

# Illusory trusts and Trojan horses

Reserving too many powers

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# Overview

- The *Pugachev* decision
- Analysis of the *Pugachev* decision
- The *Webb v Webb* decision
- The extent to which the analysis in these decisions would be followed by the courts in international finance centres even in the absence of comprehensive reserved power legislation

# Overview

- Reserved power legislation in international financial centres
- Whether such legislative provisions would modify the analysis of Birss J in *Pugachev* or that of the Privy Council in *Webb v Webb*
- Alternative lines of attack

## The *Pugachev* decision

- English High Court decision by Birss J in *JSC Mezhdunarodniy Promyshlenniy Bank v Pugachev* [2017] EWHC 2426
- Five New Zealand discretionary trusts
- Parties agreed English and New Zealand law were the same in all material respects
- Initial trustees were independent New Zealand trust companies
- Mr Pugachev (P) was the protector and one of the beneficiaries

## The *Pugachev* decision

- Protector (P) had power to replace trustees with or without cause, the power to direct a sale of specific trust property, the power to veto certain trustee decisions and the power to veto (a) appointments to other beneficiaries (but not the power to appoint assets to himself), (b) the removal of beneficiaries, (c) variations of trust, (d) releases of trustees' powers and (e) additions of beneficiaries
- Consent powers wider than those ordinarily seen in trust instruments in IFCs since consent needed for investment decisions and income distributions

## The *Pugachev* decision

- Background to litigation: P had founded Mezhprom Bank in Russia which was liquidated after a financial crisis in 2014; liquidator sought recover, by challenging the validity of the trusts, assets worth \$95m which P had settled after fleeing Russia; liquidator argued that P effectively retained control of the trust assets via the reserved powers
- (Trusts' validity also challenged on basis that trusts were alleged to be shams and the transfer of assets to the trustees was challenged on the basis of provisions in the English Insolvency Act 1986)

## The *Pugachev* decision

- P not represented at the hearing
- Background stark. Case one of many involving P and the Russian state in various jurisdictions and in other proceedings P had been handed down a sentence of two years' imprisonment for contempt (which he had not served, being a fugitive from justice)

## The *Pugachev* decision

- Birss J held P's powers were personal non-fiduciary powers (in the sense that they could be exercised in his own selfish interests and without regard to the interests of other beneficiaries). He relied, in particular, on the fact that P was the settlor, a discretionary beneficiary and the protector of the trusts and held that the effect of P being able to exercise his powers in his own interests was 'to allow to retain complete control over the assets he had settled into the trusts'. He could prevent trust property being distributed to other beneficiaries and could ensure property was distributed to him by replacing the trustees



## The *Pugachev* decision

- Birss J concluded that 'on their own terms these trusts do not divest [P] of the beneficial interest he had of the assets transferred into them. In substance the deeds allowed [P] to retain his beneficial ownership of the assets.'

## Criticism of the *Pugachev* decision

- Decision heavily criticised prior to *Webb v Webb* decision
- Lewin, 20<sup>th</sup> edn, para 5-035: ‘In a 2017 English case, the court...held that the reservation by the settlor of powers as protector, including the power to remove and appoint trustees, which was classified as a beneficial power, meant, on the true construction of the settlement, that the settlor never divested himself of the beneficial ownership of the trust property. We consider this decision to be doubtful...’

## Criticism of the *Pugachev* decision

- The footnote which follows that passage reads: ‘The reasoning of the judge depended heavily on his categorisation of the powers of the settlor/protector all being personal powers. Even if the power to appoint or remove trustees could be properly so viewed, this would only give the settlor effective beneficial ownership if he could direct a new trustee to act contrary to the interests of the beneficiaries, something that would be inconsistent with the finding that the trustee’s powers were fiduciary...’

## Criticism of the *Pugachev* decision

- Lewin (same paragraph): ‘earlier authority having indicated that even a retention of a personal power to revoke a trust and appoint the entire property to the settlor does not prevent there being a valid trust in the meantime, taking effect in accordance with its term. We do not consider that the reservation to the settlor even of very considerable rights and powers would make the trusts illusory during the settlor’s lifetime unless the settlor was the absolute equitable owner of the trust property during his life...’

## Criticism of the *Pugachev* decision

- ...It would make difference the terms of the settlement declared that the trust property was held in trust as to capital and income for the settlor absolutely and indefeasibly and then purported to set out trusts in favour of other beneficiaries, because those trusts would be repugnant to the absolute interest retained by the settlor. But the fact that settlor reserves powers rather than an absolute beneficial interest means that the trust can and will take effect in default of exercise of the retained powers. It is clear that, if a settlor does, as a matter of construction, fail to divest himself of the beneficial interest of the trust property, it does not mean without more that [the trust is illusory]'

## Criticism of the *Pugachev* decision

- Prior to *Webb v Webb* other (but not all) commentators had suggested that *Pugachev* would be interpreted narrowly and that it would, in effect, be confined to its facts (i.e. would be unlikely to be followed or that it would readily be distinguished by courts in other cases)
- It was generally felt that the case was an extreme case – P was not even represented at the hearing

## Criticism of the *Pugachev* decision

- *Pugachev* not considered in any detail in the current edition of *Underhill and Hayton*, possibly because, by the time of its publication, the *Webb v Webb* decision had superseded it
- Some commentaries state that the reserved protector powers in *Pugachev* are conventional, but this is actually dubious and so facts the case should be capable of being distinguished in future cases

## *Webb v Webb*

- Cook Islands Privy Council decision in *Webb v Webb* [2020] UKPC 22
- Held that trusts Mr Webb (W) purported to have created invalid on the basis that ‘he reserved such broad powers to himself as settlor and beneficiary that he failed to make an effective disposition of the relevant property’ and that such powers were ‘so extensive that in equity and in of the circumstances...[W could] be regarded as having had rights in the trust assets which were indistinguishable from ownership’



## *Webb v Webb*

- *Pugachev* not referred to in the decision (although it was referred to in the lower courts in *Webb*)
- W was the sole trustee and one of the beneficiaries of the trusts and reserved to himself very significant powers. Such powers included the power to appoint a 'consultant' (which was exercised by appointing himself to such position at the outset so that he had the relevant powers but in a different capacity). His powers as a consultant included assisting the trustee with the management of the trusts and the ability, without assigning reasons, to replace the trustee

## *Webb v Webb*

- In his capacity as trustee he also had the power to exercise all his powers 'notwithstanding that his interests may conflict with his duties to the funds of the Trust or any beneficiary'
- He also had the power as settlor to nominate himself as sole beneficiary in the place of the existing beneficiaries
- He had no fiduciary duties in relation to the powers which he had as settlor which were personal powers

## *Webb v Webb*

- The Board gave two reasons why the trusts were invalid
- One was that he had never divested himself of his rights as owner of the property transferred to the trustees
- The other was that he had acquired too many new property rights once the trusts had been created for them to take effect as trusts for the beneficiaries identified in the trust documents

## *Webb v Webb* - commentary

- The decision has been criticised in the 20<sup>th</sup> edition of *Underhill and Hayton* in that the authors indicate that, although the result of the case was surely correct, the two reasons given by the Privy Council cannot both be correct – i.e. since this would presumably result in a contradiction – and, ‘moreover [that the second reason which was given] sits uncomfortably with *dicta* that that a power to appoint property is not itself ‘property’ owned by the powerholder, albeit that this rule is not an absolute rule, and that although for some purposes a power [is] not property, for other purposes the holder of a general power [can] be regarded as being for all practical purposes an owner”

## *Webb v Webb* - commentary

- The well-know Cayman Islands decision of the Privy Council in *TMSF v Merrill Lynch* [2011] UKPC 17 is then referred to in the footnote which follows
- The authors of *Underhill* go on to state that other explanations of the decision in *Webb* are more persuasive and that such other explanations might include the lack of an intention on the part of the settlor to confer the beneficial enjoyment of assets on others and that the trusts which had purportedly been created lacked the “irreducible core” which was referred to by Millett LJ in *Armitage v Nurse* [1998] Ch 241 at 253-254

## *Webb v Webb* - commentary

- The *Webb v Webb* decision post-dated the publication of the latest edition of *Lewin*, but a supplement to that edition is due to be released imminently and it remains to be seen whether the authors of that work will have revised their analysis of the law in insofar as the latter relates to illusory trusts. Clearly, given that the decision was one of the Privy Council, and not simply a first instance decision, it is quite possible that they will do so, but quite to what extent remains to be seen

## *Webb v Webb* - commentary

- Although the analysis of illusory trusts by Birss J in *Pugachev* was fairly similar to that of Lord Kitchin in *Webb v Webb*, it was not identical since, in the former case, the analysis was dependent upon the relevant powers being such that the settlor could not be considered to have parted with beneficial ownership of the property, whereas, in the latter case, the analysis depended upon the powers in question being so extensive that they were equivalent to (or could not be distinguished from) ownership

## *Webb v Webb* - commentary

- In the *Webb* case, it also appeared to be material that the powers which W had (in various capacities) were such that, if exercised, he could have become not only the settlor and trustee of the trusts (and one of their beneficiaries), but could also become (and did become) the consultant (with very extensive powers in that capacity) and indeed sole beneficiary of the trusts, regardless of the interests of the other beneficiaries and without any external (such as third party) or fiduciary constraints



Tentative conclusion re extent to which *Pugachev/Webb* would be followed in absence of statutory provisions

- Does the analysis of Birss J in *Pugachev* reflect the principles of common law and equity which would be applied in the IFCs' courts in the absence of relevant statutory modifications?
- Probably more likely that the analysis of Lord Kitchin in *Webb* would be followed than that of Birss J in *Pugachev*

## Tentative conclusion

- Even if Birss J's analysis were to be followed in the absence of statutory reserved power provisions, it is likely that some constraints on the application of those principles are likely to be imposed by the courts, so that, e.g., the analysis might only be applied in matrimonial cases such as *Webb v Webb* and insolvency/asset protection cases such as *Pugachev* or in circumstances in which the terms of the trust are such that its settlor has the power (whether in his or her capacity as settlor, protector or consultant or in any other capacity) to engineer a situation in which he or she could, without external constraint, become beneficially entitled to the trust's assets

## Tentative conclusion

- Such tentative conclusion has been reached because the analysis of the principles of trust law, in particular by Birss J in *Pugachev* (but also by Lord Kitchin in *Webb v Webb*), was somewhat scant in the context of the apparently major departure from the existing principles of trust law in this area. Whilst it is not possible to predict, with any degree of accuracy, precisely how the courts will rein in these principles, it may well be that the relevant principles will only be applied in situations in which the relevant factual background is as 'extreme' (as it was in those two cases) and/or in cases in which spousal rights and the rights of creditors are in issue



Tentative conclusion re extent to which *Pugachev/Webb* would be followed in absence of statutory provisions

- Alternatively (or in addition) the analysis of Birss J might only be applied in situations in which the settlor (whether in his or her capacity as settlor and/or otherwise) has unrestrained non-fiduciary powers which can be exercised in such manner as can ensure that the beneficial interest in the assets of the trust can be appointed to himself or herself absolutely

Tentative conclusion re extent to which *Pugachev/Webb* would be followed in absence of statutory provisions

- Outside the matrimonial or insolvency/asset protection context, it is however probably unlikely that the courts will go so far as to treat as illusory **all** trusts which reserve to settlors personal powers of revocation or personal general powers of appointment or equivalent powers (unless there are actually exercised), since this would have the effect of invalidating so many trusts which have been settled on the basis of everyone's earlier understanding of the law (as set out in *Lewin*)



Tentative conclusion re extent to which *Pugachev/Webb* would be followed in absence of statutory provisions

- Although this remains to be seen, as and when the law is clarified by the courts, it is possible that the analysis of Birss J will only be applicable in the (probably very rare) circumstances in which a non-fiduciary power to replace trustees with trustees who will do the settlor's bidding has been reserved to the settlor (as was the case in *Pugachev* where the court held, on construction, that the protector's power to replace the trustee was a non-fiduciary power albeit that it was designated as fiduciary in the trust instruments)



Tentative conclusion re extent to which *Pugachev/Webb* would be followed in absence of statutory provisions

- In summary there exist very strong reservations as to the question of whether the analysis of Birss J/the Board would be followed by the courts in IFCs, i.e. even in the absence of reserved power statutory provisions, and one would expect such analysis to be substantially diluted, except possibly in situations in which spousal/creditors' rights are involved

# Reserved power statutory provisions in IFCs

- Section 86 of the BVI's Trustee Act (as added by the Trustee (Amendment) Act, 1993)
- Section 13 of Cayman's Trust Law (2021 Revision)
- Section 3 of The Bahamas' Trustee Act (1998)
- Article 9A of Jersey's Trusts (Jersey) Law 1984 (as inserted in 2006)
- Section 2A of Bermuda's Trusts (Special Provisions) Act 1989 (as inserted in 2014)
- Section 86 of the BVI's Trustee Act (as substituted by the Trustee (Amendment) Act, 2021)



## Section 3 of The Bahamas' Trustee Act

- 'The retention, possession or acquisition by the settlor of any one or more of the matters referred to in subsection (2) shall not invalidate a trust or the trust instrument or cause a trust created *inter vivos* to be a testamentary trust or disposition or the trust instrument creating it to be a testamentary document'

## Section 3 of The Bahamas' Trustee Act

- The list in subsection (2) includes references to powers of revocation (or withdrawal of property), appointment and amendment, powers to add and remove beneficiaries, powers to give directions to trustees in connection with the exercise of any of their powers, consent powers, the appointment of the settlor as protector, any interests of the settlor in trust property or in underlying companies or their assets and any control of the settlor over such companies/assets

## Would provisions such as those in section 3 modify the analysis in *Pugachev/Webb*

- ‘In some jurisdictions there are express statutory provisions to the effect that various kinds of powers or interests reserved by the settlor neither invalidate a lifetime trust, or [*sic*] delay or prevent it taking effect as a lifetime trust rather than a testamentary disposition. Such provisions may go no further than give effect to what is the position without statutory intervention in England and Wales, but have the advantage of eliminating doubt as to the scope of the common law rules and are no doubt a comfort to settlors who wish to establish lifetime trusts in those jurisdictions, reserving wide powers to themselves.’ (Lewin para 5-040)

## Would provisions such as those in section 3 modify the analysis in *Pugachev/Webb*

- ‘There are limited prospects of the decision in [*Pugachev*] that no trust was created as a matter of construction... being followed in a jurisdiction with such statutory provisions’ (*Lewin*)

## Would provisions such as those in section 3 modify the analysis in *Pugachev/Webb*

- Section 3 of the Trustee Act clearly states that the reservation of many, if not all, the powers which Mr Pugachev had will not, as a consequence, invalidate a Bahamian trust and so Birss J's analysis of the law relating to illusory trusts in *Pugachev*, even to the extent (which is probably dubious) that that it truly reflects the position under English law, is unlikely to be followed in those IFCs which have robust reserved power legislation
- It does not automatically follow that wide powers, such as powers of revocation and general powers of appointment, will, notwithstanding this, not be regarded as 'property' in certain circumstances, most notably perhaps in the context of matrimonial and creditors' claims (by applying non-trust law principles) where the concept of 'property' tends to be wider than it ordinarily is

## Conclusion re illusory trusts

- In summary, then, the law relating to illusory trusts is clearly in a developing state and it is not possible to state with any degree of certainty whether the analysis of Birss J or the Privy Council in *Webb* would be applied by IFCs' courts i.e. in the absence of provisions such as those in section 3 of The Bahamas' Trustee Act
- It would however be entirely reasonable to assume the courts of IFCs which have appropriately robust reserved power legislation would not apply that analysis

## Conclusion re illusory trusts

- Although there is no decided case on this issue, with the result that it cannot be guaranteed that such a view would be endorsed by the courts of IFCs, it would also be quite reasonable to conclude that the provisions of section 3 of the Bahamian Trustee Act are such that any attempt to argue that Birss J's/the Board's analysis is applicable would very probably not succeed on the basis that the provisions of that section are at odds with such analysis

## Conclusion re illusory trusts

- It remains possible that, especially in an egregious case, a court might apply the *Pugachev/Webb* analysis on the basis that a particular IFC's reserved power legislation is not formulated identically to that of the relevant *dicta* in *Pugachev/Webb* – e.g. that section 3 includes no express reference, as such, to the retention of beneficial ownership (*Pugachev*) or to relevant powers being so extensive that they are tantamount to ownership (*Webb*)



# Factors to be considered if Birss J's or the Board's analysis **were** actually to be followed

- Particularly if the Privy Council is the final court of appeal in the relevant IFC, it may well be more likely that the analysis of Lord Kitchin in *Webb v Webb*, than that of Birss J, would be applied in relation to an illusory trust challenge (especially one which reaches the Board on appeal)
- Although it cannot be guaranteed that this view would be upheld by the courts, is felt that an illusory trust challenge is very unlikely to succeed in circumstances in which the relevant powers are vested in a protector or others in a **fiduciary** capacity, since it appeared critical to the decision in *Pugachev* that the protector's powers were non-fiduciary (albeit that they were expressed as being fiduciary in the trust instruments)

# Factors to be considered if Birss J's or the Board's analysis **were** actually to be followed

- Similarly it is improbable that such a challenge would succeed in circumstances in which the relevant powers are not such as to enable the powerholder to recover or obtain the trust property without any fiduciary or external constraints (such as the need for third-party consents or the agreement of the trustee)
- The illusory trust analysis might well be inapplicable outside the matrimonial or creditor protection context. In other contexts, the traditional test of whether a trust is an illusory trust are likely to be applied. In other words, the court is likely to consider whether, at the outset, the trustee owes duties to anyone other than the settlor/powerholder which can be enforced by those other persons

# Factors to be considered if Birss J's or the Board's analysis **were** actually to be followed

- It might well be the case that, to the extent that they are upheld, the decisions in *Pugachev* and *Webb* will be confined to the facts which existed in those cases which have been described as being quite stark or extreme, particularly in the context of the powers which Mr Pugachev and Mr Webb had – which are not actually likely to be reflected in many trust deeds evidencing trusts in IFCs
- The court is likely to consider, in combination, all the powers which the relevant power holder has in **various capacities** in which he or she holds those powers

# Factors to be considered if Birss J's or the Board's analysis **were** actually to be followed

- The views of the authors of *Lewin* are considered quite weighty and the publication is often referred to in English cases. The latest edition postdated *Webb*, but a supplement is due to be published imminently

# Alternative remedies

- Alternative remedies are often brought by spouses, creditors and others who make illusory trust claims on the basis of extensive reserved powers
- Sham trust claims – on the basis that the parties never intended the trust to operate in accordance with its terms
- Insolvency and divorce claims based on settlors' powers of revocation and appointment being such that the settlor is economically in a similar position to an absolute owner. *Lewin* paras 5-032 and 5-035

## Alternative remedies

- E.g. *TMSF v Merrill Lynch* [2011] UKPC 17 (Cayman Islands Privy Council decision) – power of revocation considered to be such that in equity it would for insolvency purposes as a ‘power tantamount to ownership’ with the result that the Privy Council found that it had power to delegate it to a receiver

# Alternative remedies

- Resulting trust claims. *Petrodel v Prest* - court held that various properties which had been vested in the name of a number of companies were actually held beneficially for Mr Prest, on the basis that the presumption of a resulting trust applied, i.e. since the presumption could not be rebutted by any evidence of an intention that he had intended a gift to be made. The properties were therefore matrimonial assets which fell to be divided up between him and his wife on her claim for ancillary relief on divorce. This was however another case in which the settlor was a fugitive from justice

## Takeaways

- The law is in a developing state
- Despite the view that has been taken, it is generally advisable to reserve to the settlor (or to confer on others such as protectors) **only** such powers as are absolutely necessary, where possible to make such powers subject to fiduciary constraints and **not** to give those concerned **all** the powers which are expressly referred to in section 3 (or its equivalent elsewhere)