and type of firewall legislation in overseas jurisdictions will be important to consider, although the effectiveness of such legislation may reduce if the trust assets are not located in the same jurisdiction as the governing law of the trust.
 3. Seek specialist independent advice on the nature of the trust instrument and the settlor's powers at the earliest possible stage and ensure that all decisions and arrangements are documented.