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Sham - To Be or Not To be?

A summary of the Mezhdunarodnyy Bank v Pugachev decision

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On 11th October 2017, the English High Court of Justice, Chancery Division published its decision in *JSC*

Mezhdunarodnyy Promyshlenniy Bank, et al v Sergei Viktorovich Pugachev et al [2017] EWHC 2426 (Ch) ("*MezhProm Bank v Pugachev*").

Background

The Claimants in these proceedings were JSC Mezhdunarodnyy Promyshlenniy Bank (*MezhProm Bank*), a Russian bank which

entered into liquidation in late 2010 and its liquidator, the Deposit Insurance Agency ("*DIA*").

The first Defendant was Sergei Viktorovich Pugachev (*Pugachev*), the owner and founder of the Mezhdunarodnyy Promyshlenniy Bank. The second to tenth Defendants were trust companies. The eleventh Defendant was one of Pugachev's sons, while the twelfth to fourteenth Defendants were the minor children of Pugachev and Alexandra Tolstoy.

Between December 2011 and November

2013, five discretionary trusts were created by Pugachev; (i) the London Residence Trust, (ii) the Kea Three Trust, (iii) the Rivera Residence Trust, (iv) the Wiltshire Residence Trust and (v) the Green Residence Trust (collectively, “the Trusts”).

The terms of each of the Trusts were essentially the same in that the First Protector of the Trusts was Pugachev and in the event of his death or incapacity, his son Victor Pugachev (as Protector). The third to fifth defendants were the trustees of the Trusts while Pugachev and various members of his family were discretionary beneficiaries. During 2014 and 2015, trustees of the Trusts advanced substantial sums to Pugachev as unsecured loans and when they refused to make additional advances, the trustees were replaced and the new trustees entered into a funding agreement with Pugachev.

In connection with the liquidation of MezHProm Bank, legal proceedings were commenced in Russia against Pugachev and later in the United Kingdom (as enforcement proceedings) which resulted in a worldwide freezing injunction against the assets of Pugachev and directions that Pugachev disclose further information about the Trusts, including details of the trustees, beneficiaries, and the location and value of trust assets.

The Claimants submitted that the beneficial interest in the assets of the Trusts belonged to Pugachev and sought a declaration to this effect.

Issues

The issues for determination were:-

- i) Whether the trusts were effective in divesting Pugachev of his beneficial

ownership of the assets held by the Trusts? (the “*True Effect of the Trusts*” claim);

- ii) Whether the Trusts, or strictly the trust deeds, are shams? (the “*Sham*” claim); and
- iii) Whether there was a proper claim under Section 423 Insolvency Act 1986? (the “*S. 423*” claim).

The “*True Effect of the Trusts*” claim

It was concluded that the real Settlor of the Trusts was Pugachev. At first glance, the Trusts were set up for a well-defined class of discretionary beneficiaries. However, upon its true construction, the trust deeds conferred powers on Pugachev (as First Protector) to be exercised freely for his own benefit. The conferred powers were personal in nature and gave the Protector the ability to act in his own best interests.

The powers were not constrained by a consideration of the interests of the discretionary beneficiaries as a class. Due to the extensive nature of the Protector’s powers combined with the fact that the First Protector is the Settlor of all the trust assets and one of the named discretionary beneficiaries, it was concluded by the Court that on their own terms the Trusts did not divest Pugachev of the beneficial ownership he had of the assets transferred into them. In substance, the trust deeds allowed Pugachev to retain his beneficial ownership of the assets.


The “*Sham*” claim

The Court found that although the operation of the Trusts was consistent with their being genuine discretionary trusts for the class of discretionary beneficiaries as a whole, it did not allow one to distinguish between that and the

retention of beneficial control by Pugachev of the trust assets.

At all material times Pugachev regarded all the assets in the trusts as belonging to him and intended to retain ultimate control. The point of the Trusts was not to cede control of Pugachev’s assets to someone else; it was to hide his control of them. As such, given the intentions of Pugachev, the finding on the “*True Effect of the Trusts*” claim means that the Trusts were not shams as they fulfilled the true intention of Pugachev to retain control.

The “*S. 423*” claim

The Court focused on the question of purpose under S. 423 and that of Pugachev at the time of the transactions. The real and substantial purpose must have been to defeat the creditors; that result merely being a by-product is not enough. If the transaction was one which the debtor would have entered into in any event, the Court should not too readily conclude that Pugachev also had the purpose of defeating his creditors. The Court found that because the intention of Pugachev was always to control and use the Trusts as pretence to mislead others about his ownership of the assets, Pugachev’s purpose in setting up the Trusts and the transfer of assets (either himself or by his nominee, Victor) satisfied the test in Section 423. 



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