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Is the Pugachev ruling the end of Offshore Trusts and should it be?

This paper is based on a talk given at the C5 conference in Geneva.

1. Does the Pugachev litigation mark the end of Offshore Trusts? And should it?

2. In summary, my answers are as follows.

   2.1. The answer to the first question is pretty clear and it's No. One day Pugachev may be seen as a milepost along a road, a nail in a coffin, but I am not expecting the offshore professional trustee industry to call in the administrators tomorrow.

   2.2. The answer to the second question – should this be the end of offshore trusts - is not necessarily yes or no.

   - Some may say Offshore Trusts are just fine as they are;
   - some may say that they should be shut down altogether;
   - and some may say that they need to change, to a lesser or greater extent.

3. By way of spoiler to my own talk, my answer to this second question is that the Pugachev litigation shows that the first group – "things are just fine as they are" – and the third group – "we need real change" – may have a lot in common. As Don Fabrizio said in The Leopard, "everything must change, so everything can stay the same".

4. For that reason, I think that the answer to the question "should this be end of Offshore Trusts" gives rise to a third question: what do their critics think is wrong with Offshore Trusts and what can be done to fix them?

5. And the answer to that question, for reasons I will explain later, is an awful lot of transparency.

6. In my view, those who argue that the current balance between privacy and transparency hits the right note are missing the zeitgeist. They put me in mind of a group of French

nobles discussing the problems of the peasantry in the mid-1780s and agreeing that all was broadly fine. There is a danger in group think.

7. I think that it is particularly in the interests of the offshore jurisdictions themselves to make this change, because if, as I believe and as those jurisdictions profess, the vast majority of what happens offshore is legitimate and proper, it needs saving. Popular and populist politicians see no different between offshore funds like the Queen's investment in an offshore fund, an offshore pension fund, or David Cameron's father's investment trust, and asset protection trusts like a Pugachev trust. If we want to save the former, we need to reform the latter. And that is particularly to the benefit of those providing these services.

8. I hope that what I've just said makes clear that the particular focus of my talk is not all offshore trusts, but rather the sort of offshore trust that was in issue in Pugachev: i.e. an "asset protection" trust.

The First Question

9. So, to the first question – is this the end of Offshore trusts?

10. As I've said, I don't think that this question has the right taxonomy for Mr Pugachev's trust. The right taxonomy is: asset protection trusts.

11. The short answer to the first question is: No. It plainly isn't the end.

(1) Practically, Pugachev doesn't apply to anything but megafrauds

12. The victory in Pugachev is remarkable both in its outcome and for various other things:

12.1. That it is remarkable at all – to the man on the street, unfamiliar with trusts law, the result in Pugachev would seem normal, and little to boast about. A bank takes a billion dollar bailout, fails shortly thereafter, and several hundred million that had been paid into discretionary trusts for the CEO's family comes back to the liquidator. What's so remarkable?

12.2. Westlaw has no fewer than *twenty* Pugachev judgments, and there were many more that did not make it to the law reports.

12.3. These judgments date from 18 July 2014 to 11 October 2017 – 3 years and 3 months.

13. So for three reasons the Pugachev example isn't going to help that much for smaller frauds:

13.1. Cost. It must obviously have cost many, many millions to achieve this outcome. We can now update Anatole France's famous dictum about the formal majesty of the law, that forbids rich and poor alike from sleeping under bridges: oh the formal majesty of the law, that allows rich and poor alike to invalidate a trust on payment of tens of millions in legal fees, if they have the right team of lawyers, and get the right lucky breaks.

13.2. Delay. Justice delayed is justice denied: that is particularly true in asset recovery cases. The fraudster likes to be able to drag things out because (a) it increases the scope to cut a deal; (b) the nuisance factor puts pursuers off; (c) sometimes the fraudster gets to enjoy the chateau a little longer.

13.3. Stamina. Not every client has the stamina to deal with this kind of litigation. You need a client with guts, and a legal team with guts, to apply for an injunction ex parte and be rejected, and to pursue that to the Court of Appeal – as the Pugachev team did. It probably helped in Pugachev that the principal creditor, for whom the Russian liquidator was effectively working, was the Russian state. Russia's not known for giving up easily.

14. So any fraudster who doesn't operate on quite such a lavish scale will be able to use the Pugachev experience to cut a deal, especially if the missing amount is "only" $50-100m.

(2) <u>"Asset protection" strategies will evolve</u>

15. The next feature that the next putative "asset protector" will, if she - or more usually he - is worth their salt, notice about the *Pugachev* judgment is that they can learn from Mr Pugachev's experience. We see this a lot in commercial litigation where you get repeat players. It's a never-ending war where the battle-lines change, and the defences built yesterday fall into the other side's hands and become a problem for the people who fashioned them.

16. In that regard, there is some good news for the Offshore Trusts industry: establishing the trusts in New Zealand didn't help Mr Pugachev.

First Lesson: exotic trust law is too good to be true

17. New Zealand provides for different rules for foreigners' trusts. I think that there is a change here just as there has been for bribery: there used to different rules for what you could get away with abroad and what you did at home. No longer for bribery, and perhaps this trend will catch on more widely. Jurisdictions that have ho-ho-ho provisions for foreigners, like the Nevis irrebutable presumption that an asset transfer wasn't made to defraud creditors

after two years – provided that the trust is purely international - are in a different category from jurisdictions that don't discriminate between locals and foreigners. So the lesson here is one that a would-be Mr Pugachev ought to know already: if something is too good to be true, it probably is. That's true of trust law too.

18. That's an important point that those from well regulated offshore centres can and should trumpet, in my view. There is plenty of suspect money here in Geneva, plenty in London, and plenty in Lichtenstein and Luxembourg. There is plenty of clean money offshore.

19. The fact that the Rothschild bank group put $265m of 1MDB's money into a *New Zealand* trust, and that Mr Pugachev also used a New Zealand structure, shows that suspect trusts aren't a rocky or sandy island problem. They are a problem for countries that deliberately create different rules for foreigners.

Second lesson: the silly clauses: flight clauses, resettlement clauses and protectors are often a gift to those attacking a trust. Settlors must really give up control

20. To clarify for those of you who are not familiar with the distinction:

- A *flight* clause is a clause that says that in the event that action against the trust appears likely, the trust will move to somewhere even less accessible – such as the Marshall Islands or the Cook Islands. So it's the same trust, but in a different place.
- A *resettlement* clause provides that the trustees may at any time appoint the trusts to a completely new trust but on similar or identical terms.
- A *protector* clause gives substantial powers or trustee appointments and discretions to a protector – often the settlor or source of funds.

21. Pugachev may be the start of the death rattle of the protector clause. It is not the death knell: Mr Pugachev's powers as protector were found to be personal, not fiduciary, so I expect that there will be another round in the battle of the drafters, where the drafters say that the protector's power is fiduciary. However, I expect that when those cases come

before the courts, judges will still say that the settlor-protector who is also found to be a major international fraudster controls the assets.

22. And this is no bad thing: these trusts are very hard to defend, because, as the CA pointed out, what they are trying to do is to enable people to have control over assets that they don't control. You only have to state the goal to see the problem: it's not one that can be drafted out of.

23. Clients who set these asset protection trusts up love flight and resettlement clauses. These settlors often think that they are very clever. Secretly – sometimes not so secretly – these settlors love the cat and mouse of litigation, and think these clauses are clever. Judges, not so much.

24. I've never seen flight clauses actually used. My experience is that they are very useful – to those who are attacking a trust. Judges generally need no further submissions on the risk of dissipation when you point to the silly clause.

25. So the next Mr Pugachev will, if sensible, avoid the exotic, too-clever-by-half clauses, that are an affront to most judicial minds because they say: this (usually not very robust) jurisdiction that I've chosen for my trust may get a bit hot for me, and if I don't think I fancy staying here I may head off somewhere even more shonky.

26. They will also note that though Mr Pugachev had put a Mr Patterson, apparently one of the most respected trust lawyers in New Zealand, on the board, he had also put a crony in as a trustee, and a solicitor who was, as Mr Justice Birss delicately put it, "not of the same standing" as Mr Patterson. So the next battle will see a tight letter of wishes, and only really reputable trustees on the board, without any right to appoint more.

27. Such a putative settlor may still get the advice that Mr Patterson apparently gave Mr Pugachev – that after the trust had been settled, Mr Pugachev could still apparently do what he liked with the assets. In which case the putative settlor may well go ahead with the trust: to the profession's shame.

28. Or, faced with that possibility that he can't actually control the trust, the putative asset-protector may decide that s/he doesn't really want to settle the trust at all. Alternatively, s/he would be well advised to put only a small percentage of their assets into this

emergency vehicle. I suspect that Mr Pugachev's trusts would have been less likely to be found a sham if they had been a smaller fraction of his wealth, so that it could plausibly have been asserted that they had been set up so that he could be sure his future grandchildren would never starve, rather than containing the bulk of the family fortune – or, more accurately, the bulk of the bank's fortune.

29. Settlors who create trusts that they control are often setting themselves up for trouble. They pay the trust company in the good times, but when it's needed the supposed protection may turn well out to be illusory.

Third lesson: the asset protection trusts will henceforth be set up in good times, not bad

30. This lesson is good news for part of the "asset protection" industry. Mr Pugachev put these trusts in place in December 2011. I suspect that Mr Pugachev's fate might have been very different if he had put all these structures in place before he fled Russia in January 2011, and even better if they had been settled before he lost a lot of money in the 2008 crisis. People who these structures in place when they are already in trouble just look suspicious.

31. One of the most notable things about Mr Justice Birss' judgment is that he dealt so briefly with the s.423 claim: he really viewed it as obvious.

32. The next Mr Pugachev will buy his umbrella when the sun's shining, not when the skies are overcast, and certainly not when it's pouring with rain.

Fourth Lesson: take the neutrality of English judges seriously and don't try claiming that you are a victim of political oppression

33. This is a short but notable point. The same jurisdiction that ruled in *Cherney v Deripaska* that the trial had to take place in England even though on any normal basis it was not the natural forum, as the Russian courts were not independent and could not be trusted to give a fair trial to those who were out of favour with the Kremlin, granted a s.25 CJJA freezing order in support of proceedings in Russia, where the ultimate recovery will presumable be for the benefit of the Kremlin. The courts did so because they were content that Mr Pugachev's conduct justified this.

34. Following the *Djibouti* litigation, there was a rash of people thinking that they could say *"it is all because the president does not like me, because I am an honest man and a true democrat"*. That hasn't washed well with English judges.

Fifth lesson: Doing a runner won't help

35. If you really want to test the imagination of the other side's lawyers, and the judge's creativity, do a runner when your trust is challenged. It is a great way to ensure that you will be debarred from defending, and almost a challenge to the other side and the Court to see what new law can be devised to hurt you as much as possible.

Conclusion on the First Question

36. So, to answer the question "is this end of the Asset Protection Trust"? No, it isn't because:
    - This trust had been set up after the settlor was in trouble;
    - This trust contained clauses that left the settlor too much control;
    - The source of funds breached the passport order and ran away;
    - The trust had an enemy who while not popular (the Russian State) was resourceful and willing to invest to win.

The second and third questions: should this be the end of the asset protection trust?

37. So now I come onto the question: should this be the end of the Asset Protection Trust?

38. I think that it is in the interests of the offshore jurisdictions to be very cautious about the role of asset protection trusts and the damage that they can do to the wider trust industry – investment trusts, and pension funds. I think that asset protection trusts are becoming more trouble to the industry than they are often worth, and they are only going to get more so: the public and legislative mood is moving against them, and in that sense the Pugachev decision just shows the judiciary moving with them. Given judges' reputation for not being popular trendsetters, we can expect more of this before we get less.

39. It may of course be that the only asset protection trusts that I see are the ones that have gone wrong: I'm a barrister, so practically by definition, when I am involved, something has gone wrong. But so much seems to go wrong.

Illegitimate fortunes

40. To start with there are the trusts that seek to protect illegitimate fortunes, which are created to hide assets from creditors. I hope that we can all agree that these are very bad news for everyone apart from litigators like me: they give the industry a bad name. Sometimes these are directly taking criminal money.

41. No one should be blasé about the damage that this does to the trust industry. We get too accustomed to dodgy money in our industry, like doctors getting used to the sight of blood. Try describing in general terms what you do in setting up a trust like this to a non-lawyer who you respect and admire and see how they react; he or she won't like it.

42. There is a wonderful scene in The Wire that captures some of the problem. If you've not seen it – there are a lot of barristers here, and we barristers live somewhat sheltered lives – The Wire is a sort of Dickens or Balzac for our times.

43. An eloquent and talented lawyer for a Baltimore drug gang is defending a gang member on a charge of murder. He is cross-examining the chief witness for the prosecution, who

does not deal drugs – that is against his code – but is an armed robber, whose principal target is drug dealers.

44. In his cross examination, the lawyer says to the robber: You are amoral, are you not? You are feeding off the violence and the despair of the drug trade. You are stealing from those who themselves are stealing the lifeblood from our city. You are a parasite who leeches off the culture of drugs.

45. The robber replies: Just like you, man. Me with the gun, you with briefcase. It's all the game, though, right?

46. I think that captures precisely the public mood about very rich people with fortunes dubiously acquired trying to use structures to hide their wealth from the public and from creditors. And their lawyers.

47. I also think that the courts are not immune to this feeling. There is a big difference between a trust set up by someone who has obviously made his or her money legitimately – a Bill Gates trust – and someone who has made money mysteriously and is seeking to keep it all shielded from creditors. If we don't get rid of the latter, the former will go too. As some will say that such trusts should do anyway, if they are clever offshore structures to avoid tax.

Legitimate fortunes

48. For those settlors that have legitimate fortunes that they are considering settling on trust, there is a second problem: they have all too frequently been the victims of serious mis-selling. They are sold on the basis that they allow settlors to retain control of the assets while no longer having control of the assets for tax purposes.

49. These trusts often cause complete misery for the families of those involved. I have litigated trusts like this in several jurisdictions; there are no winners in this kind of family litigation.

50. In part it's because of the inherent confusion in these trusts: the settlor has given something away; but doesn't think s/he has. The recipient of the gift has been led to believe it's his

or hers; but it often isn't fully, and there is a hidden bungee cord that can pull it back when the family have a row. Relationship counsellors spend a lot of time talking about the importance of having clear communication of expectations. Discretionary trusts do precisely the opposite: they blur the lines.

51. Advisors should say clearly: you have a choice. You can give your fortune away, or you can see it taxed. But you can't do both.

52. It is a nonsense, really, to think that some people, who've devoted their lives to building up a fortune, often by controlling everything they can and at some expense to their personal lives, actually want to give their fortune away to an accountant they've never met on an island they don't visit unless they have to, for the accountant to decide on a broad discretion where it should go.

53. These trusts are all driven by tax considerations. So the lifespan of these trusts depends on tax laws. It must be questionable how long this lifespan has left. In England, HMRC is learning all the time from its successes in stamping out some of the sillier domestic tax schemes that we have seen over the last ten years. HMRC basically had a threefold strategy for tax schemes:
    53.1. Rules requiring disclosure of schemes – so it knew what was going on;
    53.2. It removed the initial tax benefits pending appeal by advance payment notices.
    53.3. It had a steady stream of court victories so that customers came to distrust the upside.

54. It wouldn't be that hard to do the same for asset protection trusts.

<u>Privacy: a trump card?</u>

55. So far as claims to privacy are concerned, the direction of travel is all towards more transparency:

    55.1. In January the UK government announced a public register of the ultimate beneficial ownership of all UK property. This should have quite a big impact on companies from offshore jurisdictions, whose beneficial owners we do not know. Other jurisdictions will follow. No one can justify the principle that you can find

out who owns any registered land in the UK – unless the owner has chosen to pay a fee to an offshore jurisdiction to remain anonymous.

55.2. Data protection. In *Dawson-Damer v Taylor Wessing* [2017] EWCA Civ 74 the CA decided that people can make subject data requests for letters of wishes. I think that SARs are potentially huge: lots of the trusts I have seen, for tax reasons, have a charity at the very bottom of a long list of discretionary beneficiaries. It is only a matter of time before the UK charity sector starts making mass requests.

55.3. The information that has to be provided to the Trusts Register is already very substantial. I would bet that one day this register will be made publicly searchable, like Companies House.

55.4. Again as with data protection, it seems likely that over time, the penalties for non-compliance will become more severe. Expect ultimately the assets held on a trust that hasn't been registered to be found to be either invalid, or to go bona vacantia. The scope of the existing Trusts Register may well be made wider, catching any trust not just where the assets are in the UK, but where any potential beneficiary is a UK passport holder.

55.5. I would expect non-compliant trusts to end up shut out of the banking system, because increasingly, the banks' KYC checks are becoming a non-governmental police.

56. The changes are all likely to be one-way, like a ratchet. Existing UK legislation reflects the EU fourth anti-money laundering directive, and EU law is famously hard to repeal. Regardless of the UK's future, the directive is likely to remain a baseline.

57. When the best argument that can be given for existing practice is privacy, we know that existing practice is on borrowed time. If the trusts industry can't survive transparency, the trusts industry can't survive. Change is inevitable. Those jurisdictions that flourish will be those that embrace change and make transparency part of their business model.

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