

Offshore Trusts— Onshore Litigation

By Gideon Rothschild and Daniel S. Rubin

The effectiveness of the so-called “spendthrift trust” in protecting an individual’s beneficial trust interest from creditors has been firmly established in the United States ever since the Supreme Court’s 1875 landmark decision in *Nichols v. Eaton*, 91 U.S. 716, 725 (1875). (“[T]he doctrine, that the owner of property . . . cannot so dispose of it, but that the object of his bounty . . . must hold it subject to the debts due his creditors . . . is one which we are not prepared to announce as the doctrine of this court.”) With limited exceptions, however, state laws do not permit an individual to place assets in trust for his or her *own* benefit (a so-called “self-settled trust”) while at the same time effectively placing those assets beyond the reach of creditors. For this reason, U.S. residents must look to the laws of select offshore jurisdictions that, seeking to generate trust business and attract U.S. capital, have statutorily extended common law spendthrift protections to self-settled trusts, provided that the trusts were not created or funded in fraud of existing creditors.

Background

The generally accepted domestic rule invalidating self-settled spendthrift trusts has been significantly eroded of late. See, e.g., Alaska Stat. § 34.40.110; Del. Code Ann. tit. 13, § 3573; Nev. Rev. Stat. § 166.040; H.R. 1553, 76th Leg. (Tex.) (which, if enacted, would permit self-settled

spendthrift trusts in Texas). See also, *Estate of Uhl v. Comm’r*, 241 F.2d 867 (7th Cir. 1957); *Estate of German v. Comm’r*, 7 Cl. Ct. 641 (1985) (involving federal estate tax matters, but holding that certain self-settled trust protections are afforded, respectively, under Indiana and Maryland law). Nevertheless, most domestic courts remain unlikely to enforce self-settled spendthrift trust protections on the basis of their own common law rules. This is true whether the settlor’s creditors are present or future, reasonably anticipated or impossible to foresee.

An obvious result is a conflict of laws question of how a U.S. court would treat a foreign self-settled spendthrift trust. In the abstract, at least, if valid under the law that the settlor designates to govern the trust, a self-settled spendthrift trust should also be held valid by a U.S. court. For example, Restatement (Second) Conflict of Laws (Restatement) § 273 provides that a settlor may designate the law of any jurisdiction as governing the settlement, stating:

Whether the interest of a beneficiary of [an inter vivos] trust of movables is assignable by him and can be reached by his creditors is determined . . . by the local law of the state, if any, in which the settlor has manifested an intention that the trust be administered, and otherwise by the local law of the state to which the administration of the trust is most substantially related.

Practically speaking, however, and as is amply demonstrated by the few reported decisions in this area, where the spendthrift protections of a self-settled spendthrift trust conflict with the law of the forum state, the trust must still pass what may be called the “smell test” if the settlor must obtain judicial approval of the spendthrift protections.

This test is an amorphous one and may mean different things to different courts, depending on the individual judge who is presiding. Moreover, those cases that have considered creditor challenges to offshore, self-settled spendthrift trusts have involved seemingly egregious fact patterns that undermine the value of those cases as precedent for future settlors who engage in permissibly prudent asset protection planning. Nevertheless, if only by negative implication, a review of those cases may help to delineate those circumstances in which a U.S. court will uphold an offshore (or for that matter a domestic), self-settled spendthrift trust and those circumstances in which it will not.

In re Brown

In the 1996 bankruptcy case *In re Brown*, No. 95-3072 (Bankr. D. Alaska Mar. 12, 1996), the debtors purported to create a valid self-settled spendthrift trust under the laws of Belize. The debtors argued that the spendthrift provisions protected the trust’s assets from the debtors’ tort judgment creditor under Bankruptcy Code § 541(c)(2),

which provides that “[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title.” Applying Alaska conflict of law principles, the court found it “inappropriate” to apply the law of Belize and determined the law of Alaska to be controlling. Because Alaska law did not allow effective self-settled spendthrift trusts at that time, the court held the Belize trust assets to be includable in the bankruptcy estate.

The *Brown* court, however, was clearly indisposed (and rightly so) to limit itself to the law cited as governing under the trust instrument. At all times, the trust was administered as a mere alter ego of the debtor rather than as a legally distinct entity. The court found the trust to be a “sham” and cited the debtor’s retention of direct control over the trust’s assets as the “primary reason” for finding that the debtor’s transfers to it were fraudulent. It would, therefore, have been incongruous for the court to exclude the trust assets from the bankruptcy estate.

In re Portnoy

In the 1996 bankruptcy case of *In re Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996), the court summarized the pertinent facts by stating that at the heart of the case lay an irrevocable offshore trust into which the debtor placed “virtually all of his assets at a time when he knew that his personal guarantee of his corporation’s indebtedness was about to be called.” Against this backdrop, it is not surprising that the court denied the debtor’s motion for summary judgment (and consequent discharge in bankruptcy). Specifically, the creditor claimed that the debtor’s “continuous concealment” of assets barred a discharge. According to the creditor, the debtor transferred substantially all of his assets to an offshore trust more than one year before the petition date, but remained the de facto owner by continuing to maintain unlimited control

over the assets and concealing the trust within one year of the petition date. The debtor argued that this key legal issue of whether he retained a property interest in the trust ought to be determined under Jersey Channel Islands law rather than New York law. The court, however, concluded that New York had the greater interest in this issue and that the trust, the beneficiaries and the ramifications of the transfer in trust had their most significant impact in the United States. In addition, the court found that applying Jersey’s substantive law would offend strong New York and federal bankruptcy policies.

Interestingly, *Portnoy* did not consider Restatement § 273, which recognizes the invocation of foreign law with regard to the validity of spendthrift trust protections. Instead, the court referred to Restatement § 270, which regards general trust validity and which, unlike Restatement § 273, provides that a court may disregard the settlor’s designation of governing law when the application of that law would violate a strong public policy of the state with which, for the matter at issue, the trust has its most significant relationship. The *Portnoy* court misapplied the conflict of law issue by weighing the jurisdictions’ competing interests and by reference to the public policy of the forum state. The case, however, can perhaps be understood as a result-oriented decision. The debtor was undeserving of a “fresh start” because he could hardly claim to be an “honest but unfortunate debtor.”

In re B.V. Brooks

The 1998 bankruptcy case of *In re B.V. Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998), was a reenactment of *Portnoy* on a Connecticut stage. Although the facts of the case are somewhat sketchy, the debtor transferred stock in several Connecticut corporations to his wife. Over the course of several days, she then transferred the stock to two offshore trusts sited in Bermuda and the Jersey Channel Islands that named the debtor

as the primary beneficiary with the right to receive all income. Although the husband and wife ostensibly created the trusts as part of “. . . a long-term estate and tax planning strategy,” the court apparently regarded the trusts in a less than favorable light. The decision twice refers to the debtor’s acts as a “scheme.” This perception was likely buttressed by the fact that the trusts were funded in 1990 and an involuntary bankruptcy petition was filed against the debtor the following year.

Citing *Portnoy* as precedent, and in another seemingly result-oriented analysis of conflict of law rules, the court found that self-settled spendthrift trusts were contrary to the public policy of Connecticut. On this basis, and without any real consideration of the conflicting interests of Connecticut, Bermuda and the Jersey Channel Islands, the court held the assets of the two trusts includable in the bankruptcy estate.

In re Stephan Jay Lawrence

In re Stephan Jay Lawrence, 227 B.R. 907 (Bankr. S.D. Fla. 1998), is a later 1998 bankruptcy case. Following a 42 month arbitration and just 66 days before an award in excess of \$20 million was entered against him, the debtor funded an offshore trust invoking first the law of the Jersey Channel Islands and then, about a month later, the law of Mauritius as governing. Not surprisingly, the bankruptcy court found that the sole purpose of the trust was to shield the debtor’s assets from a creditor who “was about to obtain a staggering \$20 Million arbitration award against him” and that “[t]he timing of the trust’s creation is further evidence of this intent.” The court also found the debtor’s testimony not to have been credible (and on several occasions perjurious) and the debtor to have been “shockingly less than candid” with the court. Based on those facts, the court denied the debtor his desired discharge in bankruptcy.

Although it is hard to find fault with the court's denial of the discharge, the case is unsettling. Its entire analysis of the conflict of law issue, which should have been central to the holding, was to state that "[t]his Court is persuaded by the decisions of *Portnoy*, *Brooks* and *Cameron*. The Debtor's rights and obligations under the Mauritian Trust are governed by Florida and federal bankruptcy law, which have an overriding interest in the trust, and not the law of the Republic of Mauritius." *Lawrence*, 227 B.R. at 917. Moreover, it is curious that the *Lawrence* court was in part persuaded by the decision of *In re Cameron*, 223 B.R. 20 (S.D. Fla. 1998). In *Cameron*, the court accepted the trust's designated law of New York as controlling, and there necessarily was no conflict of laws issue because neither the designated law nor the law of the forum state permitted self-settled spendthrift trusts.

Anderson

The still-developing case of *FTC v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999), is colloquially known as the *Anderson* case after its individual defendants. Although the *Anderson* facts were as bad as, if not worse than, those in any of the cases discussed above the *Anderson* courts have not yet reached any issues of trust validity or conflict of laws. Instead, the district court and the Ninth Circuit have been tangling with the settlors' alleged contempt of court in failing, pursuant to the preliminary injunction, to repatriate trust assets that they had invested in an offshore trust. Specifically, the district court ordered the settlors, who were also co-trustees of their own trust, as well as the trust protectors, to instruct their foreign co-trustee to repatriate more than \$6 million in profits collected under an alleged Ponzi scheme. In their attempt to comply with the district court's order, the settlors either intentionally invoked, or intentionally failed to preclude the invocation of, an

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“anti-duress” clause in the trust agreement. The invocation of that clause resulted in their removal as trustees and ensured that the assets would not be repatriated pursuant to the order. When the assets were not timely repatriated, the court held the settlors in civil contempt and ordered them jailed pending repatriation of the assets. On appeal, the Ninth Circuit considered the settlors' defense of impossibility of performance.

The Ninth Circuit held the settlors' defense of impossibility of performance inapposite to the facts of the case. The court stated that “[b]ased upon the record before us, we find that the district court's finding that compliance with the repatriation order was possible because the Andersons remain in control of their trust was not clearly erroneous.” *Affordable Media*, 179 F.3d at 1240-41. Nevertheless, on the question of whether the settlor of an offshore asset protection trust can validly claim the impossibility himself or herself through the use of an anti-duress clause, the court stated “[w]e leave for another day the resolution of this more difficult question because we find that the Andersons have not satisfied their burden of proving that compliance with the district court's repatriation order was impossible.” *Id.* at 1240. It is certainly worth noting, however, that the Ninth Circuit had previously held that:

[I]mpossibility of performance is a complete defense to a charge of contempt. An exception exists in the *criminal* context where the impossibility is self-induced. This

court, in dicta, has asserted that self-induced inability is not a defense to a charge of *compensatory* civil contempt. *It is clear, however, that inability—whether or not self-induced—is a complete defense to a charge of coercive civil contempt.*

Falstaff Brewing Corp. v. Miller Brewing Co., 702 F.2d 770, 781 n.7 (1983) (emphasis added) (citations omitted).

The Supreme Court has also repeatedly held impossibility of performance to constitute an absolute defense to civil contempt because that remedy is not intended as a punishment (which would implicate certain constitutional rights and concerns), but rather as a coercive measure presumed necessary to obtain compliance with a court order.

Riechers v. Riechers

In stark contrast to the cases discussed above, the factual background of *Riechers v. Riechers*, Westchester County Supreme Court, Index No. 21833/94 (June 30, 1998), N.Y.L.J., July 8, 1998, p.1, col. 3, a New York matrimonial action, allowed the court to perceive an offshore trust in a much more favorable light. In 1992, following several medical malpractice suits against the settlor, he established a self-settled spendthrift trust under the law of the Cook Islands to guard against the likelihood of future medical malpractice claims. At the same time, the settlor and his wife were having marital difficulties, but the wife was aware that the settlor was establishing the trust. In 1994, the

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wife commenced a divorce action and sought to have the trust included in determining equitable distribution of the marital assets. The court noted that, because the trust was established “for the legitimate purpose of protecting family assets,” it did not have jurisdiction over the trust and that issues such as whether the wife would be entitled to any trust property should be left to a Cook Islands court to decide.

Effectiveness of Trust

The *Riechers* decision, perhaps more than anything else, proves the adage that “bad facts make bad law.” *Riechers* strongly suggests that U.S. courts may be inclined to uphold the protections afforded by an offshore, self-settled spendthrift trust, if the trust was created and funded under appropriate circumstances.

Settlors and their counsel can take two important steps to reduce the potential for adverse consequences. First, the circumstances surrounding the creation or funding of the trust must be as distant as possible from a potential creditor’s claim. A settlor should set up the trust as early as possible for the purpose of guarding against claims arising in the far future,

rather than claims of creditors who have a basis to argue that the settlor anticipated their claims in establishing the trust. Second, the settlor should retain the least amount of control over the trust. This structure requires an independent, if friendly, trustee, who has control of the trust’s assets exclusive of the settlor and perhaps an independent, if friendly, protector, as well. To retain some control, many clients will “wrap” the trust’s assets within a limited partnership or LLC of which the settlor is a 1% general partner (or manager, if an LLC) and the trust is a 99% limited partner (or sole member, if an LLC). Another alternative might be to name the settlor as an investment advisor to the trust, with the power to make all investment, but no distribution, decisions. It is also advisable to give the trustees discretion to distribute trust assets to persons in addition to the settlor via a “sprinkling power.”

Ultimately, however, the offshore trust’s effectiveness as a tool to preserve wealth will most likely not depend on whether a U.S. court accepts the application of foreign trust law when adjudicating a claim against the settlor. If the trust’s assets are located offshore (whether in the jurisdiction of the trust’s governing law or an established financial center such as Switzerland), a creditor with a U.S. judgment will still face significant hurdles before actually being able to levy on any of the trust’s assets. Because some jurisdictions will not recognize foreign judgments, the creditor may be forced to relitigate its entire case against the trust. Moreover, in some jurisdictions the statute of limitations on fraudulent conveyance claims may be as little as two years (which is likely to have already expired by the time suit is brought in that jurisdiction).

Finally, aside from the United States, most common law jurisdictions do not allow lawyers to take matters based on a contingency fee and provide that the losing party to a lawsuit

must pay all of the victor’s expenses, including attorneys’ fees. Combined with an evidentiary standard in some jurisdictions requiring proof beyond a reasonable doubt on fraudulent conveyance claims, assets held in trust may, in the end, prove unreachable notwithstanding a U.S. judgment. At the very least, the process may prove prohibitively expensive for a creditor when the potential reward is so uncertain. These realities seemingly explain reports from reliable sources that the creditors in the *Brooks* matter settled for approximately 50 cents on the dollar and that the creditor in the *Portnoy* matter settled for approximately 20 cents on the dollar.

Conclusion

Although, in the end, other factors may induce a settlement of the creditor’s claims, it cannot be said that offshore spendthrift trusts are ineffective simply because the judgment of a U.S. court remains uncertain. In fact, if a settlor can negotiate a settlement with his creditors on significantly more favorable terms than would have been possible without the trust, the effectiveness of offshore trusts for asset protection purposes remains clear.

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