CHAPTER 14

Funding the Foreign Asset Protection Trust—Onshore v. Offshore*

GIDEON ROTHSCHILD

Introduction

Over a decade ago, Warren E. Burger, the former Chief Justice of the United States Supreme Court, wrote that "[t]o demonstrate that our society is drowning in litigation, one only has to look at the overworked system of justice, the delays in trials, the clogs businessmen face in commerce and a medical profession rendered overcautious for fear of malpractice suits. The litigation explosion, which developed in barely more than a decade beginning in the 1970s, has affected us at all levels. . . ."[1]

Most indicia suggest that this trend has become even more pronounced in the intervening years. As but one example, it is estimated that in the year 2000 alone, more than 10 million new lawsuits were filed in the United States.[2] One reaction to this threat to privately held wealth is the growth of "asset protection planning" as an analogue to more traditional estate-planning practices. For purposes of this chapter, "asset protection planning" is defined as the implementation of planning techniques or structures designed to insulate wealth against the possibility of future potential creditor claims.[3]

For a large number of affluent Americans, asset protection planning has come to include an offshore asset protection trust as an integral component of the plan. The creation of such a trust by a U.S. citizen or resident takes advantage of a dichotomy between the law of most of the 50 states and the law of select foreign jurisdictions. Specifically, certain foreign jurisdictions permit an individual (a "settlor") to create a trust wherein the settlor is named as a discretionary beneficiary without thereby subjecting the trust fund to the settlor's potential future creditor claims. By contrast, most domestic jurisdictions provide that, as a public policy matter, such a "self-settled" trust remains fully available to the settlor's creditors. Significantly, however, under established conflict of law rules, the application of foreign law to a trust created by a United States person should be valid in any domestic jurisdiction notwithstanding that such foreign law might be diametrically opposed to local law.[4] "This permits a person who is domiciled in a state in which restraints on alienation are not permitted to create an inter vivos trust in another state where they are permitted and thereby take advantage of the law of the latter state."[5] Hence, the offshore asset protection trust's use as a valuable tool for United States residents to protect wealth from the possibility of potential future creditor claims.

Notwithstanding the foregoing, however, an extremely aggressive plaintiffs' bar espousing ever-expanding theories of liability, coupled with a seemingly innate judicial bias against the importation of foreign law, raises a question as to the efficacy of offshore asset protection trusts that are ultimately funded only with "onshore" assets (such as domestic banks, brokerage accounts or securities) and which thus remain within the ambit of the court's jurisdiction.[6] Is it necessary then to secure, through the establishment of foreign accounts (i.e., an "exporting the assets" approach), a level of protection that ought to be afforded domestically under established conflict of law rules (i.e., an "importing" of the foreign law)? This chapter will examine and resolve this important asset protection planning question.

Discussion

For many years, offshore asset protection trusts were frequently invested solely with United States situs assets. Such an arrangement provided a settlor with a certain level of asset protection, while at the same time allowing the settlor to continue with the comfort and perceived security of a domestic investment portfolio. In fact, in many instances the settlor would actually continue to directly control the investment portfolio by interposing a domestic limited partnership (in which the settlor was named as the general partner) between the trust and the investment portfolio. The hope for such trusts was that a domestic court adjudicating a potential future creditor's claim would, under established conflict of law rules, respect the validity of the designated foreign governing law. In order to ensure that the trust would protect against creditor claims, however, the foreign trustee would continually evaluate the trust settlor's creditor situation and (likely with the settlor's assistance) expatriate the trust fund if and when it might become necessary to do so. The effect of the trust fund's timely expatriation would be to render moot any potential adverse decision by a domestic court, since offshore asset protection trusts are generally established in jurisdictions that will not enforce foreign judgments.[7] Additionally, it was anticipated that an "anti-duress clause" directing the foreign trustee to ignore any instruction not given as an act of free will would insulate the settlor under an "impossibility of performance" defense for failing to effect repatriation of the assets following the possible issuance of a court order.

Although the aforementioned structure does undoubtedly provide a substantial level of asset protection, four possible issues exist within such structure which could affect its protectiveness, and which could be avoided if it were funded from its initial settlement solely with foreign accounts.

Issue One: The Specter of a Fraudulent Conveyance

The most basic claim against any offshore asset protection trust will be that the settlor's funding of the trust constituted a "fraudulent conveyance." Black's Law Dictionary defines a "fraudulent conveyance" as a " . . . transfer of property, the object of which is to defraud a creditor, or hinder or delay him, or to put such property beyond his reach."[8] One remedy for a fraudulent conveyance is for the court to void the transfer and permit recovery from the transferee.

For purposes of this chapter, it is assumed that the trust's initial settlement was not a fraudulent conveyance because, if it were assumed otherwise, expatriation of the trust fund would arguably be an illegal act in which the trustee would not want to become involved. If, however, the trust fund is initially invested in domestic bank and brokerage accounts, the trustee would likely have no compunction against closing out the trust's domestic accounts and transferring the assets thereof to foreign institutions if, in consultation with the settlor, such action appears necessary to preserve the trust fund from creditors. If the trust fund is invested through a limited partnership in which the settlor is the general partner, expatriation of the trust fund would likely involve a termination of the partnership and the transfer by the settlor, as general partner, of a proportionate share of the partnership's assets offshore to the trustee as the limited partner.

A subsequent expatriation of the trust fund is not as unproblematic, however, as it might at first appear. Although the initial funding of the trust might not be held to have been a fraudulent conveyance, the effect of a subsequent expatriation may provide the creditor with a second opportunity to make a fraudulent conveyance argument. The opportunity to present a second argument is afforded because the previously amorphous "potential future creditor" is, by the time of the subsequent expatriation, likely to have the status of an existing creditor. Although expatriation of the trust fund arguably should not be held to be a fraudulent conveyance under such circumstances (since the movement of funds from one account (onshore) to another account (offshore) should not be considered a "conveyance" for purposes of determining whether a fraudulent conveyance has occurred), there is, of course, no guarantee that a domestic court would necessarily agree under all possible scenarios.

Of course, as a practical matter the trust fund, having been moved offshore, will likely prove inviolate even though a domestic court might ultimately find in favor of the creditor on the fraudulent conveyance issue. Nevertheless, the settlor will likely remain in the United States and, thus, subject to the court's jurisdiction. As a consequence, the best practice is to avoid this issue by having the trust fund invested offshore from the trust's inception.

Issue Two: Attorney Culpability

In each of the 50 states and the District of Columbia, the conduct of attorneys is governed by a code of professional ethics the violation of which may subject an attorney to professional discipline. Although these codes transcend all areas of practice, in that assisting a client in effecting a fraudulent conveyance is an arguably unethical act, asset protection planning is sometimes suggested as raising heightened ethics concerns for attorneys. Additionally, there may be a question in a very few states as to whether, under certain particularly egregious circumstances, an attorney who assists a client in effecting a fraudulent conveyance can also be held civilly liable to the client's creditors for damages.[9]

Although these potential sources of liability are far from certain, most asset protection planning attorneys would be unwilling to accept even a marginal level of risk of sanction or civil damages by coordinating expatriation of the trust fund at a time of increased creditor threat. This is particularly true because most prudent asset protection planning attorneys advise their clients that, for optimal asset protection planning, the trust fund should be invested offshore ab initio. As a consequence of the foregoing, expatriation of the trust fund may have to be accomplished without professional legal assistance—a situation which is clearly not the best possible, since it would likely involve some level of complicity by the settlor, significant delays, and increased transaction costs.

Issue Three: The Threat of Provisional Remedies

Under certain circumstances, the courts are empowered to restrain actions by one party that would have the effect of causing irreparable harm to another party.[10] This power is relevant to offshore asset protection planning, since the effect of the asset protection plan, if the trust fund is actually invested offshore, will be to negate the possibility of a future potential creditor's recovery. More specifically, to the extent that the trust's settlement is thought to have been effected by means of a fraudulent conveyance, it is possible that a court might thus find that irreparable harm would occur if the trust fund were permitted to move offshore.

The basic requirements for the issuance of a preliminary injunction are threefold: first, a showing by the creditor of a likelihood of success on the merits of the creditor's case; second, a resultant irreparable injury to the creditor if the injunction is not granted; and third, that the potential harm to the debtor is outweighed by the probable injury to the creditor if the preliminary injunction is not issued. It is possible that the very existence of an offshore asset protection trust might satisfy the second and third prongs of this test, and the only real proof that a creditor might have to provide a court would be proof of a likelihood of success on the merits.

Under most scenarios, of course, the existence of an offshore asset protection trust, as part and parcel of an individual's personal planning, would not likely be information readily available to most creditors. As a consequence, most creditors would be unable to provide sufficient support for the issuance of a preliminary injunction on the basis of irreparable harm. In other circumstances, however, such as in a matrimonial proceeding, the creditor might have such information available to present to the court. In all events, even the possibility of a provisional remedy, such as a preliminary injunction being issued, may warrant that the trust fund be invested offshore from the original settlement of the trust.

Issue Four: The Prospect of Contempt

Finally, perhaps the most significant issue relates to the prospect of the settlor being held in contempt for failing to repatriate the trust fund following the issuance of a court order. This issue was highlighted when the Ninth Circuit Court of Appeals issued its decision in *Federal Trade Commission v. Affordable Media, LLC, et al.*[11] That case held, in part, that "[i]n the asset protection trust context . . . the burden on the party asserting an impossibility defense [to a civil contempt of court charge] will be particularly high because of the likelihood that any attempted compliance with the court's order will be merely a charade rather than a good faith effort to comply."[12] As a result of *Affordable Media, LLC*, the structure of offshore asset protection trusts began to evolve so as to minimize or negate any suggestion of the settlor having control over the trust.[13] This evolution gained even more momentum when subsequent cases began to suggest that, irrespective of control, the impossibility of performance defense may not be respected, and the settlor might be incarcerated for contempt, where the impossibility was self-created within a close temporal nexus to the issuance of the court order.[14] Thus, although the trust fund may itself be immune from the consequences of an adverse determination by a domestic court, settlors are well advised not to create a structure which, as a by-product of such protection, implicates a possible loss of the settlor's personal liberty.

These cases, therefore, recommend against expatriation of the trust's assets shortly before (and in particular, at any time after) a creditor problem has developed, since the fact of expatriation may be seen as evidence of the settlor's control over the trust (and, in fact, the settlor may, under certain trust structures, actually need to be involved to some greater or lesser extent in the expatriation). Therefore, if the protection afforded by the asset protection trust structure requires that the trust fund be held outside of the jurisdiction at such time as a formerly potential future creditor claim may be reduced to judgment, the trust fund should be invested offshore from the trust's inception.

Conclusion

Each of the foregoing issues demonstrates a potential difficulty in effecting a timely expatriation of the trust fund after a creditor issue has developed. To the extent that such difficulties prove insurmountable, the offshore asset protection trust will be forced into the position of "importing" the foreign law stated to govern the trust, and the trustees will be compelled to defend the trust before a domestic court. Whether the offshore asset protection trust structure will then suffice to protect the trust fund necessarily becomes dependent upon a domestic court coming to the correct legal conclusion on an admittedly esoteric conflict of law issue. Although strong arguments support the application of foreign law to the trust (and, thereby, the protection afforded to the trust fund notwithstanding the fact of its self-settlement), litigated matters do not lend themselves to guaranteed results—especially in the somewhat controversial asset protection planning arena.

Moreover, with some thought and creativity, the perceived benefits of an offshore trust with onshore assets can be obtained even though the trust structure is purely offshore. For example, the securities of domestic corporations can very easily be held in a foreign account in the name of the trust. The settlor's domestic investment adviser might then be named to such account and provided with the authority to change the investment of the account without authority to change the institution at which the account is held (thereby preventing repatriation upon a court order).[15] Finally, an independent foreign protector can be appointed to oversee the trust's accounts with an instruction to the foreign financial institutions that distributions can be made only upon the concurrent signature consent of both the trustee and the protector. This provides the settlor with the comfort of knowing that the assets transferred into the trust fund will continue to be professionally managed by a trusted adviser and that the trustee and the protector will act as a "check and balance" vis-à-vis each other. As a consequence of the foregoing, the settlor sacrifices little, if anything, in structuring an offshore asset protection trust that is truly "offshore" in every important respect and which, thereby, garners every possible legal advantage against the settlor's potential future creditors.

Notes

1. Warren E. Burger, *Too Many Lawyers, Too Many Suits*, N.Y. TIMES, May 12, 1991, § 7 (Book Review), at 12.

2. James Olan Hutcheson & John House, *The Best Defense*, FINANCIAL PLANNING, April 2003, at 86.

3. *See*, *e.g.*, Rosen & Rothschild, 810-2nd T.M. at A-1, ASSET PROTECTION PLANNING.

4. *See*, *e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 273 (1971) ("[w]hether 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 is to be administered. . . ."). *See also Convention on the Law Applicable to Trusts and on Their Recognition*, Oct. 8, 1984, art. 6, *reprinted* in 23 I.L.M. 1389 (1984) ("A trust shall be governed by the law chosen by the settlor."). *But cf.* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 270, which states, in relevant part, that a trust is valid under the law chosen by the settlor provided that "the application of its law does not violate a strong public policy of the state with which, *as to the matter at issue*, the trust has its most significant relationship" (emphasis added). Note that section 273 of the RESTATEMENT does not contain any public policy exception.

5. AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 626, at 419 (4th ed. 1989).

6. *See*, *e.g.*, Nastro v. D'Onofrio, 263 F. Supp. 2d 446 (2003), Sattin v. Brooks (*In re* Brooks), 217 B.R. 98 (Bankr. D. Conn. 1998), *and* Marine Midland Bank v. Portnoy (*In re* Portnoy), 201 B.R. 685 (Bankr. S.D.N.Y. 1996), as examples of cases with egregious facts in which a domestic court declined to apply foreign law.

7. *See*, *e.g.*, Section 13D of the International Trusts Act (1984) of the Cook Islands.

8. BLACK'S LAW DICTIONARY 662 (6th ed. 1990), *citing to* Dean v. Davis, 242 U.S. 438, 37 S.Ct. 130, 61 L. Ed. 419 (1917).

9. *See, e.g.*, Morganroth & Morganroth v. Norris, McLaughlin & Marcus, P.C., et al., 331 F.3d 406 (3d Cir. 2003). *Cf.* Litchfield Asset Mgmt. Corp. v. Howell, et al. (App. Ct. Conn. 2002).

10. *See, e.g.,* Bank of America, N.A. v. Brian D. Weese, et al., Case No. 03-C-01-001892 (Cir. Ct. Baltimore Cty., Md., 2001); *cf.* Grupo Mexicano de Desarrollo, S.A., et al v. Alliance Bond Fund, Inc., et al., 527 U.S. 308 (1999).

11. 179 F.3d 1228 (9th Cir. 1999); 1999 U.S. App. LEXIS 13130.

12. *Id*. at 1241; 1999 U.S. App. LEXIS 13130 at *34-35.

13. *See*, *e.g.*, Gideon Rothschild & Daniel S. Rubin, *Asset Protection After* Anderson: *Much Ado about Nothing?*, 26 ESTATE PLANNING 10 at 466 (Dec. 1999).

14. *See* Lawrence v. Chapter 7 Trustee, 251 B.R. 630, 652 (S.D. Fla. 2000); *In re* Coker (The American Insurance Co. v. Coker), 251 B.R. 902, 905 (M.D. Fla. 2000). *See also* Pesaplastic, C.A. v. Cincinnati Milacron Co., 799 F.2d 1510, 1521 (11th Cir. 1986); *In re* Power Recovery Systems, Inc., 950 F.2d 798, 803 (1st Cir. 1991).

15. Admittedly, the ownership of U.S. securities by a foreign trust, although recorded on the books and records of a foreign institution, may nevertheless be subject to attachment by virtue of the fact that DTC is the central repository for U.S. securities.