Illusory trusts in the British Virgin Islands and section 86 of the BVI's Trustee Act

The laws of the BVI

The principles of English common law and equity form part of British Virgin Islands (BVI) law and would be applied by the BVI's courts, except to the extent that they have been modified by statute. This is the case as a result of the Common Law (Declaration of Application) Act and the Supreme Court Associated States (Virgin Islands) Act.

English and Commonwealth decisions such as that in *Pugachev* and the *Webb v Webb* case to which we refer below are not binding on the courts of the BVI, but they may be regarded as persuasive authority in relation to issues involving the relevant principles of English common law and equity which would be applied by the BVI's courts, i.e. in the absence of any statutory modification of those principles, involve a two-fold analysis. The first question which needs to be considered is whether the analysis of Birss J in the *Pugachev* case insofar as it relates to illusory trusts does actually reflect those principles of English common law and equity which, apart from statute, would be applied by the courts of the BVI; the second question is whether, if it does, those principles will have been modified as a result of section 86 of the Trustee Act.

The extent to which the analysis of illusory trusts by Birss J in *Pugachev* actually reflects the principles of common law and equity which would be applied by the BVI's courts in the absence of any relevant statutory modifications

The *Pugachev* decision

This decision of the English High Court involved five New Zealand discretionary trusts which had been set up by Mr Pugachev for the benefit of his family. The parties agreed that New Zealand and English trust law were idenical in all material respects. Independent New Zealand trust companies were initially appointed as trustees of the trusts. Mr Pugachev was also one of their beneficiaries and their protector. In the capacity of their protector, he held a number of powers, such as the power to replace the trustees with or without cause, the power to direct a sale of specific trust property and the power to veto certain trustee decisions. He did not have the power to appoint trust assets to himself, but could veto any appointments to other beneficiaries. He could also veto the removal of beneficiaries, veto any variation to the terms of the trusts, veto the release or revocation of any powers granted to the trustees, veto the early termination of the trust period, veto the addition of beneficiaries and veto any amendments to the trust by the trustees.

The consent powers which Mr Pugachev as protector of the trusts were rather more extensive than the protector of a BVI trust would generally have, in that it is fairly rare for protectors to have the power to consent to investment decisions as well as the power to consent to the exercise by the trustee of all its most important dispositive powers. It is

furthermore quite rare in the BVI for the protector's consent to be required before income distributions or the power to direct a sale of residential property are made as was the case with the trusts which Mr Pugachev had established.

The background to the litigation was that Mr Pugachev had founded the Mezhprom Bank in Russia, which was liquidated by the Russian government after a financial crisis in 2014. The liquidator sought, by attacking the validity of the trusts, to recover trust assets worth $95 million which Mr Pugachev had settled on trust after he had fled Russia. The liquidator argued that Mr Pugachev effectively retained control of the trust assets via the powers he had reserved to himself. The liquidator also challenged the validity of the trusts on the basis that they were shams and furthermore challenged the transfer of the assets into trust on the basis of certain provisions in the English Insolvency Act 1986 (which do not, as such, form part of BVI law), but the sham trust challenge and the Insolvency Act challenge are outside the scope of this opinion.

Mr Pugachev was not represented at the hearing. The background to the case was egregious: the case was one of many involving Mr Pugachev and the Russian state in various jurisdictions and in other proceedings Mr Pugachev had been handed down a sentence of two years' imprisonment for contempt of court, a sentence which he had not served by since he was outside the jurisdiction of the court.

Critically Birss J held that the powers which Mr Pugachev had retained were purely personal non-fiduciary powers: they could be exercised by him in his own interests and without considering the interests of any of the other beneficiaries. He relied, particularly, on the fact that Mr Pugachev was a discretionary beneficiary as well as being both the protector and the settlor of the trusts and ruled that the effect of Mr Pugachev being able to exercise his powers in his own interests was to allow him to retain total control over the assets he had settled on trust; he could prevent trust property being distributed to any of the other beneficiaries and could make sure that the assets could be distributed to him himself as a result of the exercise of his power to remove any trustees who refused to distribute the assets to him and appointing trustees who could ensure that this could be done.

Birss J came to the conclusion that "on their own terms these trusts do not divest Mr Pugachev of the beneficial interest he had of the assets transferred into them. In substance the deeds allowed Mr Pugachev to retain his beneficial ownership of the assets".

The extent to which the *Pugachev* analysis of illusory trusts would be followed

Birss J's analysis of illusory trusts had been heavily criticised prior to the decision in *Webb v Webb to* which we refer below. For instance, in the leading English text, *Lewin on Trusts (Lewin) (*20th edition), the authors state at paragraph 5-035 as follows:

"…In a 2017 English case, the court… held that the reservation by the settlor 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…''.

In a footnote which immediately followed, the authors of Lewin went on to say that "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 new

trustees could properly be 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…"

The authors of *Lewin* went on to state in the same paragraph that, ''earlier authority having indicated that even a retention of a personal power to revoke a trust or to appoint the entire trust property to the settlor does not prevent there being a valid trust in the meantime, taking effect in accordance with its terms. We do not consider that the reservation to the settlor or 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. It would make a difference if 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 the 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].''

Prior to the *Webb v Webb* decision which is referred to below, other commentators had suggested that the analysis in *Pugachev* would be interpreted narrowly and that the decision would, in effect, be confined to one on the facts in that particular case (i.e. that it would be unlikely to be followed or that it would be readily distinguished by the court in other cases). It was generally considered that the case was an extreme case and Mr Pugachev was not even represented at the hearing.

The *Pugachev* decision is not considered in any great detail in the current edition of *Underhill and Hayton – Law of Trusts and Trustees (Underhill),* i.e. probably because, by the time that work had been published, it had been superseded by the *Webb* decision which is referred to immediately below.

One other observation about the case which has been made is that, although some commentaries state that the powers of Mr Pugachev as protector were very conventional, in our experience, they actually went a great deal further than the powers which one would normally expect to see in trust instruments evidencing trusts governed by BVI law and we would refer you to our comments on this issue which are set out above. It may well therefore be that if a trust instrument contains fewer consent powers then the courts would be more ready to distinguish the relevant case from the analysis in *Pugachev*.

The *Webb v Webb* decision

Since *Pugachev* was decided, in *Webb v Webb* [2020] UKPC 22, the Privy Council, in a Cook Islands decision, upheld the finding of the Cook Islands Court of Appeal that the trusts which Mr Webb purported to have created were 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 the powers in question were so extensive that "in equity and in all of the circumstances… [Mr Webb could] be regarded as having had rights in the trust assets which were indistinguishable from ownership".

Interestingly the *Pugachev* judgment was not referred to in the Privy Council decision, albeit that the former was referred to in the lower courts in *Webb*.

In this case, Mr Webb was the sole trustee and one of the beneficiaries of the trusts and reserved to himself very considerable powers. The powers in question included the power of requiring the trustee to appoint a "consultant" (which he exercised by appointing himself as the consultant at the outset so that he had all the relevant powers, albeit in a different capacity); his powers as consultant included assisting the trustee with the management of the trust, the ability, at his absolute discretion and without giving any reason, to remove the trustee and to appoint a new trustee in its place, assisting the trustee in relation to the management of the trust and the ability to request the immediate vesting of the trust property; in his capacity as trustee, he also had the power to exercise all his powers as trustee "notwithstanding that his interests [as settlor] 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 initial beneficiaries. He had no fiduciary duties in relation to the powers which he held as settlor which were personal powers.

The court gave two reasons why the trusts were invalid. One was that he had never divested himself of his rights as owner of the property that was 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.

Commentary on the decision in *Webb v Webb*

The analysis referred to in the previous paragraph has been criticised, for example in the 20th edition of *Underhill and Hayton: Law of Trusts and Trustees* (*Underhill)* (at paragraph 8.6) in which the authors of that work indicate that, although the result of the case was surely correct, the two reasons given cannot both be correct (i.e. presumably since this would result in a contradiction), but, "moreover [that the second reason that was given] sits uncomfortably with *dicta* that a power to appoint property is not itself 'property' owned by the powerholder, albeit that this 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". [The well-know Cayman Islands decision of the Privy Council in *TMSF v Merrill Lynch* [2011] UKPC 17 is then referred to in a 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, but consideration of those alternative explanations for the decision is beyond the scope of this opinion.

The *Webb v Webb* decision postdated the publication of the latest edition of *Lewin*, but a supplement to that edition is due to be released in November 2023 (although its anticipated publication date has been moved forward on multiple occasions since it was originally due to be published in July 2022 and so it may well be moved forwards yet again) and it remains to be seen whether the authors of that work will have revised their analysis of the law in paragraph 5-035 of the text insofar as the latter relates to illusory trusts (as set out above), although 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.

It is noteworthy that 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. In the *Webb* case, it also appeared to be material that the powers which Mr Webb 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.

Conclusion re the extent to which the analysis of illusory trusts by Birss J in *Pugachev* actually reflects the principles of common law and equity which would be applied by the BVI's courts in the absence of any relevant statutory modifications

Whilst, in the absence of any decided authority on this issue, we cannot guarantee that this conclusion would be upheld by the courts of the BVI, we are of the opinion that, even in the absence of provisions such as those in section 86 of the Trustee Act, it much more likely that the analysis of Lord Kitchin in *Webb v Webb* would be followed than that of Birss J in *Pugachev*, but that it even if the latter is followed it is likely that some constraints on the application of those principles are likely to be imposed by the courts, so that, for example, 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.

We reach the conclusion which is referred to in the previous paragraph 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 (as referred to in the extract from *Lewin* which is quoted above). 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. In this connection we would refer you to the alternative explanations for the decision which were given by the authors of *Underhill* as set out above.

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. In such cases, outside the matrimonial or insolvency/asset protection context, it is however in our view 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*). 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).

In summary, therefore, we have very strong reservations as to the question of whether the analysis of Birss J would be followed by the BVI's courts, even in the absence of the statutory provisions to which we refer below, and would expect that the analysis to be substantially diluted, especially in situations in which spousal or creditors' rights are not involved.

Section 86 and other provisions of the BVI's Trustee Act

Section 86 came into force on 9 July 2021 and applies to all BVI trusts, whenever created. It replaced the pre-existing section which had come into force on 1 November 1993.

Section 86 is worded as follows:

'(1) The reservation by the settlor to himself or herself or the grant to any other person or to any office holder or body, including (but without limitation) a protector or protective committee, in a trust instrument evidencing and recording a trust governed by the laws of the Virgin Islands of any limited beneficial interest in the trust property whether of income or capital, or any or all of the powers specified in subsection (2) or both such an interest and any or all of such powers, shall not —

(a) invalidate the trust; or

(b) prevent the trust taking effect according to its terms; or

(c) cause any of the trust property to be part of the estate of the settlor for the purposes of succession on death, whether testate or intestate.

(2) The powers referred to in subsection (1) are —

(a) in the case of a reservation to the settlor or other donor of trust property, power to revoke the trusts in whole or in part;

(b) power to vary or amend the terms of a trust instrument or any of the trusts, purposes or powers arising thereunder in whole or in part;

(c) a general, intermediate or special power to advance, appoint, pay, apply, distribute or transfer trust property (whether income or capital or both) or to give directions for the making of any such advancement, appointment, payment, application, distribution or transfer;

(d) power to act as, or give binding directions as to the appointment or removal of, a director or an officer of any company wholly or partly owned by the trust or to direct the trustee as to the manner of exercising voting rights attaching to any of the shares held in such company;

(e) power to give binding directions in connection with the purchase, retention, holding, sale of or other commercial or investment dealings with trust property or any investment or reinvestment thereof or the exercise of any powers or rights arising from such trust property;

(f) power to appoint, add, remove or replace any trustee, protector, enforcer or any other office holder or any advisor, including any investment advisor or any investment manager;

(g) power to add, remove or exclude any beneficiary, class of beneficiaries or purpose;

(h) power to change the proper law of the trust;

(i) power to change those of the terms of the trust which specify which courts have exclusive or non-exclusive jurisdiction in any proceedings involving rights or obligations under the trust; and

(j) power to restrict the exercise of any powers, discretions or functions of a trustee by requiring that they shall only be exercisable with the consent, or at the direction of, any person specified in the trust instrument.

(3) No person, other than a person in whom trust property or an interest in trust property is vested, shall be or become a trustee by reason only of the reservation or grant of any of the powers set out in subsection (2).

(4) Subject to any contrary provision herein, this section applies to any trusts governed by the laws of the Virgin Islands, whether created before, on or after the date on which this section comes into force, and to acts and omissions occurring while the trust was governed by the laws of the Virgin Islands.

(5) In this section, "settlor" includes —

(a) a testator who grants powers under a testamentary trust by the terms of his or her last will and testament; and
(b) a person who by a declaration of trust declares that assets held by him or her beneficially shall be held by him or her on the terms of the trust so declared.'

Most of the provisions of the *Hague Convention on the Law Applicable to Trusts and on their Recognition* have been extended to the BVI and there are now a number of provisions in the Trustee Act (which were added to that statute by the Trustee (Amendment) Act, 1993) which repeat, *verbatim*, some of the provisions in the Convention. One such provision which was originally repeated verbatim was that in section 2(4) of the Trustee Act which provides that "The reservation by the settlor of certain rights and powers are not necessarily inconsistent with the existence of a trust". This provision was modified by the Trustee (Amendment) Act, 2021 which added the words "or grant" after the word "reservation" (i.e. to cater for situations in which powers had been conferred on those other than the settlor).

Whether section 86 would modify the analysis of Birss J

The authors of *Lewin* refer to the statutory provisions in international financial centres (such as those which were contained in the earlier version of section 86 of the Trustee Act) in paragraph 5-040 of that work which reads as follows:

"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."

They go on to say that "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".

Section 86 of the Trustee Act (especially as it is now worded) clearly states that the reservation of many, if not all, the powers which Mr Pugachev had will not, as a consequence, invalidate a BVI trust or prevent it from taking effect in accordance with its terms and so Briss 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 the BVI, albeit that it does not automatically follow that wide powers, such as powers of revocation and general powers of appointment, may nevertheless 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 has.

Conclusion

In summary, therefore, 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 in *Pugachev* would be applied by the BVI's courts i.e. in the absence of provisions such as those in section 86 of the Trustee Act. That said, we are of the opinion that the BVI's courts would not apply that analysis for the reasons set out above. We are furthermore of the opinion that, although there is no decided case on this issue, with the result that we cannot guarantee that our opinion would be endorsed by the BVI's courts, the provisions of section 86 of the Trustee Act are such that any attempt to argue that Birss J's analysis is applicable would very probably not succeed on the basis that the provisions of that section are at odds with such analysis.

As we say, we cannot guarantee that the opinion expressed immediately above would be endorsed by the BVI's courts, but if it is not endorsed, then the following factors might well be relevant:

- Particularly because the Privy Council is the final court of appeal in the BVI, it is, in our opinion, more likely that the analysis of Lord Kitchin in *Webb v Webb* to which we refer above would be applied in relation to an illusory trust challenge (especially one which reaches the Board on appeal) than that of Birss J.
- An illusory trust challenge is, in our opinion, 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).

- 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 or 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.
- It might well be the case that, to the extent that they are upheld, the decisions in *Pugachev* and *Webb v 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 BVI trust deeds.
- 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.
- Given that the publication of the supplement to *Lewin* should be fairly imminent, it might be a good idea to await its publication and then reconsider matters, since the views of the authors of that publication are considered to be quite weighty and it is often referred to in English cases.
- **It is always advisable, when preparing fresh settlements, to confer on a protector (and to reserve to the settlor) only those powers which are actually needed - and ideally to restrict such powers to as few powers of substance as is possible.**

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