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CHAPTER 9

Asset Protection Trusts for U.S. and Foreign Persons*

SYNOPSIS

* This chapter was originally written by Carl L. Estes, II, Esq., Vinson & Elkins, Houston, Texas. It has since been updated and revised by the author.

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§ 9.01 Summary of this Chapter

§ 9.02 What Is an Asset Protection Trust? Asset protection trusts have existed in the United States for over 100 years, and some would say for much longer than that in England. Early asset protection trusts were "spendthrift" trusts to protect spendthrift heirs who were made trust beneficiaries. The controversy in more recent times has been over so-called "self-settled" trusts which are exclusively or, at the trustee's discretion, in part for the benefit of the settlor.

§ 9.03 Trust Situs. Selecting an offshore situs for a trust can provide a superior level of asset protection, but sometimes creates an inference that the settlor has an improper purpose. A trust's situs is determined by trustee's residence, law governing the trust and where it is administered. A country's rules regarding fraudulent transfers, restraints on alienation, conflict of law principles and transfers of situs are key reasons for choosing particular situs. Custodians holding trust assets should be located outside country of trust's situs.

§ 9.04 Court Jurisdiction and Enforcement of Orders. U.S. courts' perception of their in personam jurisdiction is extremely broad so that they are likely to hold that trustee of any offshore asset protection trust is subject to their jurisdiction. Under common law principles, however, courts in trust's situs will enforce U.S. court's order only if it is for fixed monetary amount and trustee was doing business in U.S. under common-law standards.

§ 9.05 State Law Remedies. Under U.S. state law, creditors can seize not only the debtor's property but also property he has previously transferred to others if the transfer was either sham or fraudulent. Fraudulent transfers are made with actual intent to hinder, delay or defraud creditors or, under certain conditions, when the debtor did not receive adequate consideration for transfer. Intent is determined by the existence (or absence) of certain fact patterns (badges of fraud), such as transfers to insiders, concealed transfers and threatened or pending legal action.

§ 9.06 Bankruptcy. Debtor's assets (including those brought back under fraudulent transfer rules) become bankruptcy estate that is liquidated and whose proceeds are distributed to creditors. Interests in spendthrift trusts and powers that cannot benefit debtor are exempted. Debtor is entitled to discharge of most kinds of debts unless he has engaged in certain types of conduct. Trust beneficiaries may be liable for some part of grantor-debtor's unpaid debts. Foreign bankrupt's creditors can receive substantial assistance from U.S. courts in pursuing his U.S. assets.

§ 9.07 Planning for Situs Change for Asset Protection Trust. Trust instrument should expressly provide for change of situs under certain circumstances. Situs of trust can be changed by modification, termination and re-creation or decanting. Changes by modification are smoothest because trust does not terminate. Changes by termination and re-creation or decanting can create substantial tax liability.

§ 9.08 Drafting for Change of Situs. Most practitioners now favor including a provision in the trust instrument which permits the trustee, or the trust protector, purely as a matter of discretion, to change the situs of the trust for any reason deemed to be in the interest of the trust beneficiaries. In addition, a settlor may wish to include in the

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trust instrument a provision for automatic and immediate change of situs of the trust, often to a pre-determined second jurisdiction, in defined circumstances.

§ 9.09 Drafting Restraints on Alienation. Restraint on alienation of trust interest may protect interest from expropriating government and creditors. Validity of restraint is governed by law of trust situs. Certain direct restraints are generally valid under U.S. law, but not under English law. Validity of indirect restraints depends on number of factors including: type of interest involved (income or principal); language used in creating restraint; and public policies of trust-situs jurisdiction.

§ 9.10 Pre-Emergency Event Planning Considerations. Trust must be created prior to occurrence of emergency event. Most Settlors desire high degree of control over trust assets or trustee, but Settlor's control prior to event may defeat purpose of trust. One solution is to appoint Protector with power of direction over trust assets and power to remove trustee. Other solutions involve creation of holding company (domestic or foreign) or limited partnership whose shares are held by trust.

§ 9.11 U.S. Tax Aspects of Asset Protection Trust. Asset protection trust is generally treated as grantor trust (income is taxed to grantor) even after emergency event. Transfer of assets to trust is not taxable gift in most cases. Trust assets are includable in settlor's gross estate.

§ 9.12 The Protector. Settlor of asset protection trust can avoid potential problems caused by retaining too much control over trust or trustee by granting control to Protector. Protector should be person (corporate or individual) who is not settlor, trustee or beneficiary, who resides outside relevant jurisdictions, and who has few economic ties to those jurisdictions. Protector should be allowed to designate his own successor.

§ 9.13 Adviser Liability Issues. When rendering advice regarding asset protection trust, U.S. lawyer must be aware of potential liabilities, under rules of professional conduct, criminal laws, and tort and other civil statutes, that could attach to suggesting asset protection trust strategy for client. Potential for liability is greatly enhanced if trust is created after client files bankruptcy petition.

§ 9.14 Goals of Asset Protection Trusts for Foreign Persons. Asset protection trust may be created to protect foreign investor's U.S. assets from: (1) expropriation in grantor's home country or in intermediate, offshore jurisdiction; (2) freezing or vesting by United States; (3) political turmoil in home country or offshore jurisdiction; and (4) bankruptcy in home country. When choosing situs of asset protection trust, advisor should consider potential forum jurisdiction's conflict-of-law principles and hospitality toward trust concept.

§ 9.15 Protection Against Expropriation. Under Act of State Doctrine, United States does not interfere with foreign country's expropriation of property located within its territory. Even if expropriated property is located within United States, foreign law is applied in most cases unless application of such law would violate U.S. public policy. Trust may protect U.S. assets from expropriation.

§ 9.16 Freezing Assets by United States—International Emergency Economic

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Powers Act. United States can freeze U.S. assets of foreign investors in cases of national emergency. Foreign investor can retrieve U.S. assets if he leaves country affected by freeze for country unaffected by freeze. Foreign corporations cannot retrieve U.S. assets during freeze because they cannot leave affected country. Trust can benefit those beneficiaries who leave affected country.

§ 9.17 Vesting Assets by United States—Trading With the Enemy Act. United States can seize property belonging to or controlled by enemy during war. If beneficiary's interest in trust vests while he is enemy, United States can seize his interest. If beneficiary's interest in trust does not vest while he is enemy, United States cannot seize his interest. Trust assets may be further protected if trust situs is non-enemy foreign jurisdiction.

§ 9.18 Drafting Elements of Asset Protection Trust. Asset protection trust should be created under laws of a jurisdiction providing that contingent remainder interests in personal property do not vest until occurrence of contingency. Trust instrument should contain escape clause and provide for Protector. Trust instrument should give trustee discretion to make distributions of income and principal and should give settlor limited power of appointment.

§ 9.19 Suggested Clauses for Asset Protection Trust. Trust instrument should define emergency events and provide terms for appointment of trustee and Protector. Trust instrument should designate which country's law governs trust administration and provide for change of governing law under certain circumstances.

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§ 9.02 What Is an Asset Protection Trust?

Asset protection trusts have existed in the United States for over 100 years, and some would say for much longer than that in England. Early asset protection trusts were "spendthrift" trusts to protect spendthrift heirs who were made trust beneficiaries. The controversy in more recent times has been over so-called "self-settled" trusts which are exclusively or, at the trustee's discretion, in part for the benefit of the settlor.

[1] History of Asset Protection Trusts

In simplest terms, an asset protection trust is a trust which is intended to the greatest extent possible to protect the trust assets from claims of the settlor's or the beneficiary's creditors, and from the beneficiary's own extravagance. The latter type of trust is known generally as a "spendthrift" trust in that it may by the terms of the trust itself, or by state law, prevent the trust beneficiary from voluntary or involuntary alienation of his interest in the trust. If not barred by state law or a provision in the trust deed, a trust beneficiary could sell or mortgage his interest in the trust, and his creditors could freely attach his interest.[1]

Asset protection trusts seem to have evolved in the United States in the late 19th century. Provisions in a trust deed barring alienation of the beneficiary's interest have been enforced in the United States at least since 1875.[2] Now state law may limit a beneficiary's right to anticipate his or her interest.[3] Some would argue that trusts from their beginning as used in England in the 14th century have existed to protect assets from creditors and from incapable beneficiaries,[4] but in general England does not recognize spendthrift trusts today.[5] Many variants of asset protection trusts are now in use – so called "Armageddon" trusts, which an individual or a corporation creates initially in revocable form but which becomes irrevocable, and may move from one jurisdiction to another in the event of catastrophic changes in the domicile of the settlor,[6] special needs trusts or supplemental benefits trusts to allow a settlor to provide for extra benefits for a disabled relative without the trust assets or income being taken into account in determining state aid available to the beneficiary[7] and, more problematic as a matter of policy, so-called Medicaid protection trusts, intended if created early enough to protect the settlor's own assets after he or she begins receiving

§ 9.02

[1] Restatement (Third) of Trusts § 56.

[2] Nichols v. Eaton, 91 U.S. 716 (1875); *see* Restatement (Second) of Trusts § 152.

[3] N.Y. Estates, Powers and Trusts Law § 7-1.5.

[4] *See* Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L. J. 625 (1995), discussed in § 8.02, text for Note 2.

[5] 2 Bogert, The Law of Trusts and Trustees § 221 (2d rev. ed. 1979).

[6] Such trusts were relatively common in Europe before the Second World War. Perhaps the most famous was the trust created in Connecticut by the Phillips Corporation, a Netherlands corporation, to hold its North American assets. With the onset of the war, the trust became an irrevocable trust for the benefit of Phillips' shareholders.

[7] N.Y. Estates, Powers and Trusts Law § 7-1.12.

Medicaid benefits such that his or her assets would normally be subject to capture by the state to reimburse it for expenses incurred to care for the settlor.[8]

The most controversial version of an asset protection trust is a self-settled trust, created by a settlor in the place of his domicile or in another state or offshore jurisdiction, in which the settlor reserves a fixed or discretionary interest for himself. (In contemporary discussions, this is what is generally meant by an "asset protection trust.") Such a trust is ignored for income tax purposes,[9] and for estate tax purposes if the settlor has a right to any income or assets of the trust[10] or if the settlor's creditors have a right to attach the assets of the trust under applicable law.[11] These are the types of trusts that this chapter will focus upon.

Historically, it was almost universally the case that the assets of a self-settled trust were subject to attachment by the settlor's creditors.[12] This remains the case in most jurisdictions today,[13] but some states of the United States, led by Alaska, Delaware, Missouri, Nevada, Rhode Island and South Dakota, and many offshore jurisdictions now offer varying levels of asset protection for self-settled trusts. In 2007, the American College of Trust and Estate Counsel created an Asset Protection Committee of its members to monitor and discuss developments in this area. Asset protection trusts thus seem to have found a receptive audience and should now be considered for their utility for many clients. Indeed some have argued that an estate planning attorney may have a duty to consider asset protection trusts.[14]

[2] What Clients Can Benefit from an Asset Protection Trust

This chapter focuses on individuals who are residents and nonresidents of the United States. See § 9.14, below, for discussion of the reasons why foreign persons might want to create an asset protection trust. The trust acts as an insurance policy; it is designed to ameliorate the economic consequences of certain *future* events. Where the client is already in financial difficulty, or an expropriation order has been issued, the creation of an asset protection trust is likely to be of little use and may even have harmful consequences. For example, if assets are transferred to the trust too late in the game, the settlor may be denied a discharge at the end of a bankruptcy proceeding as discussed in § 9.06[5], below. For these reasons, he is unlikely to find a lawyer or a trustee who will be willing to assist him. Therefore, the client referred to in this chapter is one who can act without causing or reacting to an impending bankruptcy, expropriation and the like.

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[8] *See* discussion at Eason, *Policy, Logic and Persuasion in the Evolving Realm of Trust Asset Protection*, 27 Cardozo L. Rev. 2621 (2006) at 2679 et seq. The author found Professor Eason's article very thorough and helpful in preparing this introductory summary.

[9] I.R.C. §§ 673, 677.

[10] I.R.C. § 2036.

[11] Treas. Reg. § 20.2036-1(b)(2).

[12] Griswold, Spendthrift Trusts § 282 (2d ed. 1947).

[13] N.Y. Estates, Powers and Trusts Law § 7-3.1.

[14] Osborne and Terrill, Fundamentals of Asset Protection Planning, 31 ACTEC Journal 319 (2006).

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What situations may prompt a client to seek the shelter of an asset protection trust? Here are a few examples:

- The client will be acting as executor for an estate with a large amount of land holdings. She is worried about the potential liability imposed by federal and state law for environmental hazards on the property.
- The client believes that his daughter-in-law may soon be suing his son for divorce. He wants to provide for his son and his grandchildren without putting the property within reach of his daughter-in-law.
- A professional client (doctor, lawyer, architect, *etc.*) is not comfortable with the amount of her liability insurance or cannot obtain insurance at a reasonable price.
- The client will soon be selling a business and realizing substantial profits. He is worried about being sued for problems connected with the business arising after the sale.
- The client is in a very profitable, but highly litigious business such as investment banking, and would like to insulate some prudent portion of his assets from potential claims of future creditors.
- The client would like to create an "intentionally defective" grantor trust for the benefit of his children. As a U.S. person, if he creates an irrevocable foreign trust for the benefit of his U.S. citizen descendants, it will be a "grantor" trust for U.S. income tax purposes, the income of which is taxable to him while being accumulated for, or distributed to, his descendants.[15] As he pays his descendants' or the trust's income tax for the balance of his life, he depletes his free assets while retaining no interest in the trust.

In short, there are a multitude of entirely appropriate reasons to create an asset protection trust. There are also clearly inappropriate reasons such as:

- The client expects his wife to file for divorce from him, or indeed she has already done so, and he wishes to shield his assets from her.
- The client has already been sued and wishes to place his assets beyond the claims of creditors.
- The client is a surgeon who has not yet been sued but who just performed an operation in which the patient died and she fears she will be sued.

While the foregoing examples are clearly "over the line," the fundamental issue today for asset protection trusts, as a matter of law and policy, is confronted in the following situation:

- The client has no current creditors and no knowledge of any action or failure to act that may give rise to a claim against him, but as a matter of prudence, his lawyer advises him to place a fraction of all of his assets in an asset protection trust either within or without the United States, in which he has no

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[15] I.R.C. § 679.

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> fixed interest but the trustee (whom he presumably trusts to protect his interests) has discretion to distribute income or principal to him. Should such a trust protect its assets from future creditors of the settlor? What if the trustee has regularly made distributions to the settlor until a creditor/tort judgment holder/former wife/dependent child files a claim?

This is the current center of debate with respect to asset protection trusts.

As a matter of policy, all states of the United States agree that certain assets of a debtor should and will be protected from creditors. The simplest way for an individual to protect his or her assets from potential future creditors is to transfer title to the assets to his or her spouse.[16] Most judicial decisions protect asset transfers to spouses if made before a lawsuit is filed or creditors' claims mature.[17] In today's world, however, some individuals are reluctant to transfer outright title to their assets, or significant assets, to their spouse, out of fear of future marital disputes. (The author was once told by a friend of his father-in-law, "I put the house in her name and she changed the locks.")

State policy in protecting a debtor's assets from creditors is demonstrated by the laws protecting life insurance contracts from the creditors of the insured. Presumably, legislators favor supporting the insured's dependents over interests of his creditors, thereby limiting claims upon the state to support indigent widows and orphans of decedents whose life insurance was liquidated by creditors. These laws vary greatly from state to state, in particular as to the rights of creditors of the insured (at least where he or she purchased the policy and is paying premiums on it) to either levy against the policy or claim some interest in the cash value or proceeds of the policy.[18]

[3] Summary of Trust Objectives, Legitimate and Illegitimate

The principal objectives of an asset protection trust are to have:

(1) the trust respected (*i.e.,* recognized as valid and not a sham);

(2) the trust assets protected by law against the effective enforcement of claims by third parties against the settlor;

(3) any beneficial interest in the trust that third parties can reach have little value in their hands; and

(4) the settlor be able to obtain a discharge of most debts in a bankruptcy proceeding.

The first objective is controlled largely by the form of the transactions and whether

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[16] See, for example, Klein v. Klein, 112 N.Y.S.2d 546 (N.Y. Sup. Ct. 1952); Palumbo v. Palumbo, 284 N.Y.S.2d 884 (N.Y. Sup. Ct. 1967).

[17] The Florida case of Hurlbert v. Shackleton, 560 So. 2d 1276 (Fla. Ct. App. 1990) examines the difference between possible and likely future creditors at the time of a transfer to the spouse.

[18] For example, New York Insurance Law § 3212. For an excellent summary of the laws of the various states on protection from creditors given to life insurance. see Gideon Rothschild and Daniel Rubin, Asset Protection, published as Chapter 4 of *The PPLI Solution: Delivering Wealth Accumulation, Tax Efficiency and Asset Protection Through Private Placement Life Insurance*, Bloomberg Press (2005), Kirk Loury, editor.

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that form has had economic consequences, that is, has not been ignored by the settlor or the trustee. The second objective depends on the existence of a legal barrier that denies creditors an effective avoidance remedy with respect to transfers made to the trust. The third objective requires that the beneficial interest either be subject to a valid restraint on its alienation or be a discretionary one. The fourth objective depends on whether the settlor has transferred assets within a defined period of the filing of a bankruptcy petition with the actual intent to hinder, delay, or defraud creditors or has taken certain other actions during the bankruptcy proceedings. The defined period for fraudulent transfers under the Bankruptcy Code was formerly one year prior to the debtor's filing for bankruptcy. This period was extended to two years by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[19] Transfers to self-settled trusts may be recaptured if made within 10 years of the debtor's filing for bankruptcy if the transfer in trust was made with the intent to hinder, delay or defraud present or future creditors.[20] See § 9.06, below.

An effective asset protection trust divorces the settlor from the legal ownership of the assets placed in the trust. Creditors, because they stand in the place of the settlor with respect to nonexempt property, no longer have direct access to those assets. A transfer to the trust triggers the running of statutory time periods for fraudulent transfers, so that as the trust ages, it affords an increased level of protection. Such a trust can offer the settlor:

(1) a reasonable degree of control or influence over the trust's investment and distribution policy;

(2) the opportunity to change the trustee; and

(3) the assurance that when (or if) it is "safe" to do so, the trust assets will re-vest in the settlor.

The trust will not alter the settlor's tax position under the Internal Revenue Code if he or she can benefit from the trust: that is, it will be tax-neutral. See § 9.11[1], below. Finally, the creation of, transfers to, and operation of the trust must not violate any criminal law or in any way inhibit the settlor's willingness to disclose to any court all relevant information he possesses and to carry out any act ordered by a court. Where the act required involves a request, demand, or order to a third party over whom the court does not have jurisdiction, a court cannot legitimately hold the party before it responsible for any failure of the required act to have the desired consequences (*i.e.,* compliance by the third party with the request, demand, or order) unless that third party is controlled by the party before the court. For this reason, it is necessary to ensure that the settlor does not control the trustee of an asset protection trust. This is the source of one of the principal tensions in asset protection trusts, because the settlor normally wants as much control as possible over the trustee. See the discussion of civil contempt orders in § 9.04[6], below.

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[19] 11 U.S.C. § 548(a), (b).

[20] 11 U.S.C. § 548(e).

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§ 9.03 Trust Situs

Selecting an offshore situs for a trust can provide a superior level of asset protection, but sometimes creates an inference that the settlor has an improper purpose. A trust's situs is determined by trustee's residence, law governing the trust and where it is administered. A country's rules regarding fraudulent transfers, restraints on alienation, conflict of law principles and transfers of situs are key reasons for choosing particular situs. Custodians holding trust assets should be located outside country of trust's situs.

The discussion of domestic and foreign trusts in this section is solely in the context of trust and commercial law and is not concerned with the classification of the trust under the Internal Revenue Code.

[1] Domestic Versus Foreign

An asset protection trust is, after all, a trust. As far as trust operations generally are concerned, the laws of the various states are perfectly adequate. The powers and duties of trustees and the rights of beneficiaries are recognized and enforced. No country has greater political stability than the United States. If these were the only criteria, as they typically are when the settlor is not a beneficiary and has no concerns about future creditors, a domestic situs would be a foregone conclusion for most United States settlors.[1] However, when the nature of the settlor's interest in the trust and the reach of any future creditors that the settlor may have are important considerations, as they are in the case of an asset protection trust, a domestic trust may be a poor choice.

Under the fraudulent transfer statutes of every state and under the Federal Bankruptcy Code,[2] a settlor's creditors (including those whose claims arise in the future) have the right to reach assets transferred by the settlor if he made the transfer with the actual intent "to hinder, delay, or defraud" his creditors. See discussion at § 9.05[2] and § 9.06[6], below. The principle on which these rules rest is not unique to the United States. It originated in England and are found in almost every common-law jurisdiction. However, this principle has been implemented differently in some of these other common-law countries and it is precisely such differences that make a foreign trust the vehicle of choice for U.S. settlors. For somewhat different reasons an offshore trust is also the better choice to protect the U.S. assets of foreign investors. See § 9.14, below.

[2] Meaning of Situs of a Trust

A trust can have multiple siti:

(1) the residence of the trustee;

(2) the place where the trust is administered; and

(3) the jurisdiction under whose law the trust is created.

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§ 9.03

[1] Of course, a settlor may have good reason for locating a trust abroad apart from asset protection, including tax reasons or because the trust is for foreign beneficiaries.

[2] 11 U.S.C. § 101 *et seq.*

Other authors have suggested that it is possible to exploit these different siti. For example, the trustee could be resident in a civil-law country that has a favorable tax treaty with the United States with the trust itself created under the law of another common-law country.[3] However, using different jurisdictions must be a destabilizing influence on what is already a delicate structure, particularly in trying to ensure that a particular "situs jurisdiction" will apply its creditors'-rights laws to the trust. It is not enough simply to specify that the law of that foreign country applies, because this is likely to be construed by U.S. courts as referring to the law governing the interpretation of the trust and not to the law governing its administration (which would include the laws relating to creditors' rights as against the trust assets).[4] There must be a nexus (sufficient contacts between the settlor or the trustee and that foreign country) to justify a court's honoring a choice-of-law provision in the trust agreement. This nexus requirement so limits planning opportunities that multi-situs trusts are seldom tried. Therefore, as used in this chapter, the situs of a trust refers to the single jurisdiction:

(1) whose laws govern the administration of the trust;

(2) which is administered therein;

(3) by a resident trustee.

A change of situs involves a change in all three of these elements.

The residence country is selected when the trustee is chosen. The place of administration is the trustee's residence, unless the trust agreement provides to the contrary.[5] The trust instrument should not rest on this assumption, but should specify that the place of administration is the residence of the trustee, which will be helpful in supporting a change in that place of administration if a new trustee, resident in a different jurisdiction, is appointed.

The law under which the trust is created should also to be fixed in the trust agreement, and that law specifically be made applicable to both the interpretation and the administration of the trust. This should prevent U.S. courts from making a distinction between the law governing the construction of the trust terms and the law governing the administration of the trust. There is no such distinction under English law: a single "proper law" exists for both the interpretation and the administration of the trust.[6] England has the same kind of nexus requirement for respecting a choice-of-law clause, so that the available choices are not unlimited:

> Although there is no express English decision to this effect, there can be no

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[3] *See* Zaritsky, 854 T.M., *Foreign Trusts, Estates, and Beneficiaries* A-42 (1993).

[4] *See* Restatement (Second) Conflict of Laws § 268 (construction), § 271 (administration).

[5] *See* Stetson v. Morgan Guaranty Trust Co., 164 A.2d 239 (Conn. Super. Ct. 1960); *In re* Shipman's Will, 40 N.Y.S.2d 373 (Sur. Ct. 1942). The Hague Convention on the Law Applicable to Trusts and Their Recognition generally recognizes the settlor's selection of the law to govern the trust. See Chapter 8, § 8.03[2].

[6] Chellaram v. Chellaram, Ch. 409 (1985).

> doubt that the settlor could select the proper law, at any rate if the trust has a substantial connection with the chosen law. The settlor's freedom of choice might be subject to the requirements of English public policy; for example, an English court would presumably not allow a settlor creating an essentially English trust to evade the English rule against perpetuities by selecting as the proper law of the trust the law of some foreign country where the rule does not apply.[7]

A foreign trust does not necessarily entail tax consequences that are different from those arising out of the use of a domestic trust. A foreign trust involves different and more extensive tax reporting requirements. See § 9.11, below, for a more detailed discussion of U.S. taxes. However, these reporting obligations should not be seen as a detriment, because they are simply mechanisms for informing the Internal Revenue Service that certain events have occurred and for keeping the Service informed about the continuing consequences of those events.

Using a foreign situs for the asset protection trust introduces the issue of that situs jurisdiction's stability. The best locations for these trusts are likely to be British colonies or small, new countries that were formerly British colonies. However, the governments or laws of these places can be radically changed with little warning. As a consequence, the trust arrangement should incorporate a mechanism for moving the trust's situs under certain circumstances. It must be recognized, however, that those mechanisms have not been tested to any great extent. The changes against which they guard either have not happened or, at least, the effectiveness of those mechanisms has not been subjected to scrutiny by a court.

[3] Selection of a Situs

Choosing the foreign situs for the trust is not a simple task, because the substantive and procedural law of that country is more critical to the creation and effective operation of asset protection trusts than to other trusts. The initial question is the degree of recognition that the jurisdiction accords the trust concept. This ranges:

(1) from civil-law states without a trust law (*e.g.,* Switzerland);

(2) to civil-law states with a statutory trust law (*e.g.,* Panama);

(3) to common-law jurisdictions with sketchy statutory law (*e.g.,* Isle of Man); and

(4) to common-law states with extensive statutory trust law (*e.g.,* Turks and Caicos Islands).

Finally, a few common-law jurisdictions exist (*e.g.,* the Cook Islands) that have enacted special legislation applicable only to "international" or "offshore" trusts whose settlor and beneficiaries are not locally resident.

Trusts are creatures of equity that are based on the notion of fairness. Any attempt by creditors or other adverse parties to reach the property in an asset protection trust

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[7] 2 Dicey & Morris, The Conflict of Laws 1074 (Lawrence Collins gen. ed., 11th ed., Stevens & Sons Ltd. 1987).

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will likely include a claim that such a trust is an abuse of the trust notion or, at least, pushes the concept beyond its legitimate boundaries. Therefore, it is critical that the jurisdiction's trust law be well developed, which is not likely to be the case in any civil-law state, such as Switzerland or Panama.

For an asset protection trust to accomplish its mission, the jurisdiction's substantive law regarding the following must all be favorable:

(1) the extent to which creditors can have transfers to a trust avoided as fraudulent under bankruptcy or similar creditors'-rights laws (see §§ 9.05, 9.06, below);

(2) the effect and validity of trust provisions for the change of the situs of the trust (see § 9.07, below); and

(3) the validity of restraints on the alienation of beneficial interests in trusts (see § 9.09, below).

Caution: Jurisdictions, such as the Isle of Man and the Channel Islands, which lack specific legislation on the fraudulent transfer issue should probably be avoided as a trust situs.

[a] The Cook Islands. The Cook Islands may be an attractive choice for a trust situs. The Cook Islands law requires that a fraudulent transfer be proved by a creditor beyond a reasonable doubt, which is a heavier burden of proof for the creditor to meet than the "preponderance of the evidence" or even a "clear and convincing" standard typically applied in the United States.[8] The Cook Islands also permit the useof self-settled spendthrift trusts and have a significantly shorter limitation period in which creditors are permitted to challenge transfers as compared to a limitations period under the Uniform Fraudulent Conveyance Act.

The Cook Islands have since the enactment of the International Trust Act 1984 been seeking international trust business, with an emphasis on asset protection. Section 13D of the International Trust Act 1984 provides that, notwithstanding any treaties or statutes, foreign judgments are not enforceable as such against an international trust in the Cook Islands. Instead, the creditor/claimant must bring an action in the Cook Islands to set aside the trust. As noted above, Section 13B of the Act requires, in order to set aside the trust, that the creditor prove "beyond reasonable doubt" both (a) that the settlement of assets in the trust by the debtor had a "principal intent to defraud that creditor of the settlor" and (b) that the settlement left the settlor either insolvent or at least without sufficient property to satisfy the claim of that creditor. Section 13B(3) provides that an international trust will not be fraudulent if it is settled more than two years after the creditor's claim accrued. Section 13B(4) provides that an international

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[8] *See* The Cook Islands' International Trust Act 1984 § 13B. *See also* Alan R. Jahde and Michael P. Franzmann, *What are Creditors' Rights Against Asset Protection Trusts?*, Estate Planning, Nov. 1999, 410, 414; J. Ben Vernazza, James Bennett, Vernon Jacobs and Richard S. LeVine, *Protecting and Conserving Assets Using an Overseas Asst Protection Trust*, J. Retirement Plan., Feb. 2001; Gideon Rothschild and Daniel S. Rubin, *Self-Settled Asset Protection Trusts*, Estate Planning Tax Advisor, Volume 1, Issue 5 (June 2002).

trust will not be fraudulent as to a creditor whose claim accrues after the trust is settled. Section 13K of the Act further requires that the action be commenced in the Cook Islands within two years of the settlement of the trust in the Cook Islands.

In the so-called *Orange Grove* decision[9] the High Court of the Cook Islands[10] considered an appeal from the trial court's decision denying a so-called "mareva" injunction, barring further transfers of the administration or the assets of the international trust from the Cook Islands pending a trial on the substance of the claim,[11] on the basis that the statute of limitations had passed. The High Court reviewed all of the facts, including that petitioner appellants were individual condominium owners, and the homeowners' association of all of the condominium owners, that the individual respondents were the developers of the project, who had sold the condominium apartments to petitioners in 1988 and 1989, that after protracted negotiations concerning damages as to defects in the apartments, petitioners sued the individual respondents in Los Angeles Superior Court in 1992, and after a full trial before a jury received a favorable verdict, and a judgment of the California Court, in April of 1994. Individual petitioners each received judgments in varying amounts, aggregating $593,850 U.S., and petitioner homeowners' association received a judgment for $5,753,874 U.S. Judgment was entered on April 13, 1994. But the individual respondents had established 25/25 1993 Investment Trust, a Cook Islands international trust, in December of 1993. They promptly transferred all of their assets to the trust and moved to Mexico. Petitioner/Appellants brought suit in the Cook Islands to set aside the trust in late 1994, on learning of the Cook Islands trust.

In the arguments before the High Court, counsel for respondents argued that the case was time barred, because the claims of petitioners were based on defects in apartments they purchased in 1988, more than two years before they sought to set aside the trust as a fraudulent transfer. The Court noted that counsel for respondents argued, "The purpose of the legislation is the unashamed soliciting of funds to improve the economic position of the Cook Islands by giving protection against creditors exercising their rights."[12] After lengthy consideration of the relevant statutes, the High Court concluded that in the case of a suit brought in the Cook Islands, to set aside a trust for fraud based upon a judgment, the two-year period begins with the jury verdict or decision of the Court upon which the judgment is based, not the original acts. The Court reversed and reinstated the "mareva" injunction pending a full trial on the fraud charges. We understand the case was settled thereafter.

There were several court proceedings in the Cook Islands from 1999 to 2001 involving Mr. and Mrs. Michael Anderson. The United States District Court for

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[9] 515 South Orange Grove Homeowners Assn. v. Orange Grove Partners [1995] CKHC 9.

[10] The High Court of the Cook Islands is the highest appeals court in the Cook Islands. From the High Court, appeals lie to the Court of Appeals in New Zealand, and then to the Privy Council in London.

[11] "Mareva" injunctions owe their name to the decision of the English Court of Appeals in Mareva Compania Naviera S.A. v. Int'l Bulkcarriers S.A., discussed below at § 9.10[1].

[12] Orange Grove, [1995] CKHC 9, at 21.

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Nevada had sentenced Mr. Anderson to prison for six months for civil contempt for his refusal to repatriate assets from a Cook Islands' trust which Mr. and Mrs. Anderson had created, in order to pay the claims of their creditors in connection with a telemarketing investment scheme in the United States.[13] The cases are not reported decisions under the names of the parties, but are generally known and discussed in the Cook Islands. Mr. and Mrs. Anderson had been automatically removed as co-Trustees of their Cook Islands' international trust upon the entry of the order of the United States District Court, upon the basis that it was an "event of duress." As trust protectors, Mr. and Mrs. Anderson then sought to remove their Cook Islands trust company as Trustee, and to substitute as Trustee a new company owned by the United States Federal Trade Commission. The Cook Islands High Court barred the change of Trustees, on the basis that the Federal Trade Commission was an "excluded person" under the original trust deed. Again, the case was eventually settled, apparently by payment to the Federal Trade Commission of the bulk of the assets in the trust,[14] but the position of the Cook Islands was that the trust was a validly created trust, that no timely claims were filed under the International Trust Act 1984, and that any claims against Mr. and Mrs. Anderson were based upon United States statutes, and not acts cognizable as crimes in the Cook Islands.

The most recent case from the Cook Islands is *E and B v. A*,[15] sometimesreferred to as the "Bookworm" case. E and B, a husband and wife residing in Baltimore, Maryland, had created a corporation, P, Inc., which opened four bookstores between 1995 and 1999. The creditor bank had loaned $17,000,000 U.S. to P, Inc. upon the personal guarantee of E and B. Ultimately, the business failed, but when the bank creditor tried to realize upon its claim against E and B, it found they had transferred all or most of their assets to a Cook Islands' trust. The evidence was that B, the husband, testified at trial that the reason for the creation of the Cook Islands' trust was "standard" estate planning and protection of their children, and that "he believed" that E and B retained sufficient assets to satisfy the bank's claims when they transferred their assets, other than their shares of P, Inc. and other miscellaneous assets, to the Cook Islands' trust. The Cook Islands Court of Appeal, in New Zealand, reviewed all of the transactions, and the disputed facts and conclusion as to whether the settlor/respondents had committed a fraud. The issue before the Court was whether the attorney-client privilege was, by order of the Court, to be eliminated (in contrast to waived, by the client) in order to examine whether fraud had been committed sufficient to overturn a transfer to an international trust. The Court of Appeal decided, citing important decisions from the United Kingdom[16] and the United States,[17] that the

[13] See the discussion of Federal Trade Commission v. Affordable Media, LLC, 179 F.3d 1228 (9th Cir. 1999) at § 14.03[3].

[14] San Diego Union — Tribune, February 1, 2003.

[15] Cook Islands Court of Appeal, held at Auckland, New Zealand, CA 8/02.

[16] Derby & Co. Ltd. v. Weldon, [1990] 3 All ER 164.

[17] Clark v. United States, 289 US 1 (1933). *Clark* concerned the existence, or absence, of privilege and confidentiality of the deliberations of a jury, but Cardozo, J. found his authority in cases holding that the

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attorney-client privilege does not exist when the transaction with respect to which information is sought is fraudulent. All documents were to be produced.

In summary, the Cook Islands continue to aggressively build their offshore trust business, and they may be the most welcoming situs for a foreign trust created by a settlor seeking asset protection. However, recent cases show that the Cook Islands are trying to accommodate their laws to those of the rest of the world on creditor protection matters where the facts would suggest overwhelming sympathy for the petitioner.

[b] The Channel Islands. For those considering the use of Jersey or Guernsey for the establishment of an asset protection trust, the 2004 decision in *Minwalla v. Minwalla and DM Investments SA*[18] will provide some concern. The case was a divorce proceeding in England. Mr. and Mrs. Minwalla had been involved in a relationship for almost 15 years, and married for almost 10 years. While they had no children, Mrs. Minwalla's two children from her first marriage had been supported by Mr. Minwalla for the last 15 years. The couple had homes in England, New York and Pakistan. Mr. Minwalla was an international businessman, with a family owned hotel in Karachi, and a position as manager for Cathay Pacific airlines in Pakistan and Afghanistan.

When the marriage began breaking down, it became clear that Mr. Minwalla had transferred most of his assets to a Panamanian corporation, and subsequently transferred ownership of the Panamanian corporation to a Jersey trust. The trust was initially for the benefit of charity, but thereafter there was some doubt as to the identity of the beneficiaries. Judge Singer notes that the evidence discovered showed two different letters of wishes, both signed by Mr. Minwalla on the same day, one declaring Mr. Minwalla to be the primary beneficiary of the Jersey trust for the balance of his life, and Mrs. Minwalla to receive one-third of the trust assets outright on his death, and the other letter declaring that Mr. Minwalla's children by his prior marriages were the only beneficiaries. The Court found the evidence of two simultaneous and conflicting letters of wishes repugnant to any normal off-shore trust structure,[19] and that in fact Mr. Minwalla had treated the trust as his own piggy bank.[20] Interestingly, and reminiscent of the result in *Fillman v. United States*,[21] Mr. Minwalla had ignored (as apparently had his Trustee) all of the ownership structure of the Panamanian company and the Jersey trust, and treated the assets as his own. As a result, the Court held that the trust assets were to be treated as personal assets of Mr. Minwalla.[22] The Court entered a substantial lump sum award against Mr. Minwalla (£4,185,000) and

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attorney-client privilege must fall where a defendant consults an attorney in order that he may commit a fraud. Clark, 289 U.S. 1, at 15.

[18] [2004] EWHC 2823 (Fam), [2005] 1 FLR 771.

[19] Minwalla, at Pars. 47 through 51.

[20] Minwalla, at Pars. 57 through 59.

[21] See discussion of *Fillman* at § 1.12[1].

[22] Minwalla, at Par. 60.

noted that some portion of the award would probably have to be met from the Jersey trust. Noting that all requests of the authorities in Jersey had "been dealt with the utmost courtesy, speed and efficiency,"[23] the Court adjourned further proceedings until it could be determined if Mrs. Minwalla's judgment was to be satisfied from the Jersey trust or other sources.

[c] The Cayman Islands. The Cayman Islands also are a jurisdiction where settlors may choose to create trusts to protect assets from creditors, and there are statutes that operate to protect the trust assets. In particular, the Fraudulent Dispositions Law provides that a disposition of property in trust in the Cayman Islands "made with an intent to defraud and at an undervalue shall be voidable at the instance of a creditor thereby prejudiced."[24] The burden of establishing an intent to defraud is on the creditor.The statute of limitations is six years from the disposition of the property in trust.[25] However, the recent case of *Al Sabah and Another v. Grupo Torras SA*[26] shows that there are limits to the protection offered by the Courts of the Cayman Islands. Sheikh Fahad Mohammed Al Sabah (the "debtor") was the head of the Kuwait Investment Authority in London. After long civil trials in London, the debtor was found liable for very large damages for fraud in 1999. The debtor established two trusts in the Cayman Islands in 1992, one for his principal benefit and the other for the principal benefit of his son. The debtor moved to the Bahamas and in 2001 was declared bankrupt under the law of the Bahamas. Grupo Torras SA, a major creditor of the debtor, commenced proceedings against his Cayman Islands trusts in 1995 for settlement of its claims. The Courts below had held that the assets of the Cayman Islands trusts were available to meet the claims of the debtor's creditors. The wife and child of the debtor, as beneficiaries of the trusts, appealed. After a complex analysis of the bankruptcy law of Great Britain, Jamaica and the Cayman Islands, the Privy Council affirmed the judgment that the trusts' assets were to be considered assets of the debtor in bankruptcy.

[d] United States Domestic Situs. Led by Alaska[27] and Delaware[28] in 1997, several states of the United States now recognize self-settled asset protection trusts in varying degrees. The number of states recognizing such trusts may be expected to increase as state legislatures are convinced by their constituent trust companies and trust advisors that business is being lost to other states which have enacted such legislation. The advantages to a settlor of a domestic situs include convenience, appearance (choosing, for example, Delaware over the Cook Islands) given recent publicity over some lawsuits involving foreign asset protection trusts with bad facts, and greater confidence that the trust assets will by maintained and administered in

[23] Minwalla, at Par. 97.

[24] Fraudulent Dispositions Law (1996 Revision) S. 4(1).

[25] Fraudulent Dispositions Law (1996 Revision) S. 4(3).

[26] [2005] UKPC1, [2005] 2 AC 333.

[27] Alaska Code § 34.40 (1997).

[28] 12 Del. Code § 3570 *et seq.*

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accordance with the settlor's wishes. The disadvantage is that the courts of the settlor's state of residence are likely to have greater access to assets in a sister state in enforcing creditors' claims than they will to assets in a trust established offshore.

[e] Choosing a Situs. A choice of a trust situs must take into consideration numerous factors, which may include the jurisdiction's tax legislation, minimum assets requirements, residency requirements, registration of trusts requirements, perpetuity period, recognition of revocable and irrevocable trusts, recognition of self-settled trusts, limits on trust income accumulations, flexibility and restrictions of beneficiary requirements, flexibility with respect to trustees and trust companies, confidentiality rules, financial disclosure requirements, forced heirship rules, existence of tax treaties.[29]

The situs jurisdiction's conflict of laws principles are also critical. Although the trust instrument may specify that the trust is to be governed by local law, in any action by creditors, there will doubtless be a claim that such a provision pertains to the administration of the trust (or perhaps to the bare legal title to trust assets) but not to the rights of creditors. A persuasive case can be made for that result, at least from U.S. decisions.[30] Consequently a U.S. court would probably order transfers that violate domestic fraudulent transfer rules to be undone. The effectiveness of such an order is discussed in § 9.04, below. In an action brought in the trust's situs, will the local court accept this argument? If so, what creditors'-rights law will apply? Only if the answers result in applying the local fraudulent transfer rules can the trust provide the expected protection.

The laws governing trusts and creditors' rights in each jurisdiction are different. Most of the law of trusts is found in court decisions, not in statutory enactments. Outside the United States, the English decisions are the principal source of this law. Consequently, most common-law jurisdictions can be said to start at the same place in determining their trust law. However, England and each of the other jurisdictions will have enacted specific statutory provisions dealing with some or many aspects of trust law. The careful adviser cannot therefore assume that the law of trusts will be the same in different common-law states and must become sufficiently familiar with the peculiarities of each to select the jurisdiction that best serves the settlor's goals of protecting the trust assets and implementing his estate planning, with a minimum of taxes and administrative costs and inconveniences. This will require preliminary discussions with advisors (such as lawyers and trust companies) in a number of jurisdictions; selecting one of more countries for more extensive consideration; and finally making a choice of one.[31]

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[29] Some commentators have distilled as many as 29 "vital elements" to consider in choosing a trust situs. *See*, *e.g.*, Walter H. Diamond, Dorothy B. Diamond, and Barry A. Kaplan, *International Trust Laws and Analysis* (WG&L, 1998).

[30] *See* Thomas H. Day, *Solutions for Conflict of Laws Governing Fraudulent Transfers: Apply the Law that was Enacted to Benefit the Creditors,* 48 Bus. L. 889 (1993).

[31] *See generally* Diamond & Diamond, Tax Havens of the World (Matthew Bender) for complete discussion of the relative merits of various offshore jurisdictions.

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[4] Location of Custodians

The trust assets will consist of principally of intangible property, such as stocks and bonds. Although the trustee can hold these directly, his possession of the property would materially delay transactions involving those assets and would also expose them directly to the laws of the trust situs. Typically, readily marketable assets should be held by independent custodians whose business is dealing with purchases and sales of those assets. If these custodians are local, the assets remain within the direct control of the situs jurisdiction's government. Consequently, consideration should be give to requiring foreign (as to the trust situs) custodians. This requirement would avoid the necessity of changing custodians when a situs shift occurs (see the discussion in § 9.08[3], below) and, in that event, would provide a measure of continuity.

Logically, a custodian should be located where the assets that he holds are located. In that way, the custodian will be familiar with changes in laws and regulations that might affect the trustee's decisions about sales or purchases. This logic may not have much force if the country is the United States, because the trustee is likely to be very aware of what happens here, and the settlor's lawyer is also likely to keep the trustee informed of developments, at least in a general way.

In any event, the identities of the custodians are likely to be more important than their locations. If the custodian is known and if he is domestic, creditorswould not have any jurisdictional problems in getting freezing or transfer orders directed to the custodian from a United States court. The ramifications of the identity of the custodians is discussed in § 9.04[3], below.

§ 9.04 Court Jurisdiction and Enforcement of Orders

U.S. courts' perception of their in personam jurisdiction is extremely broad so that they are likely to hold that trustee of any offshore asset protection trust is subject to their jurisdiction. Under common law principles, however, courts in trust's situs will enforce U.S. court's order only if it is for fixed monetary amount and trustee was doing business in U.S. under common-law standards.

For a creditor or bankruptcy trustee to obtain any legal remedy, the court in which the action is brought must have jurisdiction over both: (1) the type of claim (subject matter jurisdiction), and (2) either the defendant (*in personam* jurisdiction) or the property at issue (*in rem* jurisdiction or *quasi-in-rem* jurisdiction). A U.S. subject matter jurisdiction for claims against a U.S. citizen or resident by creditors is present in the case of an asset protection trust. A U.S. court will probably find that it has jurisdiction over the trustee of the asset protection trust or the trust's assets under U.S. rules. For this to have any effect, however, the U.S. court must have the power to enforce its orders itself or have its orders enforced by courts in the jurisdiction in which the object of its orders is found. It is the enforcement of the U.S. court's judgments and orders that presents the creditors and other adverse parties with the most difficult problem. This problem is likely to be insuperable if the trustee and the situs of the asset protection trust are chosen with care.

[1] Subject Matter Jurisdiction

Courts in the United States are tribunals of limited jurisdiction, that is, their power to hear a case depends on a constitutional or legislative grant of authority. In the context of bankruptcy matters, that subject matter jurisdiction has clearly been granted to federal courts by the Bankruptcy Code. Similarly, state courts have jurisdiction to decide fraudulent transfer issues under local law. Consequently, a claim by a creditor that a transfer to the trust was fraudulent or that it is subject to the bankruptcy court's orders would almost certainly fit within the subject matter jurisdiction of a United States court.

[2] *In Personam* Jurisdiction

To issue a valid order to a person, a court must have jurisdiction over that person (*in personam* jurisdiction). The scope of *in personam* jurisdiction in the United States is very broad, much broader than in most other countries. To appreciate the significance of this difference, a brief review of the development of *in personam* jurisdiction in the United States is provided.

The early decisions based their concept of *in personam* jurisdiction on the court's physical power over the defendant (or on the defendant's consent to the court's jurisdiction).[1] As the mobility of people increased with advances in communications and transportation, pressure arose to expand the basis of personal jurisdiction. Domicile was added to the list of jurisdictional hooks.[2]

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§ 9.04

[1] *See, e.g.,* Bank of Augusta v. Earle, 38 U.S. 519 (1839).

[2] McDonald v. Mabee, 243 U.S. 90 (1917).

The next step was to broaden the consent basis of jurisdiction. In its early form, actual consent was required. Actual consent had been of little significance to individuals, but of much more importance to corporations, because a state typically required consent to local jurisdiction as a prerequisite to granting permission to do business in the state. The new idea was implied consent. It began with the notion that by using a state's highways, the motorist consented to the state being his or her agent for service of process.

In the United States, the basis for *in personam* jurisdiction was completely overhauled by the Supreme Court in *International Shoe Co. v. Washington*.[3] The fiction of implied consent was discarded. Instead, the new criterion for jurisdiction was whether the defendant had sufficient "contacts" with the forum state so that the exercise of a court's jurisdiction over the defendant did not offend "traditional notions of fair play and substantial justice."[4] Decoupling *in personam* jurisdiction from its traditional bases created an unparalleled opportunity for U.S. courts to expand that jurisdiction. The early cases focused on the "minimal contacts" needed to confer jurisdiction, and these turned out to be minimal indeed. For example, California courts had jurisdiction over a Texas insurance company, because the insurance contract was delivered in California (by the postman, having been mailed in Texas), the premiums were mailed (to Texas from California) and the insured was a resident of California when he died.[5]

In an ironic twist, what at first appeared to be a limit on the minimal contacts theory became the springboard for further expansion. For example, in denying Florida's jurisdiction over a Delaware trustee who had never done or solicited any business in Florida (the settlor was not a Florida resident or domiciliary when the trust agreement was executed in Delaware), the Supreme Court held that "it is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protection of its laws."[6] It did not take thelower courts long to turn the "purposefully availed" test from a limitation into a basis for *in personam* jurisdiction. If the defendant had purposefully availed himself of the benefits of the forum state, that state had jurisdiction regardless of the number of contacts.[7] It soon became evident that it was not necessary for the defendant to intend to avail himself of the forum state's laws, at least in the case of products. It was enough that the defendant introduced the product into the "stream of commerce," and it was reasonably foreseeable that the product would be sold or used in the forum state.[8]

The "stream of commerce" basis applied only to products. The next step was to

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[3] 326 U.S. 310 (1945).

[4] 326 U.S. at 316 (1945).

[5] McGee v. International Life Ins. Co., 355 U.S. 220 (1957).

[6] Hanson v. Denckla, 357 U.S. 235, 253 (1958).

[7] *See, e.g.,* Vault Corp. v. Quaid Software Ltd., 775 F.2d 638 (5th Cir. 1985).

[8] *See e.g.,* Plant Food Co-op v. Wolfkill Feed & Fertilizer Corp., 633 F.2d 155 (9th Cir. 1980).

enfold activities outside the forum state that had an "effect" in that state. For example, California was held to have jurisdiction over a Florida reporter and editor in a libel action brought by a California resident, on the theory that the defendants knew that the article was about a California resident and that it would be read in California.[9] In other words, the defendants had knowingly engaged in conduct (albeit in Florida) that had an effect in California.

In view of the extraordinarily broad reach of *in personam* jurisdiction in the United States, it is likely that a U.S. court would hold that it had jurisdiction over the foreign trustee of an asset protection trust. Even with the best facts (*e.g.,* no official of the foreign trustee has ever traveled to the United States to conduct or solicit business; the trustee has never mailed any business solicitation material to the United States; the trust was formed under foreign law and was executed outside the United States; and all transfers to the trust were made outside the United States), it is probable that *in personam* jurisdiction would be found by a U.S. court on the "effect" theory. In other words, the trustee could reasonably foresee that its activities would have an effect in the United States.

[3] *In Rem* and *Quasi-in-Rem* Jurisdiction

Like *in personam* jurisdiction, *in rem* and *quasi-in-rem* jurisdiction were originally based on the territorial principle. However, the scope of these two property-derived jurisdictional bases has remained relatively unchanged.[10] A U.S. federal court has always had jurisdiction over:

(1) real property located in the United States;[11]

(2) chattels physically present in the United States;[12]

(3) shares of stock in domestic corporations (which would include shares in domestic mutual and money market funds);[13] and

(4) intangible property (*e.g.,* debt obligations issued by domestic or foreign entities), the ownership of which is represented by a document which is physically located in the United States.[14]

Consequently, a U.S. court has jurisdiction over the trust assets to the extent that they consist of these four types of property.

The practical problem for creditors in the context of an asset protection trust will probably be finding the location of the trust assets. Although this might seem easy in the case of real property, it is likely that any realty will be owned by some intermediate entity (such as a holding company), because the foreign trustee will not want to own

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[9] Calder v. Jones, 465 U.S. 783 (1984).

[10] *See, e.g.,* Shaffer v. Hertner, 433 U.S. 186, 205 (1977).

[11] Restatement (Second) Conflict of Laws § 59.

[12] Restatement (Second) Conflict of Laws § 60.

[13] Restatement (Second) Conflict of Laws § 64(1).

[14] Restatement (Second) Conflict of Laws § 63.

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real property directly. Someone must have possession of the trust assets (or at least the evidences of their ownership), but discovering this information may be impossible. Of course, the settlor will provide the bankruptcy trustee with all the information he possesses, such as the name and address of the foreign trustee and a description of the assets owned by the trust (which will be taken from the regular statements furnished by the trustee).

Comment: Other authors have suggested that the trust agreement prohibit the trustee from supplying the beneficiaries with information that specifies the exact nature of the trust assets. This secretiveness may be for the ostensible reasons of avoiding conflicts of interest and insider trading violations. However, unless these are legitimate concerns, such a provision may increase the likelihood that a U.S. court will view the transfers to the trust as “fraudulent.” Moreover, such a provision may not be effective, because the trust law of most jurisdictions gives the beneficiaries the right to demand details regarding trust assets. Therefore, the settlor-beneficiary (under court order) would probably be able to obtain that information despite a contrary provision in the trust agreement.

The settlor will almost certainly not know the names of any custodians (*e.g.,* brokerage houses) that the foreign trustee may be using to hold trust assets. Nothing is unusual about this, because it would be atypical for a trustee to routinely advise the beneficiaries (or the settlor) which nominees or brokerage houses the trustee used to hold trust assets. A domestic trustee would doubtless disclose these names if asked, but a foreign trustee of an asset protection trust would not. Without knowing the name and location of the custodians, the bankruptcy trustee would not know against whom (assuming them to be United States persons) to seek an order requiring the assets to be turned over. This difficulty can effectively prevent the “dawn raid” in which creditors attempt to sequester the debtor’s assets (and those alleged to be recoverable in a bankruptcy proceeding, which could include the trust’s assets) in a surprise move on the eve of an involuntary bankruptcy proceeding.

Planning Note

Trustee May Protect Trust Assets by Changing Custodians When Request for Information is Received. An inventive bankruptcy trustee might cause the settlor’s request for information from the foreign trustee to incorporate the rationale that such information was sought to ensure that no self-dealing existed between the trustee and the nominees or custodians. Such an approach might produce (eventually) the names of the custodians as of the time that the inquiry was made. If the trustee of the asset protection trust was at all knowledgeable of U.S. proceedings, he would have liquidated any investment of trust assets in shares, interests, and debt obligations of U.S. persons. Then, he would transfer those proceeds and any other trust assets in the hands of the original custodians to different (and foreign) custodians. In doing so, custodians whose names and locations were ultimately produced would, by that time, no longer have any trust

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assets in their custody nor would any of the trust assets be subject to the *in rem* or *quasi-in-rem* jurisdictions of a U.S. court.

[4] Enforcement

Obviously a U.S. court cannot directly enforce its judgments and orders against persons who neither are physically present within the United States nor have property in the United States that can be found.[15] Therefore, in those cases, the enforcement of these judgments and orders has to be carried out by the courts of other jurisdictions. In the context of an asset protection trust, it generally would be the courts of the trustee's home jurisdiction that would be asked to enforce the foreign (as to that jurisdiction) judgment or order rendered by a United States court. If the asset protection trust has been properly set up in an intelligently selected foreign situs and if the trustee understands the risks, the applicable laws (those of the trust situs) are likely to treat those judgments as undeserving of respect. In other words, they will not be enforced with the result that the creditors will face an insurmountable hurdle in their quest for the trust assets.

The English rules on the enforcement of foreign judgments are likely to be the foundation for such rules in any current or former British colony. Therefore, any analysis of this topic begins with an examination of English common law. The basic principle at common law is that English courts do not actually "enforce" foreign judgments.[16]

If the foreign judgment is for a sum certain (*e.g.,* a judgment against the trustee for the value of the assets transferred to the trust), the obligation to pay that amount can be enforced in an English action to collect a debt.[17] Technically this is not the same as enforcing the foreign judgment, but for all practical purposes, there is no difference between the English approach and the actual enforcement of a foreign judgment in the case of fixed monetary judgments. However, that difference is evident where the foreign judgment is for specific performance (*e.g.,* a judgment requiring the trustee to turn over the trust assets). English courts would not enforce such an order.[18]

Assuming that the U.S. judgment is of the type that an English court would "enforce" (*i.e.,* is for a fixed sum of money), the next question is under what circumstances an English court would act. The foreign judgment must meet a number of common law requirements.[19] Two of these are relevant in this discussion. First, the

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[15] For a discussion of the Internal Revenue Service's authority to serve administrative summonses outside of the United States upon U.S. citizens, *see* Service of Summons, Chief Counsel Advice 200107032. *See also* Priv. Ltr. Rul. 200143032.

[16] *See, e.g.,* Williams v. Jones, (1845) 67 Rev. Rep. 767, 769, 13 Meeson & Welsby 628, 633.

[17] *See, e.g.,* Godard v. Gray, [1870] 6 Q.B. 139; Schibsby v. Westenholz, [1870] 6 Q.B. 155.

[18] Peter Kaye, Civil Jurisdiction and Enforcement of Foreign Judgments 1338 (Professional Books Ltd. 1987); P.M. North & J.J. Fawcett, Private International Law 367 (12th ed. Butterworths 1992).

[19] Emmanuel v. Symon, [1907] 1 K.B. 302 (Eng. C.A.) (per Buckley L.J.); Rousillon v. Rousillon, Ch. 351 (1880).

rendering court must have had jurisdiction over the party against whom the judgment was given. This is determined by reference to criteria specifically developed by English courts for deciding whether the foreign judgment is capable of being enforced. The standards used by the foreign court where the judgment was obtained to determine its jurisdiction are irrelevant.[20] Assuming that the trustee is a corporation, these rules require that it be resident in the United States or that it have either voluntarily appeared in the U.S. court or expressly agreed to submit to that court's jurisdiction. For the corporate trustee to be resident in the United States, it must to some extent carry on business in the United States at a definite and reasonably permanent place.[21] The mere presence in the United States of an agent of the trustee who solicits clients but who has no authority to conclude contracts on behalf of the trustee will not beenough to give a U.S. court jurisdiction over the trustee for the purpose of applying this requirement of the common law rules for enforcing foreign judgments.[22] It should be relatively easy to select a foreign trustee that is not "resident" in the United States under the common law test for enforcing foreign judgments.

The second of these common law rules requires that the judgment not violate the public policy of the enforcing jurisdiction.[23] In jurisdictions without specific statutory provisions dealing with this subject, public policy is likely to be expressed in a bankruptcy law that is similar to that of England. Under Section 339 of the Insolvency Act,[24] a donative transfer can be set aside if the settlor becomes bankrupt within two years after making the transfer, and within a further period of three years (*i.e.,* within five years of the transfer) if the settlor was insolvent at the time of or became insolvent as the result of the transfer. The motive or intention of the settlor in making the transfer is irrelevant. Under Section 423 of the Act, a transfer can be set aside at any time (*i.e.,* there is no limitation period) if the settlor's "purpose" in making the donative transfer was to put assets "beyond the reach" of any creditor (present or future) or to prejudice the ability of any such creditor to pursue his claim. In other words, unless the local jurisdiction has special legislation on the subject, its public policy is not likely to be offended by the enforcement of a U.S. court order based on the bankruptcy or other creditors'-rights laws of the United States. If, on the other hand, there are statutes that address the matter, it is quite likely that the public policy of the trustee's home jurisdiction, with respect to the rights of the settlor's creditors to reach trust assets, will limit their ability to avoid transfers to trusts to those situations prescribed in the local statutes. These statues will almost certainly be very much narrower than the U.S. rules. For example, Bermuda provides in part that a Bermudian court "shall not vary [a valid

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[20] Ronald A. Brand, ed., *Enforcing Foreign Judgments in the United States and United States Judgments Abroad* 94 (ABA Sec. Int'l L. & Prac. 1992). *See* Pemberton v. Hughes, [1907]1 Ch 781.

[21] Okura & Co., Ltd. v. Forsbacka Jernverks Aktiebolag, [1914] 1 K.B. 715. To the same effect, *see, e.g.,* Littauer Glove Corp. v. FW Millington (1920) Ltd., [1928] 44 T.L.R. 746.

[22] Vogel v. R & A Kohnstamm Ltd., [1973] Q.B. 133, [1971] 2 All. E.R. 1428, [1971] 3 W.L.R. 537.

[23] Rousillon v. Rousillon, [1890] Ch. D. 351; *In re* Macartney (Macfarlane v. Macartney), [1921] 1 Ch. 522.

[24] Insolvency Act, 1986, ch. 45 (Eng).

Bermuda trust] or set it aside pursuant to the laws of another jurisdiction in respect of . . . (c) the protection of creditors in matters of insolvency unless the law of Bermuda has corresponding laws or public policy rules."[25]

Comment: At some symposia on asset protection trusts, concern has been expressed that Sections 426(4) and (5) of the United Kingdom Insolvency Act, 1986, could be used to circumvent the common law rules and local legislation regarding the enforcement of foreign bankruptcy orders. Section 426(4) requires British courts "having jurisdiction in relation to insolvency matters [to] . . . assist courts having the corresponding jurisdiction . . . in any relevant country or territory." Section 426(5) provides that "a request made to a [British] court . . . by a court . . . in a relevant country or territory is authority for the court to which the request is made to apply, in relation to any matter specified in the request, the insolvency law which is applicable by either court in relation to comparable matters . . . ." Section 426(11) provides that a " 'relevant country or territory' means (a) any of the Channel Islands or the Isle of Man, or (b) any country or territory designated . . . by statutory instrument." Those so designated include The Bahamas, Bermuda, the Cayman Islands, Gibraltar, and the Turks & Caicos Islands.[26] This statute is a one-way street. British courts are obligated to assist courts in specified countries and territories, but the legislation does not purport to make the obligation reciprocal. Therefore, even if an inventive creditor could validly institute a bankruptcy proceeding in the United Kingdom, the statute does not impose any duty on the courts of the listed jurisdictions to render any aid to the British bankruptcy court. However, the careful adviser should review this analysis with local counsel if the trust is to be created in one of the listed jurisdictions.

How these basic common law jurisdictional rules are applied in the trust situs is one of the most important consequences of selecting that situs. It should be relatively easy to choose a foreign trustee that is not "resident" in the United States under the common law test for enforcing foreign judgments. Moreover, the situs may have special rules that further restrict the enforceability of foreign judgments against trusts and trustees, which is a separate bar to its enforcement. For example the Cook Islands provide in part that "no proceedings for or in relation to the enforcement or recognition of a judgment obtained in a jurisdiction other than the Cook Islands against . . . an international trust [or its trustee] . . . shall be entertained by any Court in the Cook Islands if. . .that judgment is based upon the application of any law inconsistent with the provisions of this Act . . . ."[27]

In sum, if the trustee has not appeared in or expressly agreed to the jurisdiction of the United States court, a bankruptcy trustee or creditor with a United States judgment who has to proceed under the common law rules to enforce that judgment in the

[25] Section 11 of Bermuda's Trust (Special Provisions) Act 1989.

[26] Cooperation of Insolvency Courts (Designation of Relevant Countries and Territories) Order 1986, SI 1986/2133, art. 2, Schedule.

[27] Section 13D of the Cook Islands International Trust Act 1984 (*as amended* 1985, 1989, 1991).

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foreign jurisdiction will encounter legal hurdles that are formidable if not insurmountable. However, if the trustee uses an intermediate entity, such as a holding company, this obstacle to the creditors' success may not exist. Instead of trying to enforce a judgment against the trustee, the creditors could seek to enforce a judgment against the entity. If the settlor (or any otherperson resident in the United States) has executive power in that entity, it may well be doing business in the United States for purposes of the common law requirement for enforcing foreign judgments. In other words, the courts, in the jurisdiction in which that entity was formed, may enforce the U.S. court's orders (assuming no local public policy is violated and there is no applicable legislation restricting the enforceability of foreign judgments). See § 9.10[3][b], below. If there is time, the entity could retransfer its assets to the trustee. However, there is a risk that a preemptive strike by the creditors could trap the assets in the entity.

[5] Direct Relief

The creditors or the bankruptcy trustee could of course seek direct relief in the courts of the trust's situs rather than trying to enforce a U.S. judgment. However, the international law rules regarding the effect of a foreign bankruptcy are not particularly favorable and generally a *de novo* proceeding is required. Most countries follow the "territoriality" concept. In other words, a bankruptcy adjudication has no inherent effect outside the jurisdiction making the determination, thus necessitating a new proceeding (which will have to adjudge the settlor bankrupt *de novo*) or at least a "domestication" of the U.S. proceeding in the trust situs.[28] Until that is accomplished, the trustee is free under its law to dispose of the trust's assets and to make any distributions and to accept any directions or consents (from the settlor, the Protector, or others) permitted by the trust agreement.

A *de novo* proceeding presents two major problems to U.S. creditors. First, there may be a serious question as to the jurisdiction of a bankruptcy court in the trust situs. None of the creditors or the debtor resides there and none of the assets that the creditors seek will be found there. Whether the residence of the transferee (the trustee) is enough to confer jurisdiction under the local bankruptcy or other creditors'-rights legislation may be doubtful. Second, the local fraudulent transfer provisions would control and a number of jurisdictions have specifically limited the application of the fraudulent transfer doctrine in transfers to trusts. For example, under the statutes of the Cayman Islands, the Cook Islands, Gibraltar, and Turks & Caicos Islands,[29] pre-transfer creditors who have made claims on the settlor may be able to avoid the transfer as fraudulent (generally with short statutes of limitations, however), but post-transfer creditors cannot.

If the facts giving rise to the claim occurred before the transfer, but the claim is not

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[28] *See generally* 1 Dalhuisen on International Insolvency and Bankruptcy § 2.03[3] (1986).

[29] *See, e.g.,* The Fraudulent Dispositions Law, 1989, Supp. No 9 to Gazette No 24 (Cayman Islands 1989); The International Trust Act (Amendment) Ordinance (Cook Islands 1989); Bankruptcy (Amendment) Ordinance, 1990, First Supp. to Gazette No 2,542 (Gibraltar 1990); and the Trusts Ordinance 1990 (Turks & Caicos Islands 1990).

made known to the settlor until after the transfer, the statutes produce varying results. The Turks & Caicos Islands legislation is by far the most restrictive, that is, protective of the trust assets. It provides simply that if "(a) the settlor is an individual; (b) the settlor is not insolvent when the disposition is made; and (c) the settlor does not become insolvent by reason of the disposition, that disposition shall not be voidable at the instance of any creditor of the settlor." The settlor's motive or intent in transferring property to the trust is irrelevant. The Cook Islands are not far behind. To set aside a transfer to a Cook Islands trust, the creditor must establish "beyond a reasonable doubt" that the settlor's "principal intent" in making the transfer was to defraud that particular creditor. Even then, the creditor must have instituted his avoidance action in the Cook Islands within one year of the transfer to the trust. In the Cayman Islands, a creditor is protected with respect to "an obligation or liability (which shall include a contingent liability) which existed on or prior to the date of a relevant disposition and of which the transferor had notice." In Gibraltar, the wording is more obscure, but apparently a creditor has a remedy only if the settlor has "actual notice of such claim or of the facts or circumstances which may render him liable to such a claim" at the time of the transfer.

These statutes prevent all post-transfer (and many pre-transfer) creditors from avoiding transfers to a trust by a settlor who later becomes insolvent. They do not provide any protection against claims that creditors may make on any interest that the insolvent settlor has in the trust, or in trust assets as the result of obtaining the settlor's interest in the trust. Any such protection will turn upon the nature of the settlor's interest and the validity of any restrictions on its alienation under the law of the trust situs.

[6] Civil Contempt Orders

In a number of cases, United States courts, frustrated by their inability to exercise jurisdiction over the assets or Trustee of a foreign asset protection trust, but having jurisdiction over the person of the debtor, will enter civil contempt orders, coercing the debtor to induce the Trustee of the foreign trust to repatriate the assets to the United States in satisfaction of the judgment. Two recent cases are *Eulich v. United States*[30] and *United States v. Grant*.[31] Both are income tax cases. In *Eulich* the taxpayer had created an irrevocable trust in the Bahamas, with Canadian Imperial Bank of Commerce as Trustee, which owned several offshore holding companies The Internal Revenue Service was attempting to discover facts about the trust and the holding companies and sought production of all of the relevant documents. Mr. Eulich failed to timely produce all of the documents, and the Court entered an order calling for fines of $1,500 per day until satisfactory production was completed. Mr. Eulich thereupon went to theBahamas, hired local counsel, and at considerable expense obtained most of the demanded documents. He then sought to purge his contempt. The District Court refused, noting that compliance had not been timely.

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[30] 2006 U.S. Dist. LEXIS 2227 (N.D. Tex. 2006).

[31] 2005 U.S. Dist. LEXIS 22440 (S.D. Fla. 2005).

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In *Grant* the defendants had created two offshore trusts, one in Jersey and one in Bermuda, in 1983 and 1984. In 2003 a final judgment was entered against Mr. and Mrs. Grant for over $36 million U.S. in unpaid income taxes, resulting from improper tax shelters entered into by taxpayers. The Internal Revenue Service attempted to levy against the offshore trusts. Mr. and Mrs. Grant argued that repatriation of the assets of the offshore trusts would violate the laws of Jersey and Bermuda, and that they did not want to repatriate the assets. In this original decision of the magistrate judge, the Court did not hold the transfers in trust to have been fraudulent, but held that Mrs. Grant had the power to remove and replace the Trustees of both trusts, and that the Trustee had the power to pay or apply all of the assets of the trusts for Mrs. Grant's "health, support, benefit and living expenses." The Court ordered Mrs. Grant to change the Trustee of both trusts to a United States trustee, and to repatriate the trusts.

There is a limit to the utilization of civil contempt orders. The purpose of a civil contempt order, in particular an order for incarceration, is to induce compliance with the court's order. Once the court determines that the defendant will refuse in all circumstances to comply with the court's order, in this case to repatriate assets from a foreign trust, the order becomes punitive and the defendant must be released from prison. This was apparently the case in the *Affordable Media* decisions discussed above in § 9.03[3] as the courts were considering whether it was appropriate to incarcerate Mr. Anderson any longer when the litigation with the Federal Trade Commission was settled.[32] In the case of *Stephan Jay Lawrence, Debtor v. Alan Goldberg, Trustee*,[33] the Court of Appeals for the Eleventh Circuit cautioned the District Court to avoid a punitive contempt order, but did not order Mr. Lawrence's release. Note that Mr. Lawrence had already been incarcerated for three years when the Court of Appeals rendered its decision. See the discussion of this case at § 9.06[9].

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[32] *See* discussion in text at § 9.03[3], footnote 13.

[33] 279 F.3d 1294 (11th Cir. 2002).

§ 9.05 State Law Remedies

Under U.S. state law, creditors can seize not only the debtor's property but also property he has previously transferred to others if the transfer was either sham or fraudulent. Fraudulent transfers are made with actual intent to hinder, delay or defraud creditors or, under certain conditions, when the debtor did not receive adequate consideration for transfer. Intent is determined by the existence (or absence) of certain fact patterns (badges of fraud), such as transfers to insiders, concealed transfers and threatened or pending legal action.

[1] Principal Remedies Available to Creditors

Under U.S. state law, the principal remedy available to a creditor who has a due but unpaid obligation is levying on (taking) the debtor's property. In the context of an asset protection trust, the targeted property would generally include whatever rights the debtor had in the trust.[1] If the settlor has retained a life estate or a vested remainder interest, the creditors can reach that interest and enjoy the income (or the reversion on termination) of the trust, assuming that no valid restraint on alienation exists.

The quantum of rights and powers retained by the settlor is also one of the principal sources of tension in drafting asset protection trusts. The settlor-client usually wants to retain as much of the attributes of ownership (enjoyment of the income and the power to control) of the trust assets as is possible, and the adviser wants to distance the client as far as possible from the trust assets to avoid successful attacks by creditors. In a number of cases, U.S. courts have held that these retained rights and powers were so extensive as to amount to ownership of the trust property.[1.1] In effect, the trust was ignored as a sham, making the trust assets (and not just the settlor's retained rights) subject to levy. A decision to that effect by a U.S. court would be enforceable in the foreignjurisdiction in accordance with the principles discussed in § 9.04[4], above. Even if it is not enforceable, the creditors or bankruptcy trustee could make the sham argument in an original proceeding in the trust's foreign situs. How such an argument would be received by the courts there is an issue that the adviser should discuss thoroughly with local counsel as part of the process of selecting a situs for the trust.

Specifying a choice of law in the trust instrument (*e.g.,* that of the trust's foreign

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§ 9.05

[1] For a review of creditors' rights against asset protection trusts, *see also* Alan R. Jahde and Michael P. Franzmann, *What are Creditors' Rights Against Asset Protection Trusts?*, Estate Planning, Nov. 1999, 410. For a discussion of creditors' rights against self-settled trusts, *see* Stewart E. Sterk, *Asset Protection Trusts: Trust law's Race to the Bottom*, 85 Cornell L. Rev. 1035 (2000), Howard D. Rosen and Patricia A. Donlevy, *Domestic Asset Protection Trusts: Do They Work?*, 23 Tax Mgmt., Est., Gifts and Tr. J. 211 (1998), and Gideon Rothschild, *Asset Protection Planning — Current Strategies and Pitfalls*, Tax Management Estates, Gifts and Trusts Journal 2005, at 251.

[1.1] *See* United States v. Ritter, 558 F.2d 1165 (4th Cir. 1977); Hinson v. United States, 994 F.2d 843 (8th Cir. 1993); United States v. Kattar, 81 F. Supp. 2d 262 (D.N.H. 1999); and United States v. Engels, 2001 U.S. Dist. Lexis 17247 (N.D. Iowa 2001) (treating a trust as the debtor's "alter ego" by looking at the following factors: (1) the control the debtor exercises over the nominee and its assets; (2) the use of the trust funds to pay the debtor's personal expenses; and (3) the family relationship, if any, between the debtor and the trustee). *Cf.* Freehling v. Nielson (*In re* F & C Servs., Inc.), 44 B.R. 863 (S.D. Fla. 1984) (treating a corporation as the debtor's "alter ego").

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situs) will not have the effect of causing a U.S. court to refer to the designated law in determining whether a fraudulent transfer has occurred. The U.S. courts have rejected the application of choice-of-law provisions to fraudulent transfer determinations.[2]

At the same time, not all transfers into irrevocable trusts for the benefit of family members are void against creditors as fraudulent conveyances. In the recent case of *Lakeside Lumber Products, Inc. v. Evans*,[2.1] defendants Mr. and Mrs. Evans had created a series of irrevocable trusts in 1989 to hold title to their home and certain other assets. Mr. Evans was the beneficiary of one trust and Mrs. Evans was the beneficiary of another. Mr. Evans, in 1996, guaranteed an obligation of his business, an LLC, to the plaintiff. When the LLC defaulted, and Mr. Evans claimed he did not have sufficient assets to satisfy the guarantee, plaintiff sought to set aside the transfer of the family home as a fraudulent transfer. The Court held the transfer valid and the asset protected from the claims of plaintiff.

Not all of a debtor's property is subject to levy for the benefit of creditors. All states exempt some types of property from the reach of these creditors. However, these state-law exemptions are not particularly relevant to interests in asset protection trusts.

[2] The Avoiding of Fraudulent Transfers

If creditors are not satisfied with taking whatever vested interest the settlor-debtor has in the asset protection trust and if they cannot get it treated as a sham, the laws of every state provide them with a further remedy: the right to have prior fraudulent transfers of property by the settlor avoided. A transfer is fraudulent if it meets one of the several statutory tests described in § 9.05[3], below. The common-law concept of fraud is *not* relevant to this determination. Although most analyses (including this one) focus on transfers of property, the term, "fraudulent transfers," includes the incurring of debt that is not genuine. Avoiding a fraudulent transfer means a demand (enforceable by court order, assuming jurisdiction) that the transferee return the transferred property (or its proceeds).

Many of these laws are based on either the Uniform Fraudulent Conveyance Act[3]or the Uniform Fraudulent Transfer Act.[4] Although individual state laws may differ from one of these Uniform Acts in some details (which will require, of course, a close examination of the fraudulent conveyance statute in the state or states of the settlor's residence and domicile), a review of these two Uniform Acts should identify the relevant issues.

[3] Types of Fraudulent Transfers

Under the Uniform Acts, two types of transfers are avoidable:

(1) those made with actual intent "to hinder, delay, or defraud" either present or

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[2] *See, e.g.,* Hassett v. Far West Fed. Sav. & Loan Ass'n (*In re* OPM Leasing Servs, Inc.), 40 B.R. 380 (Bankr. S.D.N.Y. 1984), *aff'd*, 44 B.R. 1023 (S.D.N.Y. 1984), *aff'd*, 769 F.2d 911 (2d Cir. 1985).

[2.1] 110 P. 3d 154 (Utah Ct. App. 2005).

[3] 7A U.L.A. 427 (1918).

[4] 7A U.L.A. 639 (1984).

future creditors[5](the quoted phrase is disjunctive, *i.e.,* an intent to hinder or to delay is just as much a fraud as is an intent to defraud),[6]and

(2) those made in certain circumstances if the debtor does not receive full value.

The first type of transfer involves "actual fraud," because the debtor's actual intent has to be ascertained. The second can be described as a "constructive fraud," because there is no search for the debtor's intent. The difference is usually extremely important, because it can determine what kind of creditors can attack the transfer as fraudulent. In the case of actual fraud, both present and future creditors are entitled to have the transfer set aside. In effect, no statute of limitations exists with respect to the transfer, and creditors whose claims arise years later can challenge the earlier transfer. On the other hand, if the fraudulent intent is constructive rather than actual, under certain circumstances, only present creditors may complain. In those cases, subsequent creditors would have to establish actual fraud to obtain relief.

However, the distinction between present and future creditors may not be as important in the asset protection trust setting as in other cases. A present creditor is one whose claim has arisen (even if the debtor does not know of it). For example, a patient may have a malpractice claim against a doctor that does not surface until years later (*e.g.,* the patient is a minor or does not discover theproblem immediately). That patient would be a present creditor. In addition, often the settlor will make a series of transfers (*e.g.,* every year) to the trust. A person that was a subsequent creditor as to the early transfers might be a present creditor as to later ones.

Most of the fraudulent transfer cases have been decided by federal rather than state courts. Section 544(b) of the Bankruptcy Code grants the bankruptcy trustee the same avoidance rights that a creditor of the debtor has under state law. Moreover, Section 548 of the Bankruptcy Code grants the bankruptcy trustee an independent avoidance right, which is also based on either actual fraud or constructive fraud. Although the language of Section 548 is not identical to either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act, courts seem to have made no distinction between the avoidance powers of a bankruptcy trustee under Section 548 and a creditor under state law.[7] Hence, federal bankruptcy decisions with respect to what constitutes a fraudulent transfer are highly relevant to the issue under state law.

[a] Actual Intent to Hinder, Delay, or Defraud. Pre-existing direct evidence that the transferor actually intended to hinder, delay, or defraud creditors in making the transfer normally will not exist unless he (or his adviser) is exceptionally slow-witted.[8] However, in a bankruptcy proceeding the debtor is obligated to appear at a meeting

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[5] Unif. Fraudulent Conveyance Act § 7; Unif.. Fraudulent Transfer Act § 4(a)(1).

[6] Life Science Church of River Park v. Personette (*In re* Life Science Church of River Park), 34 B.R. 529, 534 (Bankr. N.D. Ind. 1983) ("An intent to hinder or delay is condemned equally with an intent to defraud, i.e., an intent not to pay creditors at all."). *See also* Shapiro v. Wilgus, 287 U.S. 348 (1932).

[7] *See* 5 Collier on Bankruptcy ¶ 548.01 (Matthew Bender).

[8] *See* Roland v. United States, 838 F.2d 1400, 1402–03 (5th Cir. 1988); Salmon v. Kaiser (*In re* Kaiser), 722 F.2d 1574, 1582 (2d Cir. 1983).

with his creditors and submit to examination under oath.[9] While courts have found the requisite fraudulent intent in numerous cases in which the creditor's claim or cause of action existed on the date of transfer,[9.1] very few cases dealt with claims of creditors whose claim or cause of action arose after the transfer, *i.e.*, future creditors.[9.2] The real source of direct evidence will likely be the answers that the settlor gives to three questions that will almost certainly be put to him in that examination:

(1) Why did he decide to create the trust?;

(2) Why did he chose a foreign situs rather than a domestic one?; and

(3) What were his reasons for choosing that particular foreign jurisdiction?

If the settlor refuses to answer any relevant question on the grounds of his privilege against self-incrimination, or if his only answer is that the choices were made to protect the trust assets from his creditors, a finding of actual fraudulent intent is sure to follow. The attorney's role in developing and recording the client's actual intent is discussed in § 9.13[1], below.

The answer to the first question enumerated above may be one of the many good reasons for creating a trust that does not involve any intent to hinder, delay, or defraud creditors. Trusts are usually established as a part of the client's overall estate and family financial planning. If the creation of the asset protection trust is simply a part of that planning, such a question can be answered favorably. Such planning is likely to require a contemporaneous review of the client's estate planning, which would involve fresh analyses of the client's financial position and the tax implications of the current dispositive plans. It might result in new wills, changes in the types or amounts of life insurance, and other normal consequences of such a review.

The answer to the second question might be any one or more of a number of reasons for choosing a foreign situs. For example, the trustee may have more experience in investing trust assets in foreign securities, or at least have a higher comfort level in investing in those investments. This assertion may ring hollow if substantially all of the trust assets consist of securities in U.S. companies or governments or if the settlor directs the trust investment policy. If the trust is designed to last as long as possible (absent some future reason for terminating it early), a foreign jurisdiction might have been chosen to permit a longer trust term than would the common-law rule against perpetuities. The settlor might havebeen concerned about the future direction of U.S. economic policy, fearing the eventual imposition of exchange controls or restrictions on the transfer of assets abroad. Creating and funding a foreign trust now would negate

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[9] 11 U.S.C. § 343.

[9.1] Zahra Spiritual Trust, 910 F.2d 240 (CA-5, 1990); Brown, 820 F. Supp. 374 (DC Ill., 1993); Walk-In Medical Centers, Inc. v. Breuer Capital Corp., 778 F. Supp. 1116 (DC Colo., 1991); *In re* Janz, 432 N.W.2d 13 (Nev., 1988); Cinocco Realty, 736 P.2d 421 (Colo. App., 1987).

[9.2] *See* Mandolini Co. v. Chicago Produce Suppliers, 540 N.E.2d 505 (Ill. App. 1 Dist., 1989); Bandas v. Emperor, 467 N.Y.S.2d 749 (N.Y. Sup., 1983); U.S. Nat'l Bank of Omaha v. Rupe, 296 N.W.2d 474 (Neb., 1980); Dep't of Public Welfare v. Thibert, 279 N.W.2d 53 (Minn., 1989); Stauffer v. Stauffer, 351 A.2d 236 (Pa., 1976).

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any such limitations imposed in the future. When the trust ceases to be a grantor trust for tax purposes, its net income will no longer be subject to United States taxation (via the settlor). The settlor might be considering giving up his U.S. citizenship and residence or providing a mechanism for avoiding taxation on the trust's income that is distributed to such other beneficiaries as may decide in the future to expatriate.

The third question is an attempt to establish that the jurisdiction's creditors'-rights laws were the reason for choosing that situs. Other reasons may exist, however, for selecting that situs. Like the answer given to the preceding question, the jurisdiction might permit trusts to last for a longer term than permitted in other jurisdictions. The settlor may have also selected the jurisdiction on the basis of the experience that trustees there had in dealing with foreign (as to that jurisdiction) settlors and beneficiaries. This reason may make jurisdictions that are relatively new to the international trust arena, such as the Cook Islands, the Turks & Caicos Islands, and perhaps Gibraltar, less defensible choices than the more established ones, such as the Bahamas and the Cayman Islands. The settlor might also have concluded that the geographical distance and cultural differences between the trustee and the beneficiaries would necessitate periodic visits by the settlor with the trustee, and the jurisdiction was chosen on the basis of where the settlor liked to go. Bear in mind, the settlor's travel schedule, that is, his actual conduct, would be highly relevant to the credibility of this assertion.

If direct evidence establishing the settlor's intent is unavailable or inconclusive, that intent can be inferred from his course of conduct[10] or from the circumstances of the case.[11]

> Since it is impossible to look into [the debtor's] mind for the purpose of ascertaining his intent, it is necessary to consider the circumstances surrounding the assignment and determine the intent from what he did or failed to do. . . . The issue of fraud is generally determined by certain recognized indicia denominated "badges of fraud" which are circumstances so frequently attending fraudulent transfers that an inference of fraud arises from them.[12]

Although no one badge is determinative, each should be considered. A strong finding with respect to even one of these badges can establish the actual intent to hinder, delay, or defraud creditors.[13] On the other hand, the absence of several significant badges can negate any such intent.[14]

The analysis or use of these badges of fraud is much more subjective than it might at first appear, as is illustrated by two companion cases: *Norwest Bank Nebraska, N.A.*

[10] *See, e.g.,* Farmers Co-Operative Ass'n v. Strunk, 671 F.2d 391, 395 (10th Cir. 1982).

[11] *See, e.g.,* Devers v. Bank of Sheridan (*In re* Devers), 759 F.2d 751, 753–54 (9th Cir. 1985).

[12] Gafco, Inc. v. H.D.S. Mercantile Co., 263 N.Y.S.2d 109, 114 (Sup. Ct. 1965).

[13] *See, e.g.,* Hubbell Steel Corp. v. Cook (*In re* Cook), 126 B.R. 261, 269 (Bankr. E.D. Tex. 1991); Penner v. Penner (*In re* Penner) 107 B.R. 171, 176 (Bankr. N.D. Ind. 1989).

[14] Bank of Chester County v. Cohen (*In re* Cohen), 142 B.R. 720, 729 (Bankr. E.D. Pa. 1992).

v. Tveten[15]and *Panuska v. Johnson*.[16] Each involved a debtor who was a Minneapolis doctor who had personally guaranteed the same $19,000,000 partnership note. Both engaged the same bankruptcy counsel, converted some $700,000 into exempt assets, filed their bankruptcy petitions in the same court, and listed essentially the same creditors. The only real difference was that they drew different bankruptcy judges. In Dr. Tveten's case, the judge held that his awareness of claims together with the seventeen transfers it took to convert nonexempt assets into exempt ones evidenced an intent to defraud his creditors. In Dr. Johnson's case, the judge found that he never misrepresented or actively concealed what he was doing and concluded that there was nothing upon which to base a finding of intent to hinder, delay or defraud creditors. Dr. Tveten lost his assets and Dr. Johnson did not. Dr. Tveten's case was affirmed, with a strong dissent that noted: "In effect, the Court today leaves the distinction between permissible and impermissible claims of exemption to each bankruptcy judge's own sense of proportion."[17]

Section 4(b) of the Uniform Fraudulent Transfer Act sets out a list of the activities which includes most of the badges of fraud that the courts have recognized.[18]A court is not limited to these badges of fraud in trying to ascertain the debtor's intent in making transfers. For example, some courts have held that there is a presumptive intent to defraud creditors when the settlor is also a beneficiary.[19] Nevertheless the statute does provide a convenient checklist. In brief, the statutory badges are:

Transfer to Insider. An "insider" includes a relative of the debtor, a partnership in which the debtor is a general partner, a general partner of such a partnership,and a corporation in which the debtor is a director, officer, or person in control.[20]"Relative" means a person related by blood or marriage within the third degree or in a step or adoptive relationship with the third degree.[21] In transfers that implement estate plans, this badge will almost certainly be present. A transfer to an asset protection trust is likely to present this badge even if the trustee (the transferee) is not an insider. The transfer would probably be bifurcated into a transfer of the legal title to the trustee and a transfer of the beneficial title to the beneficiaries (who will almost certainly be insiders). Because the real value will be in the beneficial interests, it is probable that the transfer will be viewed as being made to insiders.

Retained Interest. The retention of possession or control of transferred property may

[15] 70 B.R. 529 (Bankr. D. Minn. 1987).

[16] 80 B.R. 953 (Bankr. D. Minn. 1987).

[17] Norwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871, 879 (8th Cir. 1988) (Arnold, J, dissenting). *See also* Albuquerque Nat'l Bank v. Zouhar (*In re* Zouhar), 10 B.R. 154, 156 (Bankr. D.N.M. 1981). Many of the cases are collected in S. Wolfe, *Prefiling Engineering and Denial of Discharge: Who Should Slaughter the Hog?,* 96 Comm. L.J. 189, 195 (1991).

[18] 7A U.L.A. 654, cmt. to § 4 (1985).

[19] *See* Cooper v. Freer, 385 S.W.2d 340 (Mo. Ct. App. 1964); Ward v. Marie, 73 N.J. Eq. 510, 68 A. 1084 (1907).

[20] 11 U.S.C. § 101(31); Unif. Fraudulent Transfer Act § 1(7).

[21] 11 U.S.C. § 101(45); Unif. Fraudulent Transfer Act §§ 1(11).

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be present, for example, if the transferor retains an interest in a trust to which he transfers property or if he is the trustee of that trust (or exercises significant control over the trust). The cases are not entirely consistent. On the one hand, it seems reasonably clear that a settlor who creates a trust and retains some type of income interest (mandatory or discretionary) but retains nothing else except a testamentary power of appointment with respect to the principal, will generally be treated as having given away the remainder interest rather than having "retained" anything.[22] Even if not fraudulent, the settlor's income interest is usually reachable by his creditors, because any restraint on its alienation is likely to be invalidated. See § 9.09[5], below.

On the other hand, if the settlor also retains an inter vivos power of appointment, he has in substance retained the equitable fee estate in the transferred assets. These transfers have almost always been ignored.[23] The amount of control that the settlor retains can be equally important in finding the presence of this badge.[24] This is a very difficult issue, because clients generally want as much control as possible. If no control is "retained" by the settlor but instead is "granted" to a Protector or to an Advisory Committee, this badge may not be present. However, if the settlor is the Protector or if he is the sole member of the Advisory Committee, the distinction between retaining and granting control is not likely to be significant, that is, this badge may be present. Moreover, the amount of control can be inferred from what actually happened in the administration of the trust. The volume of communications (and, perhaps more importantly, the contents of those communications) from the settlor to the trustee, and the degree to which the trustee always followed the settlor's suggestions or heeded his advice, are likely to be relevant facts. This reasoning has lead some settlors to give suggestions or advice that the trustee did not follow.

Concealed Transfer. To avoid this badge, the transfer to the trust must be openly documented. The transferred assets must also be removed from the settlor's financial statements, because he no longer owns them.

Threatened or Pending Legal Action. A transfer made after the transferor has been sued or threatened with suit is a badge of fraud. Special care must be used in analogizing transfers to asset protection trusts to conversion fact patterns (changing nonexempt assets into exempt assets) for the reasons discussed in § 9.05[4], below. A transfer to an asset protection trust after claims have surfaced is likely to fit this badge, without the necessity of any other extrinsic evidence.

Transfer Of All Assets. The transfer of substantially all of the transferor's assets is a badge of fraud. For this reason, the proportion of the client's assets that are transferred to an asset protection trust must be limited. However, no bright-line test exists. Like the preceding badge, the cases dealing with conversions must be relied on with care.

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[22] *See* Mercantile Trust Co. v. Bergdorf & Goodman Co, 173 A. 31 (Md. 1934); Crawford v. Langmaid, 50 N.E. 606 (Mass. 1898).

[23] Sargent v. Brudett, 22 S.E. 667 (Ga. 1895); Jamison v. Miss. Valley Trust Co., 207 S.W. 788 (Mo. 1918).

[24] *See* Stephens v. Reginstein, 8 So. 68 (Ala. 1890).

Absconding. Permanently leaving the state or the country is a badge of fraud.

Removing Assets. Removal of assets from the jurisdiction of the court is a badge of fraud. It might seem that a transfer of assets to a foreign trust would be an obvious example of this badge. Given the right facts, however, two arguments exist for not applying this badge to such a transfer. First, to the extent that the assets consist of stocks and bonds issued by domestic corporations, those assets have not been removed from the jurisdiction of any U.S. court. The ownership has changed, but the situs of the assets for purposes of *in rem* and *quasi-in-rem* jurisdiction has not been altered. Although this appears to be correct technically, it may not be sufficient if the court cannot find those assets (*e.g.,* they are located in an unknown street name and the foreign trustee refuses to disclose that name).

The second argument arises if the debtor has transferred accounts rather than assets, that is, has given the trustee a brokerage or bank account rather than the assets in those accounts. Like the first argument described above, the transfer of account ownership does not remove the underlying assets from any court jurisdiction. If the trustee subsequently withdraws the assets from the account, it is the trustee and not the debtor that moved the assets around. The question is, of course, whether the actions of the trustee can be imputed to the settlor. This is likely to depend on several factors, such as the time span between the transfer of the account to the trustee and the withdrawal of assets from the account and the degree of control that the settlor is seen to have over the operation of the trust.

Hiding Assets. Concealment of assets (*e.g.,* the omission of an asset from a financial statement furnished to a creditor or bankruptcy trustee) is a badge of fraud. In the case of an asset protection trust, it may not be as easy to avoid this badge as it might first appear. The problem is the interest in the trust that the settlor retains. If that interest is just what is set out in the trust agreement, there should be no difficulty, because it is disclosed to anyone reading that agreement. Often, the settlor will not be satisfied with this, wanting more control over the trust assets. A number of cases exist holding that where legal title to assets is transferred, but the transferor continues to use and enjoy those assets, the transferor may have concealed a *de facto* equitable interest in those assets.[25] If that *de facto* interest is not identical with that which is spelled out in the trust agreement, a risk exists that the "real" equitable interest will have been concealed.

Transfer For Inadequate Consideration. A badge of fraud exists if the value of the consideration received by the transferor is not reasonably equivalent to the value of the asset transferred. If the debtor claims that the transfer was made for reasonably equivalent value, the determination of whether adequate consideration was received is

[25] Thibodeaux v. Olivier (*In re* Olivier), 819 F.2d 550, 553 (5th Cir. 1987); Freidell v. Kauffman (*In re* Kauffman), 675 F.2d 127, 128 (7th Cir. 1981) (*per curiam*); Hubbell Steel Corp. v. Cook (*In re* Cook), 126 B.R. 261, 266–267 (Bankr. E.D. Tex. 1991); Saklow v. Vecchione (*In re* Vecchione), 407 F. Supp. 609, 614 (E.D.N.Y. 1976).

a question of fact.[25.1] Although "reasonably equivalent value" does not mean exact mathematical equivalence,[25.2] there must be a reasonable equivalence between the purchase price and the value of the property received as a result of, and at the time of, the transfer.[25.3] Furthermore, the transferee's good faith with respect to the transaction is irrelevant to a determination of the adequacy of the consideration under the Uniform Fraudulent Conveyance Act.[25.4] Any estate planning that involves gifts will automatically bear this badge, which includes transfers to asset protection trusts.

Insolvency. If the transferor is insolvent when, or becomes insolvent shortly after, the transfer is made, this badge exists. This is one of the most important badges, and may itself be enough to convince a court that the transfer was fraudulent.[26] The Uniform Fraudulent Conveyance Act treats the transferor's insolvency as causing the transfer to be *ipso facto* fraudulent.[27] The Uniform Fraudulent Conveyance Act defines insolvency as when the present fair value of his assets is less than the amount that will be required to pay his liability on his existing debts as they become absolute and matured.[28]

The Uniform Fraudulent Transfer Act substantially expands the definition of insolvency: A debtor is insolvent when the sum of a debtor's debts is greater than all of the debtor's assets at a fair valuation or when he is not generally paying his debts as they become due.[29] Assets that have been transferred, concealed, or removed with intent to hinder, delay, or defraud creditors are not counted as assets in determining whether the particular transfer renders the transferor insolvent.[30]Therefore, if the debtor has made multiple transfers while insolvent, the voiding of one of them cannot increase his assets so as to possibly eliminate the condition of insolvency when the others were made.

Surprisingly, the meaning of being "insolvent" is far from clear. The courts do not agree on what is the proper measure of the debtor's assets. Compare the conclusion that a company with highly illiquid assets would not be insolvent if the operation of its business produced sufficient cash for the payment of its debts as they matured,[31]with the conclusion that a debtor is insolvent if the *present* salable value of

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[25.1] *In re* Metropolitan Steel Fabricators, 191 B.R. 150 (Bkrtcy. D. Minn., 1996). *See also generally*, *In re* Bay Plastics, 187 B.R. 315 (Bkrtcy. C.D. Cal., 1995).

[25.2] *In re* WCC Holding Corp., 171 B.R. 972 (Bkrtcy. N.D. Tex., 1994).

[25.3] *In re* Morse Tool, 148 B.R. 370 (Bkrtcy. D. Mass., 1992).

[25.4] Unif. Fraudulent Transfer Act § 4. Comment (2).

[26] *See, e.g.,* Cross v. Wagenmaker, 44 N.W.2d 888, 891 (Mich. 1950); O'Banion v. Henry, 96 S.W.2d 233, 235–36 (Tex. 1936).

[27] Unif. Fraudulent Conveyance Act § 4.

[28] Unif. Fraudulent Conveyance Act § 2.

[29] Unif. Fraudulent Transfer Act § 2(a), (b).

[30] Unif. Fraudulent Transfer Act § 2(d).

[31] United States v. Gleneagles Inv. Co., Inc., 565 F. Supp. 556, 579 (M.D. Pa. 1983).

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assets are less than the amount required to pay existing debts as they mature.[32] However, there seems to be general agreement that assets which are exempt are not included as assets for purposes of determining insolvency.[33]

Moreover, the courts do not agree on what are debts for the purpose of measuring solvency. The statutory language appears to exclude debts that are either contingent or not yet due. Yet, some courts include those debts and even include debts the collection of which will be barred by statutes of limitations. This is based on the theory that limitations is an affirmative defense and not an absolute bar, and might therefore not be raised by the debtor.[34]

As discussed in § 9.05[4], below, reliance on cases involving conversions can be risky in concluding that the transferor is not insolvent when contemplating a transfer to an asset protection trust.

Transfer Contemporaneous With Debt. A transfer occurring shortly before or shortly after a substantial debt is incurred is a badge of fraud. It is not necessary to establish that any particular debt was contemplated; a general intention is enough.[35]

Indirect Transfer to Insiders. It is a badge of fraud when a debtor transfers the essential assets of a business to a lienor who transfers the assets to an insider of the original transferor.

> **Caution:** It is important to note that, with the exception of the insolvency badge, the financial condition of the transferor is irrelevant to a finding that a badge of fraud (and hence an indication of actual fraud) exists. If actual intent to hinder, delay, or defraud creditors can be established, the transfer can be avoided even if the transferor's insolvency does not arise until later as the result of some subsequent event.

[b] Constructive Fraud. The second type of avoidable transfer does not involve any actual intent on the part of the transferor in connection with the transfer. Present (but not future) creditors can attack the transfer on the basis of constructive fraud.[36]If the debtor did not receive a "fair consideration" (the Uniform Fraudulent Conveyance Act term) or "a reasonably equivalent value" (the Uniform Fraudulent Transfer Act term) for the transfer, it is fraudulent in three specified circumstances:

(1) The debtor is insolvent at the time of the transfer or it renders him insolvent;

(2) The debtor intends to or believes (or under the Uniform Fraudulent Transfer Act reasonably should have believed) that he will incur debts beyond his

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[32] Larrimer v. Feeney, 192 A.2d 351, 353 (Pa. 1963).

[33] Adams v. Prather, 167 P. 534, 538 (Cal. 1917).

[34] *See* United States v. St. Mary, 334 F. Supp. 799 (E.D. Pa. 1971) (contingent liabilities); Davis v. Nielson, 515 P.2d 995 (Wash. Ct. App. 1973) (barred debt).

[35] Hartnett v. Doyle, 64 S.W.2d 227 (Tenn. Ct. App. 1932).

[36] Unif. Fraudulent Conveyance Act § 4; Unif. Fraudulent Transfer Act § 5.

ability to pay as they mature;[37] and

(3) The debtor is engaged or about to become engaged in a business or a transaction for which the property remaining in his hands is an unreasonably small capital[38] or the remaining assets of the debtor were unreasonably small in relation to the business or transaction.[39]

This last category has given the courts the most difficulty. There is general agreement that whether the remaining assets are inadequate is a question of fact that depends on the nature of the debtor's business.[40] Many cases seem to stand for the proposition that the subsequent insolvency of the transferor is proof of the fact of inadequacy.[41] However, most of these involved transfers when financial problems already existed. Where the liabilities have arisen at a later time, the courts have been more reluctant to set aside the transfer on this ground.[42] This is to be expected, because otherwise the adjective "unreasonably" would have very little meaning.

Logically, this issue is the same as the one involved in deciding whether the limited liability attribute of a corporation is to be disregarded and whether its shareholders should be held liable for the company's debts. The question in both cases is whether the assets available should be viewed as being reasonably sufficient to carry on the business. In one case, the question is whether enough assets were retained and, in the other case, the question is whether enough assets were invested. However, the case law does not reflect any consideration of this parallel. The question has not been rejected, just never considered. This may be because the bankruptcy rule arose at a time when limitations on liability were viewed as bad public policy and the rule's rationale has never been revisited. Another reason may be because the limitation of liability through the corporate form is good public policy (so that the protection ought not to be lightly stripped away) whereas there is no similar public policy favoring transfers for inadequate consideration. In other words, a smaller amount may be adequate in the investment case than in the retention case.

Properly timed and advised transfers to an asset protection trust should not fit any of the three categories of constructive fraud. The settlor would not be insolvent at the time (or as a result) of the transfer. The fear of some future "home-run" liability is not the same as intending to incur such a debt or believing that it will be incurred. The fact

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[37] Unif. Fraudulent Conveyance Act § 6; Unif. Fraudulent Transfer Act § 4(a)(2)(ii).

[38] Unif. Fraudulent Conveyance Act § 5.

[39] Unif. Fraudulent Transfer Act § 4(a)(2)(i).

[40] Jenny v. Vining, 415 A.2d 681 (N.H. 1980); Zuk v. Hale, 330 A.2d 448 (N.H. 1974).

[41] *See, e.g.,* Spanier v. United States Fidelity & Guar. Co., 623 P.2d 19 (Ariz. Ct. App. 1980); United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983).

[42] Oakford Realty Co v. Boorman, 143 A. 644 (Md. Ct. App. 1928); Palumbo v. Palumbo, 284 N.Y.S. 2d 884 (Sup. Ct. 1967); Holcomb v. Nunes, 283 P.2d 301 (Cal. Ct. App. 1955); Patterson v. Missler, 48 Cal. Rptr. 215 (Dist. Ct. App. 1965); Finger v. Kemp, 163 A. 153 (N.J. Ct. Ch. 1932); Zuk v. Hale, 330 A.2d 448 (N.H. 1974); Cram v. Cram, 160 N.E. 337 (Mass. 1928); *In re* Decker's Estate, 268 N.Y.S. 280 (Sur. Ct. 1933).

that we live in a litigious society should not support a reasonable belief that such a liability will be incurred. Finally, the assets remaining in the client's hands should not be unreasonably small.

[4] Bankruptcy Estate Planning: Conversions

Cases involving the conversion of nonexempt property into exempt assets may be poor guides for judging the outcome of challenges to transfers to asset protection trusts. Debtors have a right to the exemptions created under state law or the Bankruptcy Code. For this reason, courts have been unwilling to hold that a debtor who positions himself to take advantage of that right (by converting property) has *ipso facto* engaged in a fraudulent transfer.[43]This view was in effect sanctioned in the legislative history of the Bankruptcy Code. Both the House and Senate committee reports accompanying that legislation stated:

> As under current law, the debtor will be permitted to convert nonexempt property before filing a bankruptcy petition. That practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.[44]

A transfer to an asset protection trust does not involve any exemption created by state or federal law.

A considerable amount has been written about "bankruptcy estate planning."[45]However, the definition of that phrase has been limited to a strategy whereby a debtor attempts to shield property from the reach of creditors by converting nonexempt property to an exempt form of property prior to filing a bankruptcy petition.[46] Thus, these materials focus almost exclusively on the conversion scenario, making their analyses irrelevant to the asset protection trust strategy.

[5] Statutes of Limitations

An action to avoid a transfer must be brought within the applicable statute of limitations. The length to time varies from state to state. Four years is the most general term, but some states have periods as long as ten years.

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[43] *See, e.g.,* Hanson v. First Nat'l Bank, 848 F.2d 866 (8th Cir. 1988).

[44] H.R. Rep. No. 595, 95th Cong., 1st Sess. 361, reprinted in 1978 U.S. Code Cong. & Admin. News 5963, 6317; S. Rep. No. 989, 95th Cong., 2d Sess. 76, reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5862.

[45] *See, e.g,* Frank W. Koger & Sheryl A. Reynolds, *Is Prefiling Engineering Prudent Planning or Section 727 Fraud? (Or, When Does a Pig Become a Hog?),* 93 Comm. L.J. 464 (1988).

[46] Kevin A. Shacter, *Bankruptcy Estate Planning: Grounds for Denial of Discharge under Section 727(a)(2)(A),* 7 Bankr. Dev. J. 199 (1990). *See also* Panuska v. Johnson (*In re* Johnson), 80 B.R. 953 (Bankr. D. Minn. 1987).

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§ 9.06 Bankruptcy

Debtor's assets (including those brought back under fraudulent transfer rules) become bankruptcy estate that is liquidated and whose proceeds are distributed to creditors. Interests in spendthrift trusts and powers that cannot benefit debtor are exempted. Debtor is entitled to discharge of most kinds of debts unless he has engaged in certain types of conduct. Trust beneficiaries may be liable for some part of grantor-debtor's unpaid debts. Foreign bankrupt's creditors can receive substantial assistance from U.S. courts in pursuing his U.S. assets.

[1] Definition of Bankruptcy

Bankruptcy, as discussed in this chapter, is a proceeding in a U.S. federal court pursuant to Chapter 7 of the Bankruptcy Code. Simply stated, it involves a liquidation of the debtor's nonexempt and nonexcluded assets and the eventual cancellation (discharge) of most debts. A bankruptcy trustee is appointed to represent all of the creditors. He collects (marshals) all of the debtor's assets that are neither exempt nor excluded, and uses those assets (or their proceeds) to satisfy the claims of the creditors according to a plan approved by the court. In marshaling the debtor's assets, the bankruptcy trustee can avoid any fraudulent transfers made by the debtor before the filing of a bankruptcy petition. The transferee of property in the avoided transaction can be ordered to turn over the property to the bankruptcy trustee, assuming that the court has *in personam* jurisdiction over him. See § 9.04, above, for a detailed discussion of *in personam* jurisdiction and the enforceability of a U.S. bankruptcy court's orders. As a part of the bankruptcy proceeding, the debtor may be ordered to provide information and to assist the bankruptcy trustee in gathering assets. At the conclusion of the proceeding, the debtor is entitled to receive a discharge of most kinds of debts, unless the debtor has engaged in certain specified misconduct.

The principal issues are whether:

(1) any interest in or power over the asset protection trust retained by the client is an exempt asset under the Bankruptcy Code;

(2) any transfers of assets to that trust by the client can be avoided by the bankruptcy trustee; and

(3) the client's activity either in setting up the trust and transferring property to it or during the bankruptcy proceeding permits either a denial of any discharge of debts or a finding of contempt of court.

[2] Extent of Bankruptcy Estate

The definition of a U.S. debtor's bankruptcy estate is very broad under the Bankruptcy Code:[1] all legal or equitable interests in the property of the debtor as of the commencement of the proceeding.[2]It includes a debtor's interest in a trust,[3]even

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[1] D. R. Cowan, 2 Cowan's Bankruptcy Law and Practice 50 (1989 ed.).

[2] 11 U.S.C. § 541(a)(1).

[3] *In re* Dolard, 275 F. Supp. 1001 (Bankr. C.D. Cal. 1967).

though the trust was created under foreign law with an offshore trustee. However, the statute does not provide any rules for determining what is the debtor's property interest, so this must be determined under nonbankruptcy law.[4] For interests in trusts this presumably would be the law of the trust situs. Note that a restriction on the transferability of a trust interest does *not* prevent that interest from being transferred to the bankruptcy estate,[5]except in the limited situation discussed in § 9.06[3], below. However, the alienation restriction is not abrogated. It still applies to the interest in the hands of the bankruptcy trustee because that restriction is an integral part of whatever interest the debtor has.[6] While the fact that the trust has a foreign situs does not prevent interests in the trust from becoming part of a bankruptcy estate, it does significantly alter the way in which the Bankruptcy Code can be enforced against the foreign trustee and the trust assets. See § 9.04[4], above.

[3] Exemption of Certain Trust Interests

A beneficial interest in a trust is not includable in the bankruptcy estate if there is a restriction on the transfer of that interest which is enforceable under applicable nonbankruptcy law.[7]The statutory language describes a direct restraint on alienation. The cases interpreting this exemption have dealt almost exclusively with ERISA,[8]which requires a direct restraint on the alienation of benefits provided under the benefit plan.[9]Consequently, there is no answer to the question of whether an indirect restraint (forfeiture of trust interests upon an attempted transfer) will also keep that interest out of the bankruptcy estate. There are three arguments supporting an affirmative answer. First, whatever public policy underlies the exemption for direct restraints ought to apply to indirect ones as well. Second, since not all states of the United States recognize the validity of direct restraints (see § 9.09[2], below) the residents of those states would be denied an exemption available to most U.S. persons unless their trusts were formed in a state recognizing direct restraints. Third, a settlor ought to be able to accomplish indirectly what he can do directly.

The question is important because, as discussed in §§ 9.09[2], [3], below, most common-law jurisdictions (other than the states of the U.S.) do not recognize the validity of direct restraints, but do enforce indirect restraints. Thus an offshore asset protection trust is likely to have only an indirect restraint on the transfer of beneficial interests. Given the uncertain state of the law on this point, however, a conservative advisor may conclude that the Bankruptcy Code's exemption for certain trust interests cannot be relied upon to exempt interests in a foreign asset protection trust that is subject only to an indirect restraint on alienation.

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[4] 5 Collier on Bankruptcy § 541.02 (15th ed. Matthew Bender).

[5] *See, e.g., In re* Farmers Markets, Inc., 792 F.2d 1400 (9th Cir. 1986).

[6] *In re* Polycorp Assoc., Inc., 47 B.R. 671 (Bankr. N.D. Cal. 1985).

[7] 11 U.S.C. § 541(c)(2).

[8] 29 U.S.C. § 1056(d)(1).

[9] *See, e.g., In re* Goff (Goff v. Taylor), 706 F.2d 574 (Bankr. 5th Cir. 1967).

[4] Powers Over Trusts

Expressly excluded from the bankruptcy estate are powers that can be exercised solely for the benefit of an individual or entity (including a trust) other than the debtor.[10]A general power of appointment would be includible because the debtor can appoint himself or his estate. A limited power of appointment, on the other hand, is not included in the bankruptcy estate so long as the permissible appointees or takers in default of appointment do not include the debtor or his estate.[11]The exclusion of these powers from a debtor's estate plays a central role in the efficacy of an asset protection trust. The ability to maintain control over the devolution of the trust assets upon the termination of the trust by using a limited power of appointment gives the debtor a large measure of influence over the potential appointees. However, the retention of such a power may increase the risk that any retained beneficial interest will be viewed as a badge of fraud. See § 9.05[3][a], above.

The exclusion is not limited to powers of appointment. For example, a power to remove the trustee and to appoint a successor generally ought not to be included in the bankruptcy estate, even though that power gives the debtor significant indirect control over the administration of the trust. However, if the debtor can name himself trustee such a power might be includable in the estate if the trustee is either entitled to compensation for services rendered or has the discretion to make distributions to or for the benefit of the debtor.

Another power to be considered is that of revocation. A literal reading of the Bankruptcy Code appears to capture such a power since it can be exercised forthe benefit of the debtor.[12] However, there are cases holding that a right of revocation is not includable in the bankruptcy estate if it is not a property right under state law.[13] Providing for a power of revocation in reliance on these cases is a matter of judgment. If the debtor has any other interest in the trust, even though it is an exempt asset because of a valid restraint on alienation, a greater degree of concern may be justified.

[5] Discharge

The client expects to emerge from a bankruptcy proceeding with a discharge: the forgiveness of all but a few specified kinds of debts. If there is no discharge, the client remains liable for all existing debts. In effect, this will deny him any future benefits out of the asset protection trust because his creditors will be waiting to seize any distributions to him, unless they lose patience and allow their judgments against him to lapse.

A debtor has a right to a discharge unless he has engaged in one of the ten types of

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[10] 11 U.S.C. §§ 541(b)(1), 101(14), 101(30). This is also the English rule. Insolvency Act, 1986, ch. 45, § 283(4).

[11] Forbes v. Snow, 140 N.E. 418 (Mass. 1923).

[12] 11 U.S.C. § 541(b). *See* Nossaman & Wyatt, 1 Trust Administration and Taxation, Ch. 24 (Matthew Bender).

[13] *See, e.g.,* George v. Kitchens by Rice Bros., Inc., 665 F.2d 7 (Bankr. 1st Cir. 1981).

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conduct described in Section 727(a) of the Bankruptcy Code. The most likely to cause a problem in the asset protection trust context is the transfer of property within one year of the bankruptcy filing with the actual intent to hinder, delay or defraud creditors. In practice, the determination of a debtor's intent is highly subjective. See § 9.05[3][a], above. The only sure defense is to be outside the one-year window.

A second potential ground for denying a discharge is knowingly and fraudulently providing false information or withholding any recorded information relating to the debtor's property or financial affairs in or in connection with a bankruptcy case.[14] An asset protection trust must be designed so that the settlor can disclose fully and completely whatever he knows and turn over any written documents he has. The more the creditors know about that barrier, the more effective it can be, because they may conclude that they have little chance at getting the trust assets. A more subtle problem can arise in preparing the debtor's Statement of Financial Affairs and its accompanying schedules. The settlor may have a de facto equitable interest in the trust assets that is not disclosed by the trust agreement. If that is the case, the failure to list that de facto interest can result in denial of the discharge. This is essentially the same issue discussed in § 9.05[3][a], above.

Finally, a discharge is denied if the debtor refuses to obey an order of the bankruptcy court. One of the consequences of setting up a well-drafted asset protection trust is that the settlor who is in a bankruptcy proceeding cannot compel the trustee of that trust to do anything. The debtor ought not to be responsible for the outcome of demands and commands that he gives the trustee of the asset protection trust at the court's direction. However, if the court concludes that the debtor does control the trustee, it may decide that the debtor is responsible for the outcome of those demands, and hence deny a discharge.

[6] Fraudulent Transfers

In addition to the property belonging to the debtor at the commencement of the bankruptcy action, the bankruptcy estate can be augmented by the avoidance rights given the bankruptcy trustee under Sections 544(b) and 548 of the Bankruptcy Code. The first section incorporates the local fraudulent transfer legislation: any transfer that could be avoided under the local state law can by avoided by the bankruptcy trustee. The second is an independent, self-contained avoidance right. However, the transfers it covers are so similar to those described in the UFTA that for practical purposes they are indistinguishable. Consequently, the discussion of avoiding fraudulent transfers in § 9.05, above, is not duplicated here. There is one important difference, however, between the local fraudulent conveyance provisions which Section 544(b) imports and the Section 548 avoidance rights. Section 548 has its own fixed statute of limitations, whereas the state statutes incorporated by Section 544(b) invariably have much longer limitations periods.

Section 548(a) and (b) of the Bankruptcy Code formerly provided that transfers made within one year prior to the debtor filing his petition for bankruptcy were deemed

[14] 11 U.S.C. § 727(a)(4).

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fraudulent. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 substantially tightened that rule. First, with respect to all transfers, the one-year period was extended to two years so that all transfers made within two years prior to the debtor filing for bankruptcy are subject to being drawn back into the bankrupt's estate without proof as to any actual intent to defraud creditors.[15] More important for purposes of this discussion, a new Section 548(e) of the Bankruptcy Code now provides that transfers made to self-settled trusts or "similar devices" within 10 years prior to the filing for bankruptcy may be drawn back into the bankrupt's estate if made with the actual intent to hinder, delay or defraud present or future creditors. The trustee thus will have to prove intent, but given that the statute also applies to transfers made to hinder, delay or defraud future creditors, it may be difficult to avoid the reach of Section 548(e) with transfers to foreign asset protection trusts.[16] Section 548(e) has not yet been tested, but assuredly will be.

Section 548(e) arose because of controversy on the Senate floor during debates on the new bankruptcy law following publication of an article in The New York Times asserting that the proposed amendments helped credit card companies pursue lower and middle class borrowers but allowed wealthy taxpayers to shelter their assets in asset protection trusts.[17] Senator Talent of Missouri proposed Section 548 as an amendment to the bill during debates, saying: "We should not allow crooks to hide their assets and avoid paying their bills [through the use of self-settled trusts . . .]."[18]

[7] Other Beneficiaries

The prior discussion regarding the creditor's remedies for fraudulent transfers has focused exclusively on the recovery of assets (or their value) from the trustee of the asset protection trust. It is possible that the bankruptcy trustee has another target. Section 550(a)(1) of the Bankruptcy Code provides that where the transfer of property is avoided, the bankruptcy trustee can recover the transferred property (or its value) from either the initial transferee (the trustee of the asset protection trust) or any person "for whose benefit such transfer was made." Although there is no case directly in point, this phrase would seem to include the beneficiaries of the asset protection trust.

It is clear that the beneficial interests themselves cannot be taken, because the statute provides only that the trustee may recover the property transferred, or the value of the property.[19] The first remedy would not be available in the context of an asset protection trust, because the beneficiaries do not have any access tothe trust assets so as to be able to transfer them to the bankruptcy trustee. Thus the real issue is the

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[15] Pub. L. No. 109-8, 119 Stat. 23. For a broad discussion of the Act on asset protection planning, *see* Duncan E. Osborne, Joseph D. Martinec and Michael W. Johnson, *Asset Protection Planning After the Bankruptcy Act*, Texas Bar Journal, Vol. 68, No. 11, at 1006.

[16] *But see* continuing strategies in Gideon Rothschild, *Asset Protection Planning — Current Strategies and Pitfalls*, Tax Management Estates, Gifts and Trusts Journal 2005, at 252 *et seq*.

[17] Morgenson, The New York Times, March 2, 2005.

[18] 151 Congressional Record, at __.

[19] 11 U.S.C. § 550(a)(1).

amount that can be recovered from the trust's beneficiaries (both term and remaindermen).

The Bankruptcy Code refers to the value of the property transferred, not to the value received by a person "for whose benefit such transfer was made." Most of the decided cases involved a transfer that relieved the "beneficiary" of a debt to the transferee.[20] In those situations, it is easy to see that the amount of the award should be the value of the transferred property, because it was equal to the value which that person had received (the extinguishment of the liability). The effect of that person's intent or participation in the transaction was never an issue. There are only a few cases involving different fact patterns. These speculate that there may be some limit on the scope of the "entity-for-whose-benefit-such-transfer-was-made" net. In the leading case,[21] the debtor transferred funds to the transferee by check. The transferee then paid the proceeds to the bank on which the check had been drawn to satisfy a liability that the transferee had to that bank. The issue was whether the bank was an entity for whose benefit the original transfer was made. The bank argued that it was not such an entity, because it did not intend to be the beneficiary of the transfer; it was not in cahoots with the transferor or the transferee and did not know of their plans. The bank was held not liable for other reasons, but the court's response to the "intent" argument is interesting:

> To what extent does 'intent' matter under § 550(a)(1)? If intent matters, whose? To what extent must courts find the true economic benefits of a transaction? If the Bank were undersecured, would the transfer make the Bank the beneficiary by the amount of the difference between the loan and the security? Suppose [the transferee] planned to, and did, buy a Rolls Royce with the money; would the dealer be the beneficiary by the difference between the wholesale and retail price of the car? How are bankruptcy courts to determine 'intent' and compute the benefit in transactions of this nature?[22]

Although the court gave no answer to the question of the role of a beneficiary's intent, the practitioner may want to ensure that the trust beneficiaries (other than the settlor) are innocent of *any* intent regarding the settlor's creditors. This would require that the settlor refrain from any discussion of planning or creating the trust, or making transfers to it, with any beneficiary until well after it is in place and funded.

The court assumed that any recovery would be measured by the benefit received ("the difference between the wholesale and retail price of the car") rather than by the property transferred (the purchase price of the car). This seems to be the proper result because there is something fundamentally unfair (possibly offending the due process notion) in imposing a liability on a person for whose benefit the transfer was made that exceeds the value of the benefit that he has received.

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[20] *See e.g.,* Merrill v. Dietz (*In re* Universal Clearing House Co.), 62 B.R. 118 (Bankr. D. Utah 1986).

[21] Bonded Financial Servs., Inc. v. European American Bank, 838 F.2d 890 (7th Cir. 1988).

[22] 838 F.2d at 895 (7th Cir. 1988). *See also* Harley v. Sorani (*In re* Richmond Produce Co., Inc.), 118 B.R. 753, 757–758 (Bankr. N.D. Cal. 1990).

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If, indeed, this is the proper measure of liability under Section 550(a)(1), the value of the beneficial interests in the trust (since they are what the beneficiaries received) would have to be determined. A discretionary interest (in either income or principal) has little value since future distributions cannot be predicted. Remainder interests do not appear susceptible of any rational method of valuation. Assumptions could be made regarding the termination date (which might be the maximum period permitted the existence of the trust under the law of the situs due to "evergreen" renewals), the probability that the beneficiary would survive to that termination date, the growth rate of the value of the trust assets, and a present-value discount rate. However, there are two other factors that bear on the computation of the current value of that residuary interest: (1) the fraction of the whole, which is likely to be dependent upon the number of siblings that the remainderman has (or an ancestor has had) who are alive when the trust terminates, and (2) the size of the trust at termination, which will depend upon the amounts of discretionary distributions made during the remainder of the term of the trust. It is difficult to see how any assumption could reasonably be made about either of these factors. Past distribution patterns are no predictor of future ones because the personal and financial conditions of the beneficiaries almost certainly will change over time.

Planning Note

Avoid Value Being Assigned to Beneficiary's Interest by Making it Contingent. By making the vesting of remainder interests subject to a condition precedent, assuming that the law of the trust's situs recognizes the difference between that and a vesting subject to divestiture on a condition subsequent, the assignment of value to the remainder interests can be avoided. The problem with this strategy is that determining what language is required to create a contingent remainder interest is one of the most difficult problems in the field of legal construction.[23] The samelanguage can create a condition precedent or a condition subsequent, depending upon the settlor's intent.[24]

Example: *B,* a U.S. person who is not the settlor of an offshore trust, has two beneficial interests in the trust: a vested interest during the trust's term (the trustee can at its discretion make distributions to *B*) and a contingent remainder interest (at the termination of the trust, *B* is entitled to a share of the trust assets if she is fully able to enjoy them). If the settlor's creditors are successful in having Bankruptcy Code Section 550(a)(1) applied to *B,* and their recovery from *B* is limited to the value of what she has received, her liability should be negligible. A third party would not pay anything for either a discretionary interest in an asset protection trust knowing that the trustee would never make any distribution to him, or a contingent remainder interest in the trust knowing that nothing would

[23] 3 Powell on Real Property § 20.04 (Matthew Bender); Nossaman & Wyatt, 1 Trust Administration and Taxation Ch. 23 (Matthew Bender).

[24] Robinson v. Comyns, Eng. Rep. 718 (K.B. 1736); Finlay v. King, 28 U.S. 346 (1830).

ever be distributed to him because the remainder interest would never vest.

An inventive bankruptcy trustee might obtain some kind of judgment against all the other beneficiaries as a class, without trying to value the individual beneficial interests, on the theory that there is joint and several liability among the persons for whom the transfer was made. If it reached only trust assets (or their value) as they were received by the beneficiaries in the future, the issue of liability in excess of value received would be avoided. The difficulty in monitoring these judgments (*i.e.,* distributions to beneficiaries and keeping the judgments alive), plus the necessity of ensuring that the bankruptcy trustee never collected more than the value of the originally transferred property (the bankruptcy trustee cannot recover more than the value of the transferred property because under Section 550(c) of the Bankruptcy Code he "is entitled to only a single satisfaction"), may make such an attempt impractical. Nevertheless, it could seriously affect the planned operation of the asset protection trust.

[8] Foreign Bankruptcy Representative's Rights Under U.S. Law

If a representative in bankruptcy is appointed for a foreign investor in his home country, the investor's U.S. assets can be affected. The U.S. courts offer the foreign bankruptcy representative substantial assistance in seizing the U.S. estate of the foreign debtor. The foreign bankruptcy representative has several options:

(1) Commence an involuntary proceeding against the foreign debtor in the United States as an ancillary case to the foreign proceeding[25] (the foreign representative can thereby administer U.S. assets in a manner consistent with the foreign proceeding);[26]

(2) Request a U.S. court to order the property of the foreign debtor, or its proceeds, to be turned over to the bankruptcy representative to be included as part of the foreign proceeding[27] (the turnover may be conditioned upon compliance with orders designed to protect the rights of U.S. creditors);[28] or

(3) Ask for other appropriate relief from the U.S. bankruptcy court.[29]

This latter catchall provision allows the U.S. court flexibility in determining the appropriate remedy under the circumstances. For example, it has been used to allow a foreign representative to conduct discovery proceedings in the United States to assist in a foreign proceeding.[30] Moreover, if the foreign bankruptcy law is comparable to U.S. bankruptcy law, the foreign representative may be able to rely on comity to have its foreign judgment enforced in the United States.[31]

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[25] 11 U.S.C. §§ 303(b)(4), 304(a).

[26] *See In re* Axona Int'l Credit & Commerce Ltd., 88 B.R. 597 (Bankr. S.D.N.Y. 1988).

[27] 11 U.S.C. § 304(b)(2).

[28] *In re* Lineas Areas de Nicaragua, 10 B.R. 790 (Bankr. S.D. Fla. 1981).

[29] 11 U.S.C. § 304(b)(3).

[30] Angulo v. Kedzep Ltd., 29 B.R. 417 (S.D. Tex. 1983).

[31] *See* Cunard S.S. Co. v. Salem Reefer Serv. A.B., 773 F.2d 452 (Bankr. 2d Cir. 1985).

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[9] Recent Decisions Under the Federal Bankruptcy Act

There have been recent decisions of the state and federal courts involving debtors who sought to contest efforts by their bankruptcy trustee to attach, manage and liquidate assets that they had transferred prior to their filing a bankruptcy petition. In the case of *Ashley Albright, Debtor*,[32] the United States Bankruptcy Court for the District of Colorado held that the bankruptcy Trustee of a debtor who had filed a petition for bankruptcy under Chapter 7 of the Bankruptcy Act was entitled to the management and control of a sole member LLC created by the debtor, without further notice to or consent of the debtor, because all interests of the debtor in a sole member LLC passed automatically to the bankruptcy trustee upon the filing of the petition.

In the case of *Stephan Jay Lawrence, Debtor v. Alan L. Goldberg, Trustee*,[33] the Court of Appeals was presented with a case where Mr. Lawrence, the debtor, had in 1991 settled an irrevocable offshore trust in Mauritius, initially for his own benefit. The trust contained some $7 million. Two months after Mr. Lawrence settled the trust, an arbitration award was entered against him for $20.4million. In 1993, the trust deed was amended so that the settlor's powers could not be exercised under duress or coercion, and his life interest in the trust would automatically terminate in the event of bankruptcy. In 1995, the trust deed was further amended to declare Mr. Lawrence an "excluded person," and in 1997 he declared bankruptcy. The bankruptcy trustee attempted to collect and realize upon the assets of Mr. Lawrence's offshore trust. Mr. Lawrence resisted, claiming he no longer had any powers over the trust, and that to punish him for his inability to collect the assets would be improper, because it was impossible for him to repatriate the assets, under the current, amended trust documents. The district court found that Mr. Lawrence had made the "turn over" of assets impossible by his own actions, and that the trustee had the power to reinstate Mr. Lawrence as the beneficiary. The court found Mr. Lawrence in civil contempt and sent him to jail on October 5, 1999, in addition to imposing a civil fine of $10,000 per day. Mr. Lawrence was still in jail at the time of the Court of Appeals' decision on January 23, 2002. The Court of Appeals cited with approval the decisions in *Commodity Futures Trading Commission v. Wellington Precious Metals, Inc.*[34] and *Federal Trade Commission v. Affordable Media, LLC*[35] and ordered that Mr. Lawrence remain incarcerated until he complied with the District Court's order. The Court of Appeals did note, however, that civil contempt orders are "intended to coerce compliance with a court order," and not to punish, and ordered the District Court to hold periodic hearings to determine if Mr. Lawrence was going to steadfastly refuse to comply with the court's order, or might be coerced into compliance at some future time.

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[32] 291 B. R. 538 (Bankr. D. Colo. 2003).

[33] 279 F.3d 1294 (11th Cir. 2002).

[34] 950 F.2d 1525 (11th Cir. 1992).

[35] 179 F.3d 1228 (9th Cir. 1999), see discussion at § 14.03[3].

§ 9.07 Planning for Situs Change for Asset Protection Trust

Trust instrument should expressly provide for change of situs under certain circumstances. Situs of trust can be changed by modification, termination and re-creation or decanting. Changes by modification are smoothest because trust does not terminate. Changes by termination and re-creation or decanting can create substantial tax liability.

[1] Authority for Change of Situs

All asset protection trusts should provide for a change in situs of the trust when changed circumstances require it. There is no common-law prohibition against changing the situs of a trust, nor does a change of situs appear to contravene any commonly recognized public policy.[1] Change of situs provisions are often thought essential by practitioners establishing trusts in offshore jurisdictions, if only as a matter of sovereign risk. For example, if a settlor from England has chosen to establish a trust in Bermuda for the benefit of her descendants throughout the world (not for purposes of asset protection), she will normally include provisions in the trust deed providing either for automatic change of situs of the trust, or for discretion in the trustee to change the situs of the trust if circumstances warrant. Such circumstances might include a change in the tax laws of the original situs jurisdiction or a change in government which the trustee thinks portends adverse future treatment.

Change of situs provisions may have tax consequences. It may be prudent to have a change of situs provision even for a purely United States trust. For example, if the trustee of a New York trust is about to sell a low basis asset which will result in a large capital gain for the trust, the trustee may wish to consider changing the situs of the trust to a state which imposes no capital gains tax on trusts for nonresident beneficiaries, such as Delaware, before selling the asset. But if a domestic trust includes an automatic migration provision which takes effect if a U.S. court attempts to exercise jurisdiction over the trust, the trust will be treated as a foreign trust, not a domestic trust for United States income tax purposes.[2] Note, however, that consistent with the reason that practitioners favor automatic migration provisions in many offshore trusts, the Treasury Regulation provides: "However, this paragraph (c)(4)(ii) will not apply if the trust instrument provides that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States."

If none of the settlor, beneficiaries or the new trustee is a resident or national of the original situs jurisdiction and the trust assets are located elsewhere, the original situs country has no jurisdiction over the new trust in an international sense.[3] A judgment in the original jurisdiction denying the validity of the shift would not be enforced by

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[1] *See, e.g, In re* Liddiard, 14 Ch. D. 310 (1880). *See* R. Hendrickson & N. Silverman, Changing the Situs of a Trust § 2.06 (1986); D. Parker & A. Mellows, The Modern Law of Trusts 378–383 (3d ed. 1975).

[2] Treas. Reg. § 301.7701-7(c)(4)(ii).

[3] *See* R. Graveson, Conflict of Laws 619 (7th ed. 1974).

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the courts in the new jurisdiction because the decision is fundamentally an attack on the validity of a trust under the law of the new jurisdiction and hence is impermissibly extraterritorial in effect. An attack, as an original matter in the courts of the new jurisdiction, on the validity of the situs change should be ineffective as a matter of course if the situs change is valid under the law of the new jurisdiction.

Problems in the original situs jurisdiction are not the only reasons for changing the situs of a trust. The more common ones are:

(1) a change in the residence of the income or principal beneficiary from the original situs jurisdiction to a new jurisdiction, combined with that beneficiary's desire to change the situs to permit more frequent consultation with the trustee;

(2) the substitution for the original trustee of a new trustee in a new jurisdiction; and

(3) a change of residence by the original trustee to a new jurisdiction from which it is more efficient for the trustee to continue to administer the trust.

The provisions for changing situs should be expressly set out in the trust instrument. See § 9.19, below, for suggested forms and clauses. Otherwise, a change of situs can be effected only upon a court order entered in the original situs jurisdiction or with the consent of all interested parties. The court-ordered situs change is not only cumbersome but, given the reason for changing the situs, may be difficult or impossible to obtain. The consent approach has at least three problems. First, it may be impossible to obtain the consent of a corporate trustee without court approval of the final accounting or of that trustee's administration. Second, if there are minor or contingent beneficiaries, consent without a court order is impossible. Such court approval in either case may encounter the same difficulty as a court-sanctioned move. Third, there is a possibility that the new jurisdiction will not recognize the right of all interested parties to shift the trust situs under these circumstances.

Note that the tax situs of a trust may be changed, at least in some states, by transferring the situs of administration of the trust to another jurisdiction, changing the trustees so as to eliminate any trustee from the original jurisdiction and, perhaps, eliminating any directly held investments in the first jurisdiction.

[2] Methods for Changing Situs

There are three ways to change the situs of a trust:

(1) *Modification.* Alter the three factors that created the situs in the original jurisdiction:

  (a) Replace the original trustee with a new trustee resident in the new jurisdiction;

  (b) Specify in the trust instrument that the governing law is changed to that of the new jurisdiction by reason of the change in the trustee or, if permitted by the trust instrument, change the governing law by the instrument changing trustees; and

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(c) Shift the place of trust administration to the new jurisdiction with a new trustee.

(2) *Termination and Re-Creation.* Terminate the trust in the original jurisdiction and distribute all the trust assets to the beneficiaries, who then contribute those assets to a new trust with identical terms located in the new jurisdiction with a new trustee.

(3) *Decanting.* Transfer all the trust assets directly from the original trust to a separate, distinct trust created in the new jurisdiction.

There are tax issues involved in changing the situs of a trust. From a U.S. perspective they are the income taxation of trusts (including grantor trusts) and their beneficiaries (see Chapter 4), estate and gift taxes, and the excise tax on transfers of appreciated property to foreign trusts. These are mentioned briefly in this section and in more detail in § 9.11, below.

[3] Changing Situs by Modification

Changing the situs of a trust by modification produces the fewest ripples because the trust does not terminate; it simply continues its existence in the new situs jurisdiction. In theory even less disturbance would occur if the original trustee were an individual who physically moved from the old situs to the new one. However, this would be open to the arguments that the new residence was never acquired or that the existing residence was never abandoned. If either of these arguments is successful, the result is a continuation of the existing trust situs.

This demonstrates one benefit of using a corporate trustee rather than an individual trustee, using individuals as trust protectors or advisors, but a corporate trustee. Mere presence of an individual trustee in a jurisdiction other than the existing situs can lead to arguments that an inadvertent change in situs has occurred. Since an individual may have more than one residence, this argument can be made even if the trustee's residence at the original situs has not been abandoned. Furthermore, the presence in the United States of the trustee of a foreign trust for 183 days or more will result in the U.S. taxation of the trust's capital gains[4] and would risk the reclassification of the trust as a U.S. trust if the place of administration can be inferred from the location of the trustee.

While there is a transfer of legal title to, and possession of, the trust assets from the original trustee to the new trustee, there is no transfer of beneficial interests. For U.S. tax purposes, there is no transfer of assets. If the settlor or any beneficiary is not a U.S. person, the tax consequences in the settlor's (or beneficiary's) home country of the situs shift by modification would have to be investigated. Any offshore jurisdiction chosen as the new situs of the trust is not likely to impose income or transfer taxes on trusts or their nonlocal beneficiaries. Although not a transfer for U.S. tax purposes, the change of trustee is a transfer for purposes of any blocking order issued under the

[4] I.R.C. § 871(a)(2), *amended by* Pub. L. No. 103-66, 103d Cong., 1st Sess., § 13113(d)(5) (Aug. 10, 1993); Treas. Reg. § 1.871-2.

International Emergency Economic Powers Act[5] discussed in § 9.16, below.

In most cases, a change of situs by modification will bear the lowest risk of adverse U.S. tax treatment. See § 4.11, above.

[4] Changing Situs by Termination and Re-Creation

This involves two transfers of property: (1) the terminating distribution to the beneficiaries, and (2) the contribution to the new trust. Achieving concerted action by the beneficiaries can be difficult. This problem can be ameliorated to some degree either by utilizing a declaration of trust, which is executed only by the new trustee, rather than a trust agreement, which is executed by both the new trustee and the settlors, or by having an inactive (stand-by or pilot) trust already in place.

The distribution of the trust assets can have significant U.S. tax consequences. An argument can be made under a substance-over-form theory that the transfers should be ignored and the transaction treated as a simple situs shift,[6] with the result that it is not a taxable event. The argument is strengthened if the new trust had already been created on a stand-by basis by the settlor. If this argument does not prevail, the two steps will be treated for U.S. tax purposes as a distribution from the trust to its beneficiaries, which is likely to produce taxable income for the beneficiaries and if the beneficiaries are U.S. persons and the trust is foreign, an accumulation distribution. The new trust would be a grantor trust whose income is taxable to the settlor/beneficiaries, at least if they are U.S. persons.[7] If the beneficiaries are U.S. persons and the trust is a foreign trust for their benefit, it will be a grantor trust,[8] but if the new beneficiaries are not U.S. persons, there may be a taxable event in creating the new trust.[9] In addition to income tax consequences, other tax consequences may flow from a termination and re-creation.

For example, any grandfathered status for the generation-skipping transfer tax of a trust in existence on October 22, 1986 will be lost.[10]

[5] Changing Situs by Decanting

Decanting involves only a transfer from the original trust to the new trust. The tax issues are basically the same as those of the termination and re-creation procedure discussed above, but the argument that the decanting should be ignored as a tax matter under the substance-over-form theory is stronger because the settlor of the new trust will be the trustee of the old trust. See discussion at § 4.11[3], above. If the decanting is recognized as a taxable event for U.S. income tax purposes, and if the old trust is

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[5] 31 C.F.R. § 500.310 (July 1, 1993).

[6] Some support for this proposition can be derived from MacManus v. Comm'r, 131 F.2d 670 (6th Cir. 1942), and Buhl v. Kavanagh, 118 F.2d 315 (6th Cir. 1941).

[7] I.R.C. § 672(f).

[8] I.R.C. § 679.

[9] I.R.C. § 684.

[10] Pub. L. No. 99-514, 99th Cong., 2d Sess., § 1433(b) (Oct. 22, 1986); Temp. Treas. Reg. § 26.2601-1(b).

a foreign trust and the new trust is a domestic trust, it will be taxed as an accumulation distribution under Sections 665 through 668 of the Internal Revenue Code. An accumulation distribution from the old trust not only subjects the new trust to the throwback tax (limited to income with a U.S. source if the new trust is foreign), but that distribution will be allocated to the new trust's undistributed net income for the respective years of the old trust from which it is derived.[11] If the new trust makes an immediate distribution of the accumulated income (including capital gains if the trust is foreign), the transfer to the new trust might be ignored and the accumulation distribution treated as being made directly to the beneficiaries by the old trust.[12]

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[11] Treas. Reg. § 1.668(b)-1A(c)(1)(i). Although this regulation was issued under I.R.C. § 668, which was repealed by Tax Reform Act 76, Pub. L. No. 94-455, 90 Stat. 445, its rules still apply under I.R.C. § 667.

[12] *Cf.* Treas. Reg. § 1.665(b)-1A(b)(1).

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§ 9.08 Drafting for Change of Situs

Most practitioners now favor including a provision in the trust instrument which permits the trustee, or the trust protector, purely as a matter of discretion, to change the situs of the trust for any reason deemed to be in the interest of the trust beneficiaries. In addition, a settlor may wish to include in the trust instrument a provision for automatic and immediate change of situs of the trust, often to a predetermined second jurisdiction, in defined circumstances.

The situs changing provisions have three principal components:

(1) authorization for the situs change;

(2) adjustments for differences in the trust laws of the original and new jurisdictions; and

(3) the procedure employed in effecting the change.

[1] Discretionary Change of Situs

Because there are a multitude of reasons why it may be in the interest of the trustees, or more likely the trust beneficiaries, to change the situs of a trust, most practitioners now favor inclusion of a general provision in the trust deed permitting the trustee, or the trust protector, to change the situs of a trust one or more times for any reason deemed to be in the interest of the trust beneficiaries. Particularly for long-term trusts, such clauses are important because as circumstances change over the years, both in the situs jurisdiction and in the domicile jurisdiction of the several trust beneficiaries, a change of situs of the trust may be important to the preservation of the interests of the beneficiaries. Discretionary change of situs clauses are common to all trusts, not only asset protection trusts, but should be included in the trust deed creating an asset protection trust. See § 9.19, below, for various sample clauses for trust deeds.

[2] Escape Clause

In addition to a discretionary change of situs clause, an asset protection trust should normally include an automatic change of situs clause with carefully defined terms, although if the initial trust is a domestic trust an automatic change of situs clause may have adverse U.S. income tax consequences, discussed below. Automatic escape clauses have long been included in "Armageddon" trusts, usually deemed effective at 11:59 p.m. on the day prior to the destabilizing event defined in the trust deed. Most practitioners creating asset protection trusts, at least foreign asset protection trusts, will include some form of automatic change of situs clause. The change of situs clause will, in common with all trusts in offshore jurisdictions, take effect in the event of sovereign risk changes in the original situs, but in the case of asset protection trusts, a settlor may wish to include automatic change of situs clauses in the event the courts of the original jurisdiction of the trust give, or seem likely to give, rights to creditors of the settlor.

Automatic escape clauses must be carefully drafted because they may be triggered by the terms of the trust deed when subsequent events, or even simultaneous analysis by an informed party of the current events, suggest that a change of situs is not warranted. There have been instances in the past where revocable trusts became irrevocable with significant U.S. tax consequences when clauses in the trust deed

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making it irrevocable went into effect automatically upon events which, in retrospect, should not have been considered cause to make the trust irrevocable. Tax consequences may be less important to an asset protection trust, but the lesson remains that care must be taken in drafting the terms of any automatic escape clause. Consideration should also be given to empowering the trustee, or the protector, to nullify the effect of an automatic escape clause, within a brief period after it has taken effect, if the facts show that it should not have been activated and the trustee, or the protector, is free from influence of the jurisdiction whose action triggered the clause.

[3] Compliance with Trust Laws of New Situs

The trust instrument must make it clear that when the trigger is pulled, all three elements of situs (residence of the trustee, place of administration, and governing law) change. Just shifting the place of administration or appointing a new trustee in a different jurisdiction does not automatically mean that the law governing the trust is changed.[1]

When the trust's governing law is changed, the validity of its provisions will be tested under the new law, not the old.[2] Consequently the trust agreement must spell out the impact of the situs shift on various trust provisions, such as restraints on alienation, the duration of the trust, the allocation of receipts to income or principal, and allowable investments. The penalties for failing to do this vary. For example, if the trust term violates the rule against perpetuities in the new jurisdiction, the trust may self-destruct immediately. If restraints on alienation become invalid, the trust will continue but with a significant difference in what the settlor intended to be the rights of the beneficiaries. The same is true of the allocation of trust receipts unless all distributions are discretionary and can be made out of either income or principal. If the law of the new jurisdiction does not authorize all the investments the trust made in the original jurisdiction, the new trustee will have to liquidate the forbidden assets.[3]

[4] Procedure for Selecting New Trustee and Transferring Trust Assets

The procedure for effecting the situs change must also be addressed in the trust agreement regardless of whether the situs change is to be accomplished through modification, termination and re-creation, or decanting. In the case of termination or decanting, the trust instrument should expressly direct the trustee to distribute the property in kind. Absent such a provision, the trust law of the original jurisdiction may require the property to be sold and the proceeds distributed.[4] Moreover, if the grantor has already created the new trust (a stand-by trust) there is no delay in the asset transfers while waiting for the beneficiaries to create the trust. In addition, the use of a stand-by trust enhances the substance-over-form argument regarding taxable

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[1] *See In re* Shipman's Will, 40 N.Y.S.2d 373 (Sur. Ct. 1942); Stetson v. Morgan Guar. Trust Co, 164 A.2d 239 (Conn. Super. Ct. 1960).

[2] *See In re* Griswold's Trust, 99 N.Y.S.2d 420 (Sup. Ct. 1950).

[3] A. Scott, 3 The Law of Trusts § 231 (4th ed. 1989).

[4] *See* A. Scott, 4 The Law of Trusts § 347.2 (4th ed. 1989).

transfers in the termination and decanting scenarios. See §§ 9.07[4], [5], above.

The manner in which the new trustee is selected and the method of identifying the new trustee must be absolutely clear. Otherwise, the original trustee or the actual custodians of trust assets (*e.g.,* banks, brokerage firms, and investment bankers) may refuse to accept directions from the putative new trustee because of the risk of liability if trust property is turned over to the wrong person.[5] This problem can be avoided by obtaining a decree from a court in the original jurisdiction, but this cumbersome procedure undermines the very reasons for shifting situs in the first place.

The trust instrument should expressly provide that legal title to trust property passes automatically to the new trustee. In many jurisdictions this will avoid theneed for actual transfer of legal title by the original trustee.[6] In any event the original trustee must turn over possession of trust property to the new trustee. Substantially all of the trust assets are likely to consist of intangible property such as stocks and bonds held through custodians (*e.g.,* brokerage firms). The transfer of possession occurs in practice when these custodians or the issuers (*e.g.,* the officials of a holding company) recognize the new trustee as the owner of the assets. If they do not recognize the effectiveness of those changes, litigation will be required to implement the situs shift. The practitioner may want to discuss these issues with such custodians before they are selected by the original trustee, and with the officials of any holding company owned by the trust.

Both the change in title and in possession can present problems that have the potential of defeating the effectiveness of a situs shift. If, under the law of the new jurisdiction, the new trustee does not recognize that these changes have occurred, then for all practical purposes the situs shift has not happened. At the time the trust instrument is drafted, either a stand-by trust is created or a possible alternative situs is mentally selected. In either event, the advisor should know the law of the new jurisdiction concerning the effectiveness of the situs change provisions, including the automatic title and possession provisions.

[5] Avoid Escape Clauses Designed to Forestall Government Inquiries

Practitioners who use escape clauses which are triggered by a tax or other legitimate government inquiries into the activities of a trust now risk tainting the trust for many purposes. For example, under the Internal Revenue Code, a trust which contains an automatic migrating provision, so that it will move from the United States to a foreign country if a court or tax authority attempts to exercise jurisdiction over the trust, will be treated as a foreign trust from the start.[7] And very recently, the Financial Action

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[5] *See* A. Scott, 4 The Law of Trusts § 345.3 at 555 (4th ed. 1989).

[6] *See* A. Scott, 4 The Law of Trusts § 345 at 548–50 (4th ed. 1989).

[7] Treas. Reg. § 301.7701-7(c)(4)(ii); Treas. Reg. § 301.77-1-7(d)(3). Note that the Treasury Regulations distinguish between flee clauses, which attempt to prevent a court from exercising jurisdiction over a trust (the "Court Test"), or a governmental agency or creditor from collecting information about a trust (the "Control Test"), and flee clauses "which provide that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of

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Task Force On Money Laundering (the "FATF") has suggested that governments should view automatic flee clauses with suspicion if such clauses are designed to forestall legitimate government inquiry into a trust's activities.[8]

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property in the United States." The latter type of a flee clause does not change the taxation of a trust by the IRS, and is considered to be legitimate. *See* discussion in § 4.02.

[8] *See* the FATF Consultation Paper issued on May 30, 2002 at http://www1.oecd.org/fatf.

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§ 9.09 Drafting Restraints on Alienation

Restraint on alienation of trust interest may protect interest from expropriating government and creditors. Validity of restraint is governed by law of trust situs. Certain direct restraints are generally valid under U.S. law, but not under English law. Validity of indirect restraints depends on number of factors including: type of interest involved (income or principal); language used in creating restraint; and public policies of trust-situs jurisdiction.

[1] Necessity for Inclusion of Restraint on Alienation

A beneficial interest in a trust is transferable and thus can be taken by an adverse party (*e.g.,* creditors or an expropriating government) unless the trust agreement contains a valid restraint on the alienation of that interest. There are two types of restraints on alienation: direct and indirect. A direct restraint (commonly called a spendthrift clause), is a prohibition against the transfer of the interest. An indirect restraint generally takes the form of a termination or forfeiture of the beneficial interest if an attempt is made to transfer or to reach that interest.

The level of protection offered by the trust against claims of adverse parties is heavily dependent upon the validity of the restraint on alienation. Unfortunately, the analysis of that issue is both complex and at times uncertain. The validity of any restraint is generally governed by the law of the trust situs, not that of the location of the trust assets, at least in the case of personal property.[1] As their validity is a key element of an asset protection trust, the careful advisor must be (or become) thoroughly familiar with the law of the trust situs on this point. The U.S. cases, which are apposite if the asset protection trust is created in the United States, are not uniform because there are fifty different trust laws. The English cases, which are relevant if the trust is created in an offshore jurisdiction following English law, in many instances reach results that are opposite from the U.S. cases.

The cases in the trust jurisdiction (or those that it is likely to follow) must be read carefully. Many of them refer to "income" interests when they mean interests which exist during the term of the trust, and to interests in "principal" when they mean remainder interests. Other cases apparently do distinguish between distributions of income and of principal, regardless of whether made during or at the termination of the trust. Because this chapter is not jurisdictionally specific, no close analysis of this sort is made here. Finally, and most importantly, there are special public policy concerns where the settlor retains any kind of beneficial interest in the trust. These may cause an otherwise valid restraint to fail, at least to the extent that it affects the settlor's interest.

[2] Direct Restraints

The use of direct restraints (spendthrift clauses) is peculiar to U.S. trusts. English courts have never enforced prohibitions on the alienation of beneficial interests in

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[1] *See* A. Scott, 5A The Law of Trusts § 598 (4th ed. 1989), for the U.S. cases. The English rule is the same. Re Fitzgerald v. Fitzgerald, [1904] 1 Ch. 573 (C.A.).

trusts.[2] This means that a spendthrift clause in an offshore trust created in a jurisdiction following English law will not be effective.

In almost all U.S. jurisdictions, a direct restraint on alienation of a mandatory income interest is valid.[3] The exceptions are Kentucky,[4] New Hampshire,[5] Ohio,[6] and Rhode Island.[7] Two other states (Alabama and Virginia) recognize spendthrift provisions if the trust is of limited size. Most jurisdictions that enforce spendthrift clause for income interests also recognize the validity of direct restraints on alienation of a right to receive principal at some time in the future.[8] The states enforcing spendthrift clauses generally are split on the validity of a direct restraint on the right to an immediate payment of principal, with some holding that a creditor can reach the beneficiary's right to such a payment despite any contrary terms of the trust and others holding that the creditors cannot reach the property until it is actually distributed to the beneficiary.[9] Spendthrift provisions in discretionary trusts have the same validity as they have in mandatory trusts.[10] For example, a discretionary income interest cannot be reached by third parties if a mandatory income interest could not.

Even though direct restraints are generally upheld by U.S. courts, there are certain classes of claimants who have frequently been permitted to satisfy their claims against the beneficiary of a spendthrift trust out of the trust assets: dependents of the beneficiary, persons furnishing necessities to the beneficiary, and government claims for taxes.[11] More importantly for the purpose here, however, is the fact that most commentators believe that tort claimants should not be prevented by a spendthrift clause from reaching the trust assets for the torts of a beneficiary.[12] This seems illogical since the tort victim is no worse off if the tortfeasor has property that cannot be reached than if he did not have the property at all. Nevertheless, the academic world seems united in the view that the trust assets should be liable for the beneficiary's torts even where a spendthrift provision is present. To date, however, the courts have not accepted this argument. Spouses and dependent children are also favored claimants whom the Uniform Trust Code Section 504(c) would allow to enforce claims against

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[2] Brandon v. Robinson, 34 Eng. Rep. 379 (Ch. 1811); 2 Bogert, The Law of Trusts and Trustees § 221 (2d rev. ed. 1979).

[3] A. Scott, 2A The Law of Trusts § 152.1 (4th ed. 1989); E. Griswold, Spendthrift Trusts §§ 25–32 (2d ed. 1947).

[4] Ford v. Ford, 18 S.W.2d 859 (Ky. 1929).

[5] Brahmey v. Rollins, 179 A.2d 186 (N.H. 1935).

[6] Sherrow v. Brookover, 189 N.E.2d 90 (Ohio 1963).

[7] Tillinghast v. Bradford, 5 R.I. 205 (1858).

[8] A. Scott, 2A The Law of Trusts § 153 (4th ed. 1989).

[9] A. Scott, 2A The Law of Trusts § 153 at 132–133 (4th ed. 1989).

[10] *See, e.g.,* Canfield v. First-Security Nat'l Bank, 13 Cal. 2d 1, 87 P.2d 830 (1939).

[11] A. Scott, 2A The Law of Trusts §§ 157.1–157.4 (4th ed. 1989).

[12] A. Scott, 2A The Law of Trusts § 157.5 (4th ed. 1989); E. Griswold, Spendthrift Trusts § 365 (2d ed. 1947).

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a discretionary trust, or a self-settled trust.

[3] Indirect Restraints

In both the United States and England a provision terminating a mandatory income interest upon an adverse party's attempt to reach it is valid.[13] The termination of the beneficiary's income interest in the trust is not a very satisfactory solution to the problem of adverse third-party takers, even though it is the other beneficiaries of the trust and not the third parties who will benefit. Consequently, there developed in England (it is also found in those U.S. jurisdictions following the English rule denying the validity of direct restraints on alienation) the so-called protective trust, in which the beneficiary's mandatory income interest terminates if a third party attempts to reach that interest, and is replaced by discretionary distributions to that beneficiary and his immediate family.[14] The effect is to permit the trust assets to be used for the benefit of the beneficiary's family, since distributions would not be made to the beneficiary as long as they could be reached by the adverse parties.[15] While the substitution of a discretionary interest for a fixed interest may be valid as against creditors under the law of the trust situs, the effect under that law of a claim by an expropriating government must be analyzed. See §§ 9.15[3], 9.17[2], below.

While the cases dealing with protective trusts have focused on the conversion of mandatory income interests into discretionary interests, the same reasoning ought to apply to mandatory principal interests during the term of the trust. However, a provision for the forfeiture of his right to receive the principal of the trust on its termination is probably invalid if it is a vested interest.[16] If the vesting of the interest is subject to a condition precedent so that it does not vestif the contingency has occurred the restraint ought to be valid.[17] See § 9.06[7], above, for a discussion of vested and contingent interests.

[4] Alternatives: Discretionary Distributions, Evergreen Term, and Powers of Appointment

Unless there is some overriding reason to do so, creating a mandatory income interest and relying on the protective trust mechanism to convert it to a discretionary interest when creditors or other adverse third parties appear is not advisable. If that interest is vested in the settlor, there is the risk that the public policy of the trust situs will not uphold the conversion.

The newly created discretionary interest pursuant to the protective trust will not be

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[13] A. Scott, 2A The Law of Trusts § 150 at 77 (4th ed. 1989). The leading English cases are Billson v. Crofts, 15 L.R.-Eq. 314 (1873), Re Aylwin's Trusts, 16 L.R.-Eq. 585 (1873).

[14] In England this is now codified in the Trustee Act, 1925, 15 & 16 Geo. 5, ch. 19, § 33.

[15] *See In re* Coleman (Henry v. Strong), 39 Ch. D. 443 (C.A. 1888).

[16] A. Scott, 2A The Law of Trusts § 150 at 78 (4th ed. 1989).

[17] *See In re* Forder (Forder v. Forder), [1927] 2 Ch. 291 (C.A. Eng.); Sole v. Ward, [1919] N.Z.L.R. 212 (terms of a bequest providing for forfeiture if beneficiary became bankrupt before distribution held valid).

as flexible as if it had been made discretionary in the trust instrument. Initially, a client may see the mandatory distribution requirement as an assurance that he will actually receive trust distributions. This overlooks the fact that when the real problem arises (*e.g.,* the settlor's bankruptcy), the distribution pattern will be a discretionary one. It is better to become acquainted with the trustee's exercise of his discretion when it is easy to change trustees than when difficulties arise. Making the settlor's interest a discretionary one at inception is the only way to avoid the risk that the conversion will be voided on public policy grounds.

A discretionary distribution pattern does not "solve" the problem of creditors; it simply postpones the issue until the termination of the trust. One temporizing answer is to provide that if the trustee determines at the end of the nominal term of the trust that the beneficiary to whom the trust assets are to be distributed cannot enjoy the benefits of their ownership, the term would be extended for a specified period of time. At the end of the extended term, the same provision for a further extension would apply. Hence, the term of the trust is constantly renewable or "evergreen." The maximum term is set by the applicable rule against perpetuities or its equivalent. The trustee's decision to extend the trust's term can be made subject to the consent or approval of a third party, for example, the Protector (see § 9.12, below) or an Advisory Committee. Such a consent power should not be subject to the control of the settlor's creditors.

Although extending the trust's term does not solve the problem of creditors, it may so delay any prospect of their recovery that judgments against the settlor (or other beneficiaries) are allowed to lapse, that is, become unenforceable. A resolution to the problem of creditors is to provide the settlor or someone else with a power of appointment, in effect creating a discretionary final distribution pattern. When the trust finally terminates, its assets would then be distributed to persons who are not subject to judgments obtained by those creditors.

> **Caution:** If the holder of the power of appointment is in bankruptcy, the power will be an asset of his estate and can be exercised by the bankruptcy trustee in favor of his creditors unless the power is limited so that the debtor is not among the possible recipients of the property. See § 9.06[4], above.

[5] Public Policy Limitations

Even if the trust situs generally recognizes the validity of a particular type of restraint on alienation, its public policy may require that the restraint be ignored in certain situations. Most jurisdictions severely curtail the enforceability of restraints on the alienation of a settlor's interest in a trust. This is seen in both the U.S. cases (which recognize direct restraints) and the English cases (which recognize only indirect restraints).

[a] U.S. Cases. Prior to enactment by a growing number of states of statutes permitting the settlor to retain varying degrees of interest in a self-settled trust, it was apparently the universal view that a spendthrift clause in a trust created by a settlor for his own benefit is void as to his creditors on the theory that it is against public policy to permit the owner of property to create for his own benefit an interest in that property that cannot be reached by his creditors.[18] The invalidity is not total for it applies only to the interest of the settlor in the trust. For example, if the settlor retained only an income interest his creditors cannot reach the principal.[19] If the settlor retained no right to the principal but has a general power of appointment (a power to appoint to himself, his estate, his creditors or the creditors of his estate)[20] most cases have held his creditors can reach the principal even if there are named takers in default.[21] When the power of appointment is a limited one, however, the settlor's creditors cannot reach the principal.[22] If the settlor is a discretionary beneficiary of a spendthrift trust, the beneficiary-settlor's creditors can not only take that discretionary interest but may be able to force the trustee to distribute to them the maximum amount that the trustee could pay to or apply for the benefit of the settlor-beneficiary under the terms of the trust.[23]

The law in the United States is now evolving as an increasing number of states enact statutes permitting settlors to establish trusts with trustees resident in that state which are protected from the settlor's creditors even though the settlor retains a discretionary interest in the trust.[24]

If direct restraint on alienation of a beneficiary's interest is invalid where the beneficiary is the settlor, a provision terminating any interest of the beneficiary-settlor if his creditors should seek to reach it, may also be invalid although thereare no cases in point. Surprisingly, the conversion of a mandatory interest into a discretionary interest appears to be effective.[25] This is not of much help, however, if the trustee is obligated by public policy to exercise the maximum discretion in favor of the beneficiary-settlor.

[b] English Cases. The validity of a provision terminating the settlor's interest or converting it to a discretionary interest (under the English protective trust) is heavily fact-dependent. The forfeiture or conversion appears to be valid if the creditors' actions do not involve a bankruptcy proceeding; but if the settlor is adjudicated a bankrupt while he is a beneficiary, the termination of his beneficial interest will not be respected, with the result that the trust assets are available to his creditors.[26] If the trust is created in an offshore jurisdiction, its law must be researched on this point. If the forfeiture occurs prior to the bankruptcy, for example, if the settlor "voluntarily" makes an assignment of the beneficial interest to his creditors, thus triggering the

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[18] A. Scott, 2A The Law of Trusts § 156 at 78 (4th ed. 1989).

[19] *In re* Watland, 300 N.W. 195 (Minn. 1941).

[20] I.R.C. § 2041(b).

[21] *See, e.g.,* Rienzi v. Goodin, 95 A. 259 (Pa. 1915).

[22] Avera v. Avera, 15 S.E.2d 883 (Ga. 1984).

[23] Restatement (Second) of Trusts § 156(2) (1967).

[24] For a summary of current jurisdictions, *see* Gideon Rothschild, *Asset Protection Planning — Current Strategies and Pitfalls*, Tax Management Estates, Gifts and Trusts Journal 2005, at 251.

[25] A. Scott, 2A The Law of Trusts § 150 at 80 (4th ed. 1989).

[26] Higinbotham v. Holme, 34 Eng. Rep. 451 (Ch. 1812).

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forfeiture, the subsequent bankruptcy would not void the termination of his interest in the trust.[27] However, that assignment may be treated as in substance a fraudulent transfer under the applicable bankruptcy law.

If, however, the trust is a discretionary one the result is different. The discretionary interest of a settlor in the trust can be seized by creditors but the trustee cannot be forced to make distributions to the creditors. There is no English equivalent to the U.S. maximum exercise doctrine. The authority for this statement is essentially negative. No case has ever held, much less discussed, the possibility of such a rule. Consequently, the trustee retains the power to decide whether to make distributions with respect to that beneficial interest in the hands of third parties.

[c] Noncreditor Cases. The public policy limitation on the creation of valid restraints on the alienation of beneficial interests held by settlors in trusts should not apply in the context of an expropriation or vesting of assets, because the foreign government is not a true creditor. However, if the settlor is sufficiently prominent, his home country might posit its claim on a fraud or theft theory, rather than on expropriation.[28] In any event, the court in the trust situs can examine the basis of the claim underlying a foreign judgment and refuse to enforce it if it violates the forum's public policy. See § 9.15, below, for a discussion of these public policy issues.

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[27] A. Underhill, Underhill's Law Relating to Trusts & Trustees 99–100 (12th ed. 1970).

[28] *See* Republic of the Philippines v. Marcos, 818 F.2d 1473 (9th Cir. 1987).

§ 9.10 Pre-Emergency Event Planning Considerations

Trust must be created prior to occurrence of emergency event. Most Settlors desire high degree of control over trust assets or trustee, but Settlor's control prior to event may defeat purpose of trust. One solution is to appoint Protector with power of direction over trust assets and power to remove trustee. Other solutions involve creation of holding company (domestic or foreign) or limited partnership whose shares are held by trust.

[1] Timing of Creation of Trust

One of the consequences of an emergency event is likely to be a prohibition or restriction on transfers of assets by the client. In some instances, the creditors may not be satisfied with orders directed solely at the debtor. If they have been able to discover where the debtor's assets are located (*e.g.,* banks and brokerage houses), they may obtain orders against those custodians prohibiting the execution of any transfer orders from the debtor.[1] Even though these orders do not prevent the creation of a foreign trust, any transfer of assets to that trust will either involve the settlor in a contempt of court proceeding or be impossible because the custodians will refuse to act. Even if the settlor is able to make the asset transfer in violation of a restraining order, it is likely that the courts of the trust situs will respond favorably to a request to transfer the assets back to the settlor because no local public policy concerns will cause them to sanction actions by the settlor that contravened an existing court order where the court had jurisdiction (in the view of the situs country) over the settlor. Moreover, the trustee probably would not accept the assets, because of the likelihood of their retransfer. Since avoiding such issues is one of the principal goals in creating the trust, the trust *must* be in existence with its assets before the emergency event occurs. See § 9.10[2], below.

One solution often used with Armageddon trusts is to create and fund the trust but make the trust revocable until and unless the change of control event occurs. This may be essential if the settlor is a corporation and the trust assets consist of subsidiary companies operating as a unit with the parent settlor, but which would be walled off in an irrevocable trust were the parent to be nationalized, the home country of the parent invaded, or another such change of control event occur. While the settlor will want to keep maximum flexibility during the life of the trust until a change of control event occurs, if the settlor herself or itself retains the sole right to declare the trust irrevocable, it may be too late for the settlor to act once the change of control event occurs. One solution is to empower a third party protector to declare the change of control event, discussed in the following section.

[2] Limits on Settlor's Retained Powers—Use of Protector

The decision to create and fund the trust now (as opposed to waiting until the last moment when it is probably too late) raises a new issue: What differences will there be in the day-to-day handling of the assets when they are in the trust? The least

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[1] *See* Mareva Compania Naviera S.A. v. Int'l Bulkcarriers S.A., [1980] 1 All. E.R. 213 (C.A. Eng.).

intrusive approach is for the settlor to retain (and exercise) the power to deal with the assets as though the trust did not exist, without reference to the trustee. However, that retained power is likely to defeat the purposes of the asset protection trust. A court in the settlor's home country could easily treat the trust as a sham. While this would not be controlling in the trust situs, the courts theremight reach a similar conclusion under their own law. If the settlor is to retain such power, the advisor should explore the sham theory with local counsel. Moreover, the settlor could be intimidated or coerced into turning over the trust assets. These problems could be avoided by providing that the settlor's power terminates (or at least becomes dormant) upon the emergency event. This provision may not be much of an improvement, however, for a court could treat the transfer of property to the trust as not occurring in substance until that termination or dormancy. This would generally make the transfer in trust too late to achieve the desired protection (if the court was that of the trust situs) or to permit a discharge at the conclusion of the bankruptcy proceeding (if the court was a U.S. court).

The next level of complication is for the trustee to place the trust assets in a holding company, with the settlor being the chief executive officer thereof (see § 9.10[3], below) or in a limited partnership, in which the settlor is the general partner (see § 9.10[4], below). Either would give the settlor the effective management and control of the underlying assets, albeit at the sufferance of the trustee. Both have their benefits and problems.

The third level of complication is for the settlor to retain the right to direct the actions of the trustee. Obviously this is more cumbersome than direct access to the trust assets, but it suffers from most of the same problems. The likelihood that a court would disregard the trust as a sham is probably a function of the amount of control that the settlor can exercise. For example, if the settlor can direct all investment and distribution decisions, a court could conclude either that the trust had no real function and that the trustee was simply an agent of the settlor, or that the settlor's control over the trust assets made him the substantive trustee. A court taking either view is also likely to treat a provision for the termination or dormancy of the power of direction as either effecting a transfer of the property in trust only at that time (because the putative trustee ceases being an agent of the settlor and becomes the substantive trustee) or as a transfer of the trusteeship at that time (the putative trustee succeeds the settlor as the substantive trustee). Either conclusion (if reached by a court in the trust situs) would defeat the purpose of the trust because the transfer would be too late and would deny the settlor a discharge (if reached by a U.S. court). Alternatively, a court could find that a dormancy, the length of which is defined by the duration of the emergency event, is invalid as against public policy.[2]

Nevertheless, many asset protection trusts are designed to permit the settlor to control the trust operations completely (and usually to terminate the trust), with such powers becoming dormant during the duration of an emergency event. If the settlor's only real concern is home country expropriation, it may well be reasonable to rely on

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[2] *Cf.* Comm'r v. Procter, 142 F.2d 824 (4th Cir. 1944) (holding a condition subsequent that a transfer in trust be nullified if it would be subject to US gift tax void as against public policy).

the anathema with which foreign expropriations are regarded to supply the forum court with the justification for refusing to give that expropriation validity. If creditors are a concern, however, the risk that the trust will not provide the intended benefits is very real.

If, instead, the trust agreement grants the power of direction to another person who is not under the settlor's control (*e.g.,* a Protector), the ability to successfully reach trust assets is substantially reduced because the arguments of agency and the identity of the substantive trustee point to the Protector, not the settlor. Moreover, the degree of control that the settlor is willing to give to another person will generally be less than complete, thereby increasing the likelihood that the trust and its named trustee will be respected. The Protector concept is covered fully in § 9.12, below.

The greatest protection of the trust assets will be obtained by a trust under which the trustee's actions generally cannot be compelled or directed by anyone else. Such a trust should be immune to the sham or delayed transfer attacks. However, such a trust is not likely to satisfy the settlor's concerns over proper distributions and the administration of the trust assets, because the settlor has no assurance that his desires will be carried out by the trustee. There are two additions to the arrangement that may give the settlor sufficient comfort, however.

First, the right to change the trustee without cause could be retained by the settlor (or given to the Protector or to an Advisory Committee of which the settlor is a member). The expectation is that a professional trustee is not likely to administer the trust in a way that causes it to be fired, that is, in contravention of any reasonable wishes of the settlor. If the trustee should conclude that the trust ought to be administered contrary to the settlor's wishes, it would normally rather resign than be dismissed, and would almost certainly not want to litigate the issue of removal. As this power to change the trustee may be so effective in directing the trustee's administration of the trust, a court might find that the settlor "controls" the trust and, in effect, treat him as the substantive trustee.[3] It is, of course, the conclusion of the courts in the trust's situs on this issue that ultimately controls what happens to the trust's assets, for those courts are not likely to honor a foreign judgment which determines that a trust created under their law has a trustee different than that named in the trust agreement. However, a U.S. court's determination would bear on whether the settlor receives a discharge at the conclusion of the bankruptcy proceeding or is held in contempt for failing to return the assets of the trust of which it has found he is the substantive trustee. Placing the removal power in a Protector (or an AdvisoryCommittee) should eliminate the ability of a court to reach the trust assets on the ground that the trustee is an agent of the settlor or that the settlor is the substantive trustee. In contrast to the situation where the Protector is given a power of direction with respect to trust administration, the settlor should be less concerned because the Protector cannot act with respect to the trust assets and can only appoint a new trustee under limited circumstances.

[3] Humphrey's Ex'r v. United States, 295 U.S. 602, 629 (1935). In the tax context see Rev. Rul. 79-353, 1979-2 C.B. 325.

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Second, significant trust administration decisions (*e.g.,* distributions and transactions in trust assets) can require the consent of the settlor, the Protector, or an Advisory Committee. This consent requirement can slow down the operation of the trust if the holder of the power is not responsive to the trustee's communications. It is essentially a veto power, which requires a concurrence by the trustee (who must propose the action to be taken) and the holder of the power (who must agree). This is not the same as a power to direct that an action be taken. Arguably the settlor could retain such a veto power with less risk of being found to control the trust than if he retains the power to remove the trustee, but it is not at all certain whether this would succeed.[4] Granting that veto power to a Protector should eliminate that hazard, however.

[3] Use of a Holding Company

The use of a company to hold the assets, with the trust owning the shares of that corporation, offers several benefits. First, if the settlor is an executive officer, he can (during his tenure) effectively control the trust's investment policy. Second, compensation for his services can provide the settlor with earned income (which may be taxed more beneficially than trust distributions) even when he is not a beneficiary. Third, it insulates the trustee and the trust from any claim that they are doing business in the United States as a result of the activities involving the trust assets. This removes any risk of U.S. taxation at the trust level and, more importantly, should make it impossible to establish U.S. jurisdiction over the trustee under the standards required under the common law to enforce foreign judgments. Fourth, it greatly simplifies the implementation of a change of trustees or a shift in the situs of the trust. The actual custodians of the assets (*e.g.,* banks and brokerage houses) are not involved. As far as they are concerned, nothing has happened: the holding company continues to own those assets. Only the holding company has to recognize the new trustee, and its officers and directors can be counted on to be sympathetic to the change.

If a holding company (whether domestic or foreign) is used, it is important to set it up properly. If the client transfers assets to the holding company and then transfers its stock to the trustee, third parties have two transfers by the client that they can attack. Laws that deal with transfers to trusts will not cover the transfer to the corporation by the prospective settlor. Consequently, the assets should be transferred to the trust, and then the trustee creates the holding company and transfers the trust assets to it. In form, at least, the settlor has made only one transfer, which is to the trust.

The holding company, precisely because it is separate from the trust, introduces new jurisdictional and taxation problems. Their scope is defined by whether it is a domestic or a foreign entity.

[a] Domestic Holding Company. U.S. courts clearly have jurisdiction over a domestic corporation under both U.S. standards and the common law rules for the enforcement of foreign judgments. Consequently, the company can be ordered to turn over its assets to the bankruptcy trustee, and those orders can be addressed directly to

[4] For example, I.R.C. § 674 treats a veto power as equivalent to a power of direction in determining whether a trust is a grantor trust.

the custodians of the company's assets. The location of these assets is more easily found since the records of the domestic company are likely to be kept (if not required to be kept) in the United States and, therefore, accessible through the discovery process. Because such an order to turn over assets is one for specific performance, it cannot have any extraterritorial effect under the English common-law rules, as discussed in § 9.04[4], above. In other words, the courts of other common-law jurisdictions in which custodians of the company's assets reside would not enforce any such orders directed to those custodians. This is not much of an impediment, however, because the U.S. court can simply take over the administration of the company and issue orders in the company's name to any foreign custodians. If there is sufficient time, the holding company's assets can be returned to the trust before any such order is made. However, this will require action by an executive officer of the company or the liquidation of that company. If the creditors move quickly enough, however, there is a real risk that the assets will be trapped in the holding company and subject to the U.S. court's orders. Even if the assets are successfully retransferred to the trustee, a significant likelihood exists that a U.S. court will see this as the "real" transfer of assets to the trust. In that event, no discharge would be given (assuming that the settlor was an executive officer of the company) and potentially a bankruptcy fraud has been committed.

The trustee (even if a foreign person) can transfer trust assets to a wholly owned domestic company generally without any tax consequences.[5] However, the retransfer of those assets to the trust should the settlor became involved in a bankruptcy matter will entail tax consequences that may be significant. Any net appreciation in those assets will be taxable to the holding company as thoughit had sold all of its assets.[6] The company's tax bases in any assets received from the trust will be the same as the settlor's acquisition costs of those assets, assuming that the trust is a grantor trust for U.S. tax purposes and that the assets were transferred to the holding company in a tax-free transaction.[7] The settlor will also be taxable on the difference between his acquisition costs of those assets and the value of the company's liquidating distribution to the trust, using those same two assumptions.

One way to avoid these tax issues on liquidation of the holding company is to qualify it as an S corporation. This is difficult (if not impossible) to do, because a foreign trust cannot be the shareholder of an S corporation. Consequently, the trust created under foreign law would have to be classified as a domestic trust for U.S. tax purposes. In brief, the theory is that there are six factors which determine the domestic or foreign classification of a trust:

(1) the nationality and residence of the settlor;

(2) the nationality and residence of the beneficiaries;

(3) the situs of the trust's administration;

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[5] I.R.C. § 351.

[6] I.R.C. § 332.

[7] I.R.C. § 357.

(4) the place where the trust is created;

(5) the location of the trust's assets; and

(6) the nationality and residence of the trustee.

The first three factors are more important than the last three. The first two factors point to the United States and that by having the investment advice given by a U.S. person (*e.g.,* the settlor) the third factor can be tilted towards the United States. By having both a U.S. as well as a foreign trustee the last factor can be possibly balanced, that is, not indicate either a domestic or foreign classification of the trust.

Alternatively, the holding company could be structured as a partnership for U.S. tax purposes by organizing it as a limited liability company under the law of a state which the Service has ruled will be taxed as a partnership. One drawback is the uncertainty of the effectiveness of the limited liability protection outside the state of incorporation.

If the holding company is treated as a separate taxable entity, its income is subject to annual corporate taxation. Moreover, the company is a personal holding company if at least 60% of its gross income is investment type income (*e.g.,* dividends, interest, and gains from capital asset transactions) and five or fewer individual taxpayers own more than 50% of its stock.[8] Such a classification requires the holding company either to make current distributions of its profits (thereby subjecting the trust or the settlor to current taxation at the shareholder level), or to subject itself to a penalty tax.[9] In addition, accumulations of income in the holding company expose it to the tax on accumulated earnings.[10]

[b] Foreign Holding Company. A U.S. court may assert jurisdiction over a foreign holding company on the basis that it is doing business in the United States, or because one of its executive officers (the settlor) is resident in the United States. Having done that, the U.S. court could issue orders to either the company or the custodians of its assets just as in the case of a domestic company. However, it is a simple matter for the trustee to remove all U.S. officers of the company, thereby negating any direct enforcement of those orders against the company. As the company's records would not be in the United States, the identity of the custodians of its assets would be difficult to discover, for the reasons discussed in § 9.04[4], above. To enforce those orders abroad the enforcing court has to determine that the company was doing business in the United States for purposes of the common-law requirements for the enforcement of foreign judgments. If the company's activities are limited to the handling of passive investments, this may not be the case. Even if the jurisdictional requirements are met, the U.S. judgment may require specific performance, which will not be enforced. If the holding company is organized under the laws of the trust situs, courts there may extend any special legislative restrictions on enforcing foreign orders against trusts or trustees to the holding company. This could be based on the theory

[8] I.R.C. § 542(a).

[9] I.R.C. § 541.

[10] I.R.C. § 531.

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that it is necessary to prevent an "end run" of such legislation, or that it should be viewed as an extension of the trustee for proposes of those restrictions. In other words, protection against the enforcement of the orders of a U.S. court may be possible without the necessity of transferring the company's assets.

The country in which the holding company is organized has the potential of controlling the trust's assets (the stock in that company) by virtue of the local incorporation. If that country expropriated that stock, for example, it might be able to install officers of its own choosing and effectively take the underlying assets. Even though the validity of such a taking can be challenged (particularly in the jurisdiction of the actual custodians), at the very least, this involves extensive and expensive litigation. Assuming that there is sufficient warning, the company can simply retransfer its assets to the trustee or to a new holding company in another jurisdiction. The latter would likely be a tax-free reorganization under U.S. law.[11]

The tax issues are more complex with a foreign holding company than with a domestic holding company, and the discussion here is not intended to be comprehensive but to highlight the principal issues. Obviously, any taxes (including withholding taxes on distributions to the trust) imposed by the jurisdiction in which it is incorporated have to be taken into account. If the holding company is treated as a corporation for U.S. tax purposes, generally the transfer of assets to or from it causes the settlor to be taxed on any accrued gain in the assets.[12] Whether the foreign holding company is subject to U.S. net income tax on any of its income depends on whether it is engaged in a trade or business in the United States for tax purposes and, if so, whether any of its income is effectively connected with that U.S. trade or business. Generally the trading in listed securities through independent brokers does not constitute doing business in the United States for tax purposes.[13]

Moreover, the company is almost certainly going to be a controlled foreign corporation,[14] which means that the settlor is taxed currently on its subpart F income (generally investment income in this context) and on increases in earnings of the foreign company invested in U.S. property.[15]

It is also likely to be a passive foreign investment company (PFIC) if it is not a controlled foreign corporation (CFC). A PFIC is a foreign corporation, 75 percent of whose income is from investments (such as dividends and interest) *or* 50 percent or more of whose assets produce such investment type income.[16] Domestic shareholders of such a company generally can elect either to be taxed currently on their share of the company's earnings or to defer taxation until distributions are actually made.

[11] I.R.C. § 362(a)(1)(F).

[12] *See* I.R.C. §§ 367, 351, 1491.

[13] *See* I.R.C. § 864(b)(2)(A).

[14] *See* I.R.C. §§ 951(b), 957(a), 958.

[15] I.R.C. § 951(a)(1)(A)(i), (B). *See also* I.R.C. §§ 952(a), (b), 956.

[16] I.R.C. § 1296(a).

However, then they pay an interest charge on the deferred tax.[17] The controlled foreign corporation and PFIC rules overlap to some extent, but if a foreign corporation is both a CFC and a PFIC it will not be treated as a PFIC for "United States shareholders:"[18] that is, a United States person who directly, indirectly or constructively is deemed to own 10 percent or more of the total combined voting power of the foreign corporation.[19] In any event, if the foreign holding company distributes its income currently, the effect of these special tax rules will generally be avoided. This solution is not a drawback because the holding company is not designed to achieve any deferral of taxation.

Finally, most kinds of passive income (*e.g.,* dividends, rents, and royalties) earned by the foreign holding company from U.S. sources is subject to a U.S. withholding tax.[20] This tax does not apply to most kinds of interest or to capital gains. No individual shareholder (such as the settlor if the trust is a grantor trust) will be able to credit such withholding taxes against his own tax liability.[21]

Most of these tax problems effectively disappear if the foreign holding company is not treated as a corporation for U.S. tax purposes: transfers of property to or from the holding company will either be ignored (because the holding company is deemed to be simply an extension of the settlor), or more probably treated as transfers to or from a partnership (see § 9.10[4], below). Because the rules governing accumulation distributions from trusts generally allow for more flexible planning than do the rules for controlled foreign corporations and passive foreign investment companies, it is generally better, if possible, to "check the box" so that the holding company is transparent for U.S. income tax purposes. See discussion in § 4.10, above.

Selecting the country in which to incorporate the holding company is not as simple as it might appear. On the one hand, it may be easier to use the trust situs and, as discussed above, the courts there may be less sympathetic to any attack by creditors against the holding company. On the other hand, selecting another jurisdiction separates the concern about the stability of the trust's situs from that of the holding company's place of incorporation. A problem in one country does not necessitate both a situs shift for the trust and a withdrawal of assets from the holding company. However, this dual selection of countries doubles the number of countries that have to be monitored. It may also give the settlor's creditors another jurisdiction in which they can attempt to reach the assets. The choice may turn on an entirely different consideration, however. If the structure calls for a foreign holding company that is not treated as a corporation for U.S. tax purposes, the adviser is likely to find that countries that are the most desirable for asset protection trusts do not offer the kind of entity needed for such a holding company. For example, the settlor may choose the Cayman

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[17] I.R.C. § 1291.

[18] I.R.C. §§ 951(d), 1297(e).

[19] I.R.C. § 951(b).

[20] I.R.C. § 1492.

[21] I.R.C. § 902.

Islands as the situs for the trust. Its laws do not authorize an entity with corporate status for commercial law purposes that can be treated as a partnership for U.S. tax purposes. The settlor may have to choose something like a Panamanian *limitada* as the holding company.

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§ 9.11 U.S. Tax Aspects of Asset Protection Trust

Asset protection trust is generally treated as grantor trust (income is taxed to grantor) even after emergency event. Transfer of assets to trust is not taxable gift in most cases. Trust assets are includable in settlor's gross estate.

The discussion here is not designed to cover the tax issues in a comprehensive measure, but merely to touch on the major points. See Chapter 4 for full discussion of U.S. income taxation of foreign trusts.

[1] Income Tax Aspects

Asset protection trusts are designed as grantor trusts for U.S. income tax purposes so that the creation and funding of the trust does not affect the settlor's U.S. tax position. The settlor of the asset protection trust is treated as though he still owns those assets for U.S. tax purposes.[1] This means that he will continue to take into account the income and deductions associated with those assets in computing his own taxable income. A trust is a grantor trust if the settlor retains certain powers, such as the right to revoke the trust,[2] to change its beneficiaries,[3] or to receive the income[4] or principal[5] of the trust. Even if the settlor reserves no powers, the trust is a grantor trust if an independent trustee (with or without the consent of an independent Protector) has the discretionary power to make distributions of income (or to accumulate it for later distribution) to or for the benefit of the settlor or his spouse.[6] Finally, if the settlor is a U.S. person and the trust is created under foreign law, it is a grantor trust.[7]

If an emergency event occurs, the tax consequences thereafter depend on whether the trust remains a grantor trust. If grantor trust status was created because the settlor was a U.S. person, that status will continue unless the situs of the trust was moved by a termination and recreation or decanting and non-U.S. beneficiaries are viewed as the settlors of the new trust. If the settlor, or the independent trustee (and the independent Protector if distributions require his consent), retains the powers that originally made the trust a grantor trust, that status continues. Thus, a shift in the settlor's interest from a mandatory to a discretionary one (as in the English protective trust) will not work a change in the grantor trust classification. Unless the settlor is not a U.S. person and the emergency event terminates the interests and powers of the settlor and his spouse, grantor trust status will continue.

If the beneficial interests of the settlor and his spouse are terminated and only a Protector has the power to change the trustee or to veto distributions, the trust then

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§ 9.11

[1] I.R.C. § 671.

[2] I.R.C. § 676.

[3] I.R.C. § 674(b)(5).

[4] I.R.C. § 677(a).

[5] I.R.C. § 673.

[6] I.R.C. § 677(a).

[7] I.R.C. § 679.

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becomes a separate taxable entity unless the trustee (or the Protector) is related or subordinate to the settlor and has the power to make discretionary distributions that are not subject to an ascertainable standard to other beneficiaries.[8] A related or subordinate party is any nonadverse party who is:

(1) the settlor's spouse if living with the grantor;

(2) the settlor's father, mother, issue, brother or sister;

(3) an employee of the settlor;

(4) a corporation or any employee of a corporation in which the stock holdings of the settlor and the trust are significant from the viewpoint of voting control; and

(5) a subordinate employee of a corporation in which the settlor is an executive.[9]

[2] Estate and Gift Tax Aspects

A tax is imposed on the transfer of property by gift.[10] Such a transfer occurs when the donor has parted with his dominion and control over the property, which leaves him no power to change its disposition, whether for his benefit or for the benefit of another.[11] Any beneficial or reversionary interest in the trust retained by the settlor may not be a sufficient safeguard against a completed transfer. If the donor has the power to name new beneficiaries or to change the interests of beneficiaries as between themselves, he has not parted with the requisite dominion and control over the property unless those powers are limited by a fixed or ascertainable standard.[12] Consequently, the settlor of the asset protection trust should have the power to add and to alter the interests of beneficiaries (via a limited power of appointment) in order to ensure that the gift to the trust is incomplete.[13] Requiring the consent of the trustee or theProtector to the exercise of the donor's retained power does not change this result.[14]

An emergency event does not cause the earlier transfers to the trust to become completed for gift tax purposes unless the settlor's limited power of appointment is lost, and any beneficial interest the settlor has in the trust is either terminated or taken by creditors. Note that the settlor's limited power of appointment should not be part of the bankruptcy estate, see § 9.06[4], above.

Distributions by the trustee to beneficiaries other than the settlor will cause transfers to the trust to become completed gifts in the amount of those distributions.[15] Whether

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[8] I.R.C. § 672(c).

[9] I.R.C. § 674(d).

[10] I.R.C. § 2501.

[11] Treas. Reg. § 25.2511-2(b).

[12] Treas. Reg. § 25.2511-2(c).

[13] *See* Estate of Sanford v. Comm'r, 308 U.S. 39 (1939); Rasquin v. Humphreys, 308 U.S. 54 (1939); Estate of Goelet v. Comm'r, 51 T.C. 352 (1968).

[14] Treas. Reg. § 25.2511-2(e).

[15] Treas. Reg. § 25.2511-2(f). *See also* Priv. Ltr. Rul. 8029001.

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any tax is due, however, will depend on the amounts of those distributions. They may be below the $10,000 annual exclusion per donee[16] (which can be doubled if gift-splitting is elected when both spouses are U.S. citizens)[17] or they may be to the donor's spouse in unlimited amounts if the spouse is a U.S. citizen.[18]

On the death of the settlor, the value of the trust assets will be included in his gross estate.[19]

The discussion here of transfer taxes also applies to the U.S. situs assets that are contributed to an asset protection trust created by a nonresident alien. See Chapter 1 for a full discussion of the U.S. transfer tax on nonresident aliens.

[3] Exit Tax

Transfers by United States persons to foreign trusts which are not for the benefit of United States persons and thus not taxable as grantor trusts under Internal Revenue Code Section 679, will be subject to a capital gain tax on any unrealized appreciation of each asset transferred.[20] See discussion in § 4.04, above.

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[16] I.R.C. § 2503(b).

[17] I.R.C. § 2513.

[18] I.R.C. § 2523.

[19] *See* I.R.C. §§ 2036, 2038.

[20] I.R.C. § 684.

§ 9.12 The Protector

Settlor of asset protection trust can avoid potential problems caused by retaining too much control over trust or trustee by granting control to Protector. Protector should be person (corporate or individual) who is not settlor, trustee or beneficiary, who resides outside relevant jurisdictions, and who has few economic ties to those jurisdictions. Protector should be allowed to designate his own successor.

[1] Evolution of the Protector's Role

Investment advisors, with varying degrees of legal control over trust investment policy, have been utilized for many years. Thus the concept of a third party having certain powers with respect to trust assets or the actions of the trustee is not new. What is new, however, is the much more extensive use of third parties, who in the offshore trust context are generally called "Protectors" rather than advisors. Extensive use of discretionary offshore trusts, with distant trustees is a relatively recent phenomenon. Such trusts are often the only way that certain financial goals (such as the protection of assets against governmental or creditor claims) can be achieved. The settlor probably does not want to create the trust in the first place, and certainly not with a trustee he does not know much about who resides in another country about which he may know even less. Worse, from the settlor's point of view, that trustee needs discretionary powers in order to be able to deal with future events. Often the settlor's goals could not be achieved if the settlor retained significant control over the trust assets or the trustee. Settlors were understandably uneasy with the arrangement. As a result, they looked about for some way of assuring that the trustee would administer and distribute the trust assets generally as the settlor would have done had the trust not been created.

One method was to incorporate very detailed provisions in the trust instrument that described how the trustee should exercise its discretion and how the trust assets should be invested. However, this approach suffered from an obvious fault: the future can never be fully anticipated.

A second and more common approach was to give the trustee with very broad discretionary powers but to accompany the trust with what was intended to be a precatory document (often called a letter of wishes). If this letter simply set out the settlor's views on distributions and asset management, it would have replaced the binding provisions described in the preceding paragraph with non-binding ones, a procedure of questionable value. But the letter typically went further and named one or more individuals with whom the trustee should consult regarding trust decisions. This provided a way of anticipating the future by giving the trustee someone to whom it could look for advice. However, the settlor simply had to rely on the reputation of the trustee to honor these nonbinding provisions.

The focal point of these approaches was the trustee and how to influence its actions. The use of a Protector attacks the problem from another direction. It shares (or divides, depending upon how the agreement is drafted) the power of making designated decisions between the trustee and the Protector. It has been argued that if the settlor has used due care and thought in the selection of the trustee, there is usually no need for

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a third party advisor.[1] The force of this argument may account for the paucity of cases dealing with trust advisors. However, in the context of offshore trusts, particularly asset protection trusts, that logic is usually inapplicable because the choice of trustees is very limited. Hence the use of a Protector is common in this circumstance. Moreover, the Protector can serve other functions as well. These include changing the trustee, determining whether an emergency event has occurred (or is likely to occur or has ended), monitoring the trustee's performance, and negotiating the trustee's fees.

[2] Status of Protector

It seems clear that in exercising any of his powers or duties the Protector is not acting as a trustee or an agent of the trustee.[2]Whether a Protector is a fiduciary is likely to depend upon whether he is a beneficiary of the trust. If he is, a court would usually conclude that the power is held for his own benefit,[3]that is, its exercise could not be compelled nor would any liability arise for the way in which it was exercised.[4] Where the Protector is not a beneficiary, it is likely that he does have fiduciary obligations to both the settlor and the beneficiaries.[5]A court would control the Protector in the exercise of his powers if he abuses or threatens to abuse the powers conferred upon him by the trust agreement. The principles applicable to discretionary powers given trustees would be applicable.[6]

[3] Powers of Protector

The powers that can be given a Protector fall into three categories:

(1) negative;

(2) positive; and

(3) structural.

The negative power is the Protector's right to refuse to consent to (effectively to veto) an action for which the trust agreement requires his consent. The Protector's veto does not have to be limited to actions of the trustee. For example, the settlor's power to add or delete beneficiaries might be subject to the Protector's consent. A positive power is the ability to direct the trustee to take some action. Structural powers include those of removing or appointing the trustee, moving the situs of the trust, and appointing a successor Protector.

If the Protector has a veto over too many of the trustee's actions, it will likely be

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§ 9.12

[1] [Reserved].

[2] *See* Note, *Trust Advisors,* 78 Harv. L. Rev. 1230 (1965).

[3] *See, e.g.,* Ditmars v. Camden Trust Co., 76 A.2d 280 (N.J. Super. Ct. Ch. Div.).

[4] Re Green, 45 N.B.2d 17 (N.B. Q.B. 1982).

[5] *See* Restatement (Second) of Trusts § 185 cmt. e (1967); A. Scott, 2A The Law of Trusts § 185. This appears to be the English view as well. *See* David Bates & Simon Phelps, *The Use of Protectors in Settlements,* Tr. & Est. (U.K. July/Aug. 1987). *See also* I.R.C. v. Schoder, 1983 S.T.C. 480 (holding hat a power to remove the trustee and to appoint its successor was a fiduciary power).

[6] A. Scott, 2A The Law of Trusts § 185 (4th ed. 1986).

difficult to find a responsible person willing to act as trustee. Moreover, the administration of the trust may be severely hampered by the need for frequent consents from the Protector. Typically the Protector's consent is required for one or more of the following actions:

- distributions to beneficiaries;
- the addition or removal of beneficiaries of the trust; and
- investment decisions.

The veto over investment decisions must be granted cautiously if the trust is active in trading securities. Consideration could be given to permitting trades below a dollar floor to be made without consent or to permitting a blanket consent (which can be withdrawn) for transactions advised by a particular investment adviser. If the trustee uses an intermediate vehicle, such as a holding company, the Protector's veto will be effectively thwarted unless it applies to investment decisions made at the holding company level. However, it may be difficult to accomplish because the applicable company law may prohibit subjecting a corporation's executive officers to any control exercised by a third party. If a limited partnership is used, it may be easier to extend the Protector's veto through a provision in the partnership agreement.

Granting positive powers to the Protector is not common, largely because it vests the decision making in a single person rather than in two (the trustee has to concur in a veto situation). Moreover, it is likely to relieve the trustee of liability for any adverse effects of the decision.[7] While the Protector will be liable for losses due to negligence or bad faith,[8]this may be a poor trade if the trustee is better capitalized than the Protector.

Certain structural powers are typically given to the Protector. For example, the Protector is often given the power to remove the trustee and to appoint a successor trustee when the office of trustee is vacant. This may be in lieu of such a power being retained by the settlor, or arise only after the settlor has relinquished his removal and appointment power. The power can be restricted to appointing another trustee resident in the trust's situs but, if the Protector is to be able to move the situs of the trust, the appointive power must extend to trustees resident in other jurisdictions. Restrictions are often imposed on the selection of a new trustee. For example, the trustee may be required to be a corporation, to have a specified minimum capital, to have been engaged in the trust business for a certain number of years, or not be affiliated with any corporation organized under the laws of one of the states of the United States. Usually, the Protector is expressly empowered to recover expenses and charges, to delegate powers, and to give consents prospectively. Sometimes, the Protector is given the power to release or restrict the Protector's powers. This power is expected to be exercised if necessary to keep the settlor separate from the trust for tax or other legal reasons. Finally, although rare, the Protector may be given the power to abolish the office of Protector.

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[7] Golden v. Kentile Floors, Inc. 344 F. Supp. 807 (N.D. Ga. 1972), *aff'd,* 475 F.2d 288 (5th Cir. 1973).

[8] Warner v. First Nat'l Bank of Minneapolis, 236 F.2d 853 (8th Cir. 1956).

[4] Choice of Protector

[a] The Best Choice. The ideal Protector meets the following criteria:

(1) The Protector is resident and domiciled outside of, and has no significant assets in, the United States. This eliminates the possibility that a U.S. court could effectively control the Protector's actions by injunction (having *in personam* jurisdiction over the Protector) or by fines (having jurisdiction over the Protector's property).

(2) The Protector is resident and domiciled outside of, and has no significant assets in, the trust situs. This eliminates the possibility that the courts of the trust situs could effectively prevent the movement of the trust to another jurisdiction by enjoining the Protector's removal of the original trustee and the appointment of a new one in different country (based on *in personam* jurisdiction over the Protector) or by threatening to levy fines (based on *in rem* jurisdiction over the Protector's property) if removal is ordered.

(3) The Protector is knowledgeable in trust operations. This provides the settlor with both a check on the proper operations of the trust and should ensure that the Protector does not make any mistakes out of ignorance.

(4) The Protector is a close friend of or adviser to the settlor. This should give the settlor a high degree of confidence that his wishes will be communicated to the trustee and carried out to the best of the Protector's ability.

It is highly unlikely that these ideal conditions can be fulfilled, however. Consequently, judgments will have to be made as to which of the criteria can be eliminated. While each client is different, in the absence of some overriding consideration, the importance of these criteria can generally be ranked in the order listed above for the following reasons.

An asset protection trust is designed to continue normal operations regardless of the settlor's subsequent financial condition. The settlor's creditors should not be able to interfere with the trust's activity, either directly or with orders from a U.S. court. For this reason, the trustee and the trust have to be separated from persons subject to the jurisdiction of U.S. courts as far as is possible. This is, for example, the reason that the settlor's powers with respect to the trust are so limited. To give the office of Protector to someone subject to U.S. *in personam* jurisdiction opens the door to such interference. Although it is equally desirable to have a Protector that will not be caught up in any instability in the trust situs, such political upheaval is less likely than the bankruptcy of a settlor. Consequently, it has a lower priority than avoiding U.S. court jurisdiction.

The choice between a Protector that is experienced in dealing with trusts and one that has the personal confidence of the settlor lies more on which can be replaced by another mechanism than on anything else. On the one hand, there is no substitute for experience in trust operations. On the other hand, the trustee should be well informed of the settlor's views regardless of who the Protector is. The trust agreement could provide for an Advisory Committee (of which the settlor is a member) or the settlor

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can simply keep the trustee informed of his thinking. In other words, there are ways other than through the Protector to make the settlor's views perfectly clear to the trustee.

Confidence that the Protector will exercise his powers properly in accordance with the settlor's wishes can arise from several sources. If the Protector is a trusted friend or advisor of the settlor, that confidence is present. If the Protector is a relative stranger, that confidence can come from a combination of several factors. First, if the Protector is a professional, he will have a reputation to preserve. Second, the powers granted the Protector can be such that he has no incentive to be adverse to the settlor or any beneficiary. For example, the Protector could be given the power:

- to order a situs change, including the selection of the new situs and of the new trustee resident therein, upon his determination that an emergency event has either occurred or is likely to occur or upon his concurrence with a request from the settlor;
- to dismiss the trustee and name an adequately capitalized and experience successor or upon his concurrence with a request from the settlor;
- to veto the addition or deletion of trust beneficiaries by the settlor; and
- to veto trust distributions and transactions in trust assets.

The Protector cannot receive distributions from the trust or deal with the trust assets. In short, he should never be able to benefit from any action he takes.

If the settlor cannot name a Protector that meets the four criteria set out above, there is another possibility. A professional Protector may be named. There are individuals and corporations that specialize in fulfilling the role of trust Protectors.

[b] The Worst Choice. The worst choice for the role of Protector is the settlor. As discussed in § 9.10, above, this gives adverse third-party takers many opportunities to attack the efficacy of the trust. Moreover, government pressure in the settlor's home country can compel the settlor to use the power, or political turmoil may make it impossible for him to communicate any exercise of those powers. In theory, the problem of the home country compelling the settlor to use his power can be handled by a "duress" clause which permits the trustee to disregard directions from the Protector if the trustee deems these directions to be made under duress or compulsion. This cure, however, may be worse than the problem. In the converse situation, where the trustee and not the Protector is under duress, the trustee is likely to disregard the Protector's orders. In that event, the actual custodians of the trust assets are likely to freeze the trust's assets (*i.e.,* not do anything without the protection of a declaratory judgment).

Another poor choice for the Protector is the same person who is the trustee. First, that person may have a vested interest in retaining situs in the original jurisdiction. Second, because that person is subject to the government of the original situs jurisdiction, fear of reprisals or fines can inhibit the free exercise of the powers and discretions. Third, political upheaval in the original situs jurisdiction may make it impossible for that person to communicate the exercise of the Protector's powers to anyone.

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A recent decision of the Ninth Circuit affirming a District Court order in *Federal Trade Commission v. Affordable Media*[8.1] casts doubt on the effectiveness of a "duress" clause in the face of a U.S. court's power to hold the settlor in contempt of court, especially where the settlor also serves as a co-trustee and a Protector of the trust. The settlor who serves as a trustee and a Protector may have a very hard time convincing the court that he cannot repatriate the trust assets as ordered by the court, because courts are skeptical about an argument that triggering a "duress" clause leaves the settlor with no control over the assets.

In *Federal Trade Commission v. Affordable Media*, the Andersons, a married couple, created an irrevocable Cook Islands trust, naming themselves and a Cook Islands company as co-trustees and "Protectors" of the trust. The trust instrument provided that upon the happening of an "event of duress" within the territory in which a trustee is resident, the trustee's title to the property would be immediately divested in favor of the remaining trustees. The trust defined the issuance of a court order "which in the opinion of the protector will or may . . . restrict or prevent the free disposal by a trustee of any . . . property which may from time to time be included in . . . this trust"[8.2] to constitute an event of duress.

A few years after creating the trust, the Andersons engaged in a scheme to telemarket fraudulent investments and defrauded thousands of investors. On motion by the Federal Trade Commission, the Federal District Court issued a preliminary injunction, which, among other things, required the Andersons to repatriate all assets outside the United States. After the Andersons faxed a letter instructing the Cook Islands trustee to repatriate the assets to the United States, the trustee notified them that the court order was an event of duress. As a result, the Cook Islands trustee removed the Andersons as trustees and refused to repatriate the assets. After the Commission revealed to the court that the Andersons were also the Protectors of the trust, the Andersons immediately attempted to resign as Protectors. The District Court held the Andersons in civil contempt and ordered them to be taken into custody after they failed to purge themselves of contempt.

In affirming the District Court's decision, the Ninth Circuit rejected the Andersons' claim that their inability to comply with the District Court's order was a defense to a civil contempt charge, because their role as Protectors empowered them with discretion to determine whether an event of duress has occurred. The Court of Appeals made it clear that where the physical person of the settlor remains subject to domestic courts' jurisdictions, the courts will utilize their contempt power to force a defendant to repatriate the assets to their jurisdictions. The burden on the party asserting an impossibility defense "will be particularly high" in the assets protection trust context.[8.3] The courts are likely to disregard the triggering of a "duress" clause because "[f]oreign trusts are often designed to assist the settlor in avoiding being held in

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[8.1] 179 F.3d 1228 (9th Cir. 1999).

[8.2] *Id*. at 1240, n. 9 (citing Anderson trust agreement).

[8.3] *Id.* at 1241.

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contempt of a domestic court while only feigning compliance with the court's orders."[8.4]

[5] Replacing the Protector

Provisions for the removal of the Protector are rare primarily because of the problem of who should have that power. The Protector exists to exercise powers that for tax or other reasons the settlor or a beneficiary should not have. If the settlor or a beneficiary can remove the Protector, there is a risk that the Protector'spowers will be attributed to the settlor or that beneficiary. Occasionally, a trust agreement will provide that the Protector's term of office is a fixed, short period on the theory that at the time of reappointment the Protector's performance can be reviewed.

In any event, there must be a mechanism for replacing the Protector. Giving the settlor the power to change the Protector at will can give rise to the same problems as are present if the settlor is the Protector. Providing for the appointment of a successor Protector by the settlor in the case of resignation, death, bankruptcy, or the like, while logical, opens the way for home country coercion of the appointment or the assertion that the appointive power resides in the home country government pursuant to an expropriation. Nevertheless, it is common for the settlor to have the power to appoint a successor Protector.

Another approach is to authorize judicial appointment of a successor, but this may be ineffective, because the designated court might not see this as a justiciable issue. It is not at all clear that courts will adopt a notion similar to "a trust will not fail for want of a trustee," which gives rise to the duty of a court to appoint a trustee. However, the only case considering this question did appoint a successor advisor under its general equity powers to supervise trusts.[9] Unless a court followed that reasoning, it would probably decline to act because jurisdiction cannot be generally conferred on a court by private parties.[10] Alternatively, the Protector can be empowered to appoint his own successor. The principal risk is that the successor will be completely unknown to the settlor and the trust's beneficiaries. However, if the initial Protector is a corporation, the likelihood that its designated successor may ever occupy the Protector's office may be small. Moreover, the successor Protector (like his predecessor) will have no incentive to be adverse to the settlor or the other beneficiaries of the trust. Finally, some type of fiduciary or professional experience could be required of any such successor.

As a final alternative, a third party (sometimes called an "Appointor") can be designated to make the selection. Despite the obvious complication of assuring that there will be an Appointor when the need arises, such a provision is necessary to take care of the default situation, when the office of Protector is vacant. The Appointor can

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[8.4] *Id.*

[9] Gathright v. Gaut, 124 S.W.2d 782 (Ky. Ct. App. 1939).

[10] *Cf. In re* Hooker's Settlement, [1955] Ch. 55 (provision of an inter vivos trust granting settlor power to revoke the trust with the consent of a judge of the Chancery Division held invalid on the ground that no private person can impose on a judge jurisdiction not given him by law).

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be the holder of a designated office (*e.g.,* the senior judge of the highest appellate court), acting as an individual and not as an official. Note that the workability of such a provision should be discussed with advisers from that jurisdiction.

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§ 9.13 Adviser Liability Issues

When rendering advice regarding asset protection trust, U.S. lawyer must be aware of potential liabilities, under rules of professional conduct, criminal laws, and tort and other civil statutes, that could attach to suggesting asset protection trust strategy for client. Potential for liability is greatly enhanced if trust is created after client files bankruptcy petition.

When advising a client about creating and implementing an asset protection trust a U.S. lawyer must take into account the three sets of rules or laws that govern his own conduct:

(1) professional rules;

(2) criminal laws; and

(3) civil (including tort) liability.

These are not limited to situations involving U.S. clients, but a discussion in that context will develop the pertinent issues. Only pre-petition conduct, that is, what is done before any bankruptcy case is filed, is considered. Creating such a trust after the petition is filed will almost certainly be ineffective to shield the transferred property (see § 9.10[2], above) and the likelihood of criminal fraud is great.

[1] Professional Rules

Every state has a set of rules governing the conduct of lawyers. A majority of these are based on the Model Rules of Professional Conduct, adopted by the American Bar Association in 1983. The discussion here is based on the Model Rules. Each state has different rules, however, and no lawyer can fail to consult them carefully.

There are two questions: (1) what is the standard with which the lawyer must comply?, and (2) how does the lawyer go about determining if that standard has been met? Surprisingly, there is no clear answer to either of these. Model Rule 1.2(d) sets out the following as the standard applicable to the lawyer as an adviser:

> A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

Most lawyers would read the first part of this as condemning conduct that constitutes a crime or is intended to deceive third parties. However, the commentators generally describe it quite differently. They take the view that therules that apply to the adviser are fundamentally different from, and are not an extension of, those that apply to the advocate. They would extend the rule to cover conduct that is immoral, unfair, or of doubtful legality.[1] The case law supports the narrow view,[2]but whether this will continue in the face of numerous articles advocating the broader reading is uncertain.

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§ 9.13

[1] *Professional Responsibility: Report of the Joint Conference,* 44 A.B.A. J. 1159, 1161 (1958).

[2] In re Disbarment Proceedings, 184 A.59 (Pa. 1936)

Normally, the lawyer has little difficulty in determining whether the conduct with respect to which advice or assistance is requested is criminal or fraudulent, that is, whether the narrow standard has been met in a particular situation. Sometimes, however, it is unclear because the answer turns on the client's intent. This is likely to be the case in the asset protection trust situation. Can the lawyer avoid the ethical problem by simply giving advice as to what the law is, without specific aid or encouragement to the client?[3]As a practical matter the answer must be no. Being a passive source of prognostication is almost certainly unsatisfactory from the client's point of view in the asset protection trust context. The client cannot accomplish his goals—whatever they may be—without the skill and experience of the lawyer. The asset protection trust agreement is a highly complex document with many unusual provisions, and the trustee must be selected on the basis of criteria that are wholly unobvious.

Consequently, the lawyer will be pushed into investigating his client's intent in seeking advice.[4] How far does he have to go? As might be expected, the answer is that it depends on the circumstances. A lawyer must be satisfied, on the facts before him and readily available to him, that he can perform the requested services without abetting fraudulent or criminal conduct. He must ask enough questions, and check easily verifiable matters, to satisfy himself.[5]

An inquiry into the client's intentions and motives presents a problem that is potentially destructive of the lawyer-client relationship: Does the lawyer explain the law and then ask about motives, or does he ask why the client wants advice and then advise on the consequences of making any transfer of property with those motives? The first runs the risk that the lawyer will assist the client in articulating false motives.[6]The second is likely to make the client see his lawyer as an adversary or, at best, uncooperative.[7]

There is no clear answer to the question posed above. The difficulty is compounded by the fact that the client is not likely to be able to state his intentions with clarity. The statement "I want to protect my assets from the claims of creditors" can just as easily mean that he wants to reduce his exposure to the vicissitudes of fortune as that he wants to avoid an impending liability. Moreover, he may be willing to revise his goals

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[3] Geoffrey C. Hazard, Jr., *How Far May a Lawyer Go in Assisting a Client in Unlawful Conduct?,* 35 U. Miami L. Rev. 669 (1981).

[4] *See* A.B.A. Comm. on Ethics and Professional Responsibility, Informal Op. 1470 (1981).

[5] Escott v. Bar Chris Constr. Co., 283 F. Supp. 643, 690 (S.D.N.Y. 1968). *See also* People v. Zelinger, 504 P.2d 668 (Colo. 1972).

[6] Monroe H. Freedman, Lawyer's Ethics in an Adversary System 73 (1975); Monroe H. Freedman, *Professional Responsibility of the Criminal Defense Lawyer: The Three Hardest Questions,* 64 Mich. L. Rev. 1469, 1480 (1966); John T. Noonan, Jr., *The Purposes of Advocacy and the Limits of Confidentially,* 64 Mich. L. Rev. 1485, 1488 (1966).

[7] 1 G. Hazard & R. Hodes, Legal Ethics § 1.2:505. *See* Frankel, *The Search for Truth: an Umpireal View,* 123 U. of Pa. L. Rev. 1031, 1056 (1975). Harry Jones, *Lawyers and Justice: The Uneasy Ethics of Partisanship,* 23 Vill. L. Rev. 957, 973 (1978).

into those that are permissible. Perhaps a better approach is to begin with Model Rule 1.2(e), which states that when a lawyer knows that a client expects assistance not permitted by the rules of professional conduct or other law, he must consult with the client regarding the relevant limitations on the lawyer's conduct. This means that the client has to understand what those limitations are; the lawyer cannot assist client conduct that is "criminal or fraudulent." Just stating that is not enough. The client is no wiser unless he understands what is "criminal or fraudulent" conduct in the context of the requested advice with respect to asset protection trusts. Consequently, the lawyer will have to explain that whether creating and funding such a trust is criminal or fraudulent generally turns on the client's intent at the time. If that intent is to hinder, delay, or defraud creditors, then the lawyer cannot help.

At this point, most lawyers, on the one hand, and most commentators, on the other hand, part company. The client is almost certain to ask how does he establish that he does not have that intent, or, stated another way, what demonstrates his intent? Most lawyers would feel comfortable in answering this question, seeing it as part of making sure that the client fully understood what was permissible and what was not.[8] Most commentators see this as assisting the client in developing false evidence of intent.[9]

In any event, if the lawyer is to proceed, he will have to inquire into both the client's intent in seeking advice with respect to the trust and the surrounding facts from which the client's intent can be inferred. He cannot just accept a bland assurance that no fraudulent intent exists. This means that he also has to check independently such of those facts as are easily verifiable. At a minimum the lawyer will want to be assured:

(1) The client is not currently in financial difficulties;

(2) The client has no knowledge of facts or circumstances that may render him liable to a claim in the future as a result of past activities;

(3) The client's motive in placing assets in trust is not to place those assets beyond the reach of any person to whom he is presently or contingently liable, or to whom he owes an existing obligation; and

(4) The client is contemplating neither entering into a new business nor divorce proceedings.

In addition the lawyer is likely to require a full financial statement of assets and liabilities, and will want to corroborate these to the extent reasonably ascertainable. For example, public records, such as judgment records and the dockets of bankruptcy and local civil courts, might be checked. The point is not that the lawyer should distrust his client, but that the lawyer should be aware of readily available facts that do (or do not) confirm the client's description of the facts and his intent.

The lawyer might also inform the client that any trustee of an asset protection trust

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[8] *See* M. Freedman, *Professional Responsibility of the Criminal Defense Lawyer: The Three Hardest Questions,* 64 Mich. L. Rev. 1469 (1966).

[9] M. Freedman, Lawyer's Ethics in an Adversary System 73 (1975); John T. Noonan, Jr., *The Purposes of Advocacy and the Limits of Confidentially,* 64 Mich. L. Rev. 1485, 1488 (1966).

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is likely to require affidavits from the client to the effect that:

- There are no current legal proceedings being prosecuted or contemplated against him, or if there are and the maximum amount of the claim is identifiable, that sufficient reserves outside of the proposed trust have been set aside to cover the liability.
- There are no liabilities or contingent liabilities that are not disclosed in his financial statements.
- He is not aware of any currently existing facts that might render him liable to legal proceedings that could result in a claim against his assets.

[2] Criminal Penalties

In general, a crime requires the commission or omission of a described act done with a prescribed intent. Neither the "bad act" nor the intent is by itself sufficient. While there are some strict liability crimes (those that do not require any intent), none of the possible crimes discussed in this section fall within that very limited category.

[a] Bankruptcy Fraud. There are two potential crimes arising from pre-petition activities. The principal one consists of knowingly and fraudulently transferring or concealing property either in contemplation of a case under the Bankruptcy Code or with intent to defeat the provisions of that Code.[10]It is immaterial whose property is transferred or concealed, whose bankruptcy is contemplated, or whether the person is acting individually or as an agent. Since a lawyer is an agent of his client, albeit of a special kind, the statute can apply to him as well as to the client.[11]

Despite the statute's age, there are only a handful of reported cases that deal with this provision, and they provide very little interpretative guidance, because their fact patterns were so egregious that its application was clear. For example, none of the cases discuss:

(1) how much thought of a future bankruptcy is required to constitute the contemplation thereof; or

(2) whether the intent to defeat notion encompasses avoidance as well as evasion.

Does the contemplation element mean a reasonable expectation of a future bankruptcy or the awareness that a bankruptcy can happen in the future? The latter interpretation would effectively eliminate this requirement for almost everyone knows that unexpected events can result in a bankruptcy. What little authority there is indicates that there must be some anticipation of a bankruptcy for the statute to apply.[12] What does it mean to "defeat" the provisions of the Bankruptcy Code? If the word is used in its

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[10] 18 U.S.C. § 152.

[11] *See, e.g.,* People v. Schwartz, 814 P.2d 793 (Colo. 1991); *In re* Appel, 405 N.Y.S.2d 66 (Sup. Ct. 1978).

[12] Fed. Criminal Jury Instructions of the Seventh Cir., vol. III at 12 (1986). *See also* United States v. Haymes, 610 F.2d 309 (5th Cir. 1980).

dictionary sense ("to prevent, frustrate or circumvent"),[13]it appears to cover avoidance as well as evasion. However, the only authority on this clause indicates that a bankruptcy case must be contemplated.[14] If the act which is intended to frustrate the Bankruptcy Code is done at a time when no bankruptcy case is contemplated, this requirement would not be met. Some inferential support for these narrow readings of the statute may be drawn from the reported cases because every one of them involved a debtor who was in financial difficulty at the time of the transfer or concealment, and a bankruptcy petition was filed shortly thereafter. The longest period of time between the act and the petition was six months.[15]

To be criminal, the act must be done "knowingly and fraudulently." These adverbs are not disjunctive; both knowledge and fraud are necessary to complete the crime. There must be personal knowledge of the false act, which is not thesame what a reasonable person would know.[16] Nevertheless, the reasonable (or prudent) man standard is not totally irrelevant. If a lawyer realizes that his conduct may cause a result that the law seeks to prevent, and goes ahead without attempting to determine whether this is indeed the case, he may be deemed "to have knowledge of what he would have known had he not made it a point not to know."[17] As to the meaning of "fraudulently," the courts have steadfastly refused to define it.[18]In a broad sense, it appears to describe activity that projects a false image which deceives a creditor.[19] In the context of an asset protection trust, the principal possibility of deception is the appearance that the settlor still owns the assets transferred to the trust. This can be avoided by insuring that the title to any assets is recorded (to the extent permitted) in the name of the trustee and that these assets are removed from the client's financial statements. Then no creditor should have any legitimate reason to think that the settlor has any ownership of the trust assets.

[b] Other Types of Fraud. Mail fraud, wire fraud, bank fraud, and tax fraud are covered by statutes that are similar to each other.[20]The first two apply to the use of the mail or electronic transmissions to execute any scheme or artifice to defraud.

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[13] Black's Law Dictionary 418 (6th ed. 1990).

[14] Fed. Criminal Jury Instructions of the Seventh Cir., vol. III, at 11 (1986).

[15] United States v. Moody, 923 F.2d 341 (5th Cir. 1991).

[16] Commonwealth v. Boren, 58 N.E.2d 8, 12 (Mass. 1944).

[17] Perkins & Boyce, Criminal Law 867 (3d ed. 1982). *See* United States v. Ramsey, 785 F.2d 184, 189 (7th Cir. 1986), *cert. denied,* 476 U.S. 1186; United States v. Brien, 617 F.2d 299, 312 (1st Cir. 1980); United States v. Hanlon, 548 F.2d 1096, 1101 (2d Cir. 1977).

For an extensive, and perhaps definitive, review of the cases, see Charlow, *Wilful Ignorance and Criminal Culpability,* 70 Tex. L. Rev. 1351 (1992).

[18] *See, e.g.,* Weiss v. United States, 122 F.2d 675, 681 (5th Cir. 1941).

[19] Pattern Jury Instructions, Criminal Cases, U.S. 5th Cir. Judges Ass'n 142 (1990 ed.); Fed. Criminal Jury Instructions of the 7th Cir., vol. II, at 90, 91 (1983); Manual of Model Criminal Jury Instructions for the District Courts of the 8th Cir. 228 (1992 ed.); Pattern Jury Instructions, Criminal Cases, U.S. 11th Cir. District Judges Ass'n 138–139 (1985 ed.).

[20] 18 U.S.C. §§ 1341, 1342, 1344, and 26 U.S.C. § 7206(2).

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The third applies where the defrauded creditor is a bank. As long as the activity does not involve any deceit, that is, the appearance of facts that cause the creditor to extend credit when he would otherwise not have done so, it is difficult to see how these statutes are violated.[21] The tax fraud applies to the intentional concealment of income from the Internal Revenue Service. A lawyer advising a client on a scheme designed to conceal income from the Service may be guilty of a tax fraud and a conspiracy to commit tax fraud. For example, in *United States v. Chappell*,[22] an attorney was convicted of conspiracy to market a sham offshore trust program and evasion of Federal income taxes as a result of assisting his client to prepare tax returns reflecting the sham offshore trust transactions.

[c] RICO. The Racketeer Influenced and Corrupt Organizations (RICO) Act[23] punishes those who utilize an "enterprise" to carry out certain proscribed activities (including bankruptcy fraud and mail, wire, and bank fraud) "through a pattern of racketeering activity." The necessary enterprise may well be the attorney-client relationship.[24] The statute does not define what a pattern is, providing simply that it "requires at least two acts of racketeering activity" within ten years of each other.[25] The Supreme Court has interpreted this as *requiring* at least two acts of racketeering activity, and not as *meaning* two such acts.[26] In other words, there cannot be a pattern without two acts, but two acts do not necessarily mean that there is a pattern. To constitute a pattern the acts must be related and they must amount to or pose a threat of continued criminal activity.[27] In the context of asset protection trusts, if the attorney commits fraud, it is almost certain that there will be multiple offenses and that they will be related for RICO purposes. What about the continuity requirement, however?

> "Continuity" is both a closed- and open-ended concept, referring either to a closed period of related conduct, or to past conduct that by its nature projects into the future with a threat repetition. [Citation omitted.] It is, in either case, centrally a temporal concept—and particularly so in the RICO context, where *what* must be continuous, RICO's predicate acts or offenses, and the *relationship* these predicates must bear one to another, are distinct requirements. A party alleging a RICO violation may demonstrate continuity over a closed period by proving a series of related predicates extending over a substantial period of time. Predicate acts extending over a few weeks or months and threatening no future criminal conduct

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[21] *See e.g.,* Gold v. United States, 350 F.2d 953, 953 (8th Cir. 1965); United States v. Brien, 617 F.2d 299, 307 (1st Cir. 1980) (quoting from *Gold v. United States* with approval).

[22] 2001 U.S. App. LEXIS 16895 (9th Cir. 2001).

[23] 18 U.S.C. § 1961 *et seq.*

[24] *See* Model Rules of Professional Conduct Rule 1.2, cmt. (1983) (in many cases the client-lawyer relationship partakes of a joint undertaking.).

[25] 18 U.S.C. § 1961(5).

[26] Sedima S.P.R.L. v. Imrex Co., Inc., 473 U.S. 479, 496 n14 (1985).

[27] H.J. Inc. v. Northwestern Bell Tel. Co., 492 U.S. 229, 239 (1989).

do not satisfy this requirement; Congress was concerned in RICO with long-term criminal conduct.[28]

The closed-end concept of continuity would encourage the attorney to move his client rapidly through the consulting and implementing process. If the attorney-client relationship lasts for only a few months (and all the advice is implemented in that time period), the attorney (and the client) might well have a viable defense to a RICO charge as this type of continuity would seem to be lacking.[29] However, an open-ended type of continuity ("the project[ion] into thefuture with a threat of repetition") may be more difficult to avoid. If the client is or becomes an ongoing client so that the relationship with the attorney continues after the asset protection planning is completed, an open-ended period may exist. Even if it is a "one-shot" relationship, the nature of the mechanisms established as the result of the lawyer's advice may be designed to accommodate (or at least capable of accommodating) future transfers. For example, if the client learns that a certain type of annuity is exempted from the reach of creditors, that client could purchase such an annuity at any time in the future. Such an action by the client would also seem to fit the relationship requirement. However, for racketeering activity to violate RICO, it must have some nexus with the enterprise.[30] As the enterprise (the attorney-client relationship) would have ended prior to that time, it is difficult to see a RICO violation arising out of that potential future act by the former client.

[d] Conspiracy. In addition to the substantive offenses discussed above, a defendant can also be convicted of conspiring to violate those statutes.[31]

[3] Civil Liability

The discussion in this section relates only to liabilities to nonclients and, even there, only to claims arising out of competent representation. It does not address the issue of when a lawyer's malpractice has denied these other parties the benefit that the client directed be conferred upon them.

A lawyer has no privilege to commit intentional torts against third parties in the course of representing a client or to assist the client in committing intentional torts against third parties. A conspiracy to commit a fraudulent transfer or aiding and abetting in a fraudulent transfer are torts in some states.[32] In the preparation and

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[28] H.J. Inc. v. Northwestern Bell. Tel. Co., 492 U.S. 229, 241–242 (1989).

[29] *See, e.g.,* Eastern Publishing & Advertising Inc. v. Chesapeake Publishing & Advertising, Inc., 895 F.2d 971 (4th Cir.), *cert. denied,* 497 U.S. 1025 (1990) (holding that predicate acts committed over a three month period did not amount to a pattern).

[30] United States v. Erwin, 793 F.2d 656, 671 (5th Cir.), *cert. denied,* 479 U.S. 991 (1986); United States v. Cauble, 706 F.2d 1322, 1331–1332 (5th Cir. 1983), *cert. denied,* 465 U.S. 1005 (1984).

[31] 18 U.S.C. § 371; Miller v. United States, 125 F.2d 517 (6th Cir. 1942).

[32] *See* McElhanon v. Hing, 728 P.2d 256, 273 (Ariz, App., 1985), *aff'd in part and vacated in part* 728 P.2d 273 (1986) *cert. denied*; Van Royen v. Lacey, 277 A.2d 13 (Md., 1971); Joel v. Weber, 602 N.Y.S.2d 383 (App. Div. 1st Dept., 1993); and Crowthers McCall Pattern, Inc. v. Lewis, 129 B.R. 992, 999 (S.D. N.Y., 1991).

implementation of an asset protection trust, there should be no misrepresentation or false document so there is nothing on which that the lawyer can reasonably foresee that any third party would rely. Hence, there does not appear to be a basis for concluding that the attorney has committed an intentional tort in this situation. The real question is whether he has assisted his client in committing such a tort.

The only case that discusses the lawyer's role in circumstances similar to those of creating and implementing an asset protection trust is *Newburger, Loeb & Co., Inc. v. Gross*.[33] Robert Persky represented several general partners in a failing brokerage firm. He helped implement a plan to transfer the partnership's assets to a newly formed corporation. New York law required that all partners consent to the transfer unless the partnership agreement provided otherwise. Persky issued an opinion letter that construed the partnership agreement as giving the general partners the right to make the transfer without the consent of the other partners, who then sued. The court found "simply no language in the partnership agreement" that could legitimately be construed in this manner, and held that the transfer was a conversion.

Persky argued that because he was acting in his professional capacity, he was immune from suit by third parties for having given bad advice to his clients. The court rejected this defense on the ground an attorney was not protected under New York law when his actions were "beyond the scope of his honorable employment." Persky was found to be at the heart of the entire transaction, guiding the entire plan. More importantly, he was found to have carried the threats to the dissidents and to have knowingly counseled, advised and instituted baseless and fraudulent lawsuits to achieve his goal. It was these latter findings that supported the conclusion that Persky went "beyond his honorable employment," and hence was liable.[34]

Almost without exception, Persky's activities were found to involve direct dealings with third parties in bad faith. Compare this with the typical asset protection trust scenario. Although the lawyer may well be at the heart of the planning, guiding it to fruition, there are no dealings with third parties. At the time the lawyer is advising and assisting his client, others are not being threatened or sued or induced to breach fiduciary duties, nor are baseless opinion letters issued. That difference in the lawyer's activities should provide sufficient basis for distinguishing the *Newburger* case.[35]

Finally, there is the civil aspect of RICO, which authorizes treble damages for injury to a person's business or property "by reason of a violation of section 1962."[36]The plaintiff's cause of action is not dependent on any criminal conviction of the defendant, and the burden of proof is the simple "preponderance of the evidence."[37]

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[33] 563 F.2d 1057 (2d Cir. 1977).

[34] 563 F.2d at 1080.

[35] *See* Worldwide Marine Trading Corp. v. Marine Trans. Serv., Inc., 527 F. Supp. 581, 586 (E.D. Pa. 1981). *See also* Yoggerst v. Stewart, 623 F.2d 35, 38 (7th Cir. 1980).

[36] 18 U.S.C. § 1964(c).

[37] Sedima, S.P.R.L. v. Imrex Co. Inc., 473 U.S. 479, 481 (1985) (dicta); Liquid Air Corp. v. Rogers, 834 F.2d 1297 (7th Cir. 1987), *cert. denied*, 492 U.S. 917 (1989).

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§ 9.14 Goals of Asset Protection Trusts for Foreign Persons

Asset protection trust may be created to protect foreign investor's U.S. assets from: (1) expropriation in grantor's home country or in intermediate, offshore jurisdiction; (2) freezing or vesting by United States; (3) political turmoil in home country or offshore jurisdiction; and (4) bankruptcy in home country. When choosing situs of asset protection trust, advisor should consider potential forum jurisdiction's conflict-of-law principles and hospitality toward trust concept.

The asset protection trust may be useful for a foreign person who has acquired or is acquiring assets with a U.S. situs and wishes to protect those assets from a range of possible events. Broadly speaking, these assets requiring protection are real property located in the United States, tangible personal property present in the United States, equity interests in U.S. corporations, and evidences of indebtedness of U.S. persons (including bank deposits). Generally the situs rules are derived from state rather than federal law.[1]

In the normal course of events, an ownership structure is developed for the foreign investor to acquire and hold the U.S. assets. It may involve an "offshore" entity formed under the laws of a third country. The principal considerations in developing that structure are usually taxes, administrative costs and convenience, home country laws regarding property interests (*e.g.,* marital or forced heirship rights), and any special rules in the United States regarding foreign ownership of assets. See Chapter 10.

The structure is initially static, that is, not purposefully planned to accommodate extraordinary changes in laws or political climates. Thereafter, the addition of insulating elements, designed to limit the adverse consequences of such changes, must be considered. As these elements generally involve greater administrative costs and inconvenience, and sometimes higher taxes, the amount of protection they offer must be analyzed and evaluated. This process requires an understanding of the law applicable to the particular risk in the absence of any such elements, and the effect those elements have in ameliorating the consequences of that risk if it occurs. This applicable law has two components: (1) the substantive law of the jurisdiction where the event occurs, for example, the law of the home country in an expropriation situation or of the United States in a "vesting" context; and (2) the substantive and procedural law of the trust situs. The degree of the foreign investor's concern (whether or not objectively justified) must also be taken into account.

[1] Emergency Events

Typically the foreign client fears the following extraordinary events (collectively referred to as emergency events):

(1) expropriation in his home country jurisdiction (see § 9.15, below);

(2) expropriation or new taxes in any intermediate, offshore jurisdiction;

(3) freezing or vesting of assets by the United States (see §§ 9.16, 9.17, below);

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[1] *Cf.* Butner v. United States, 440 U.S. 48, 55 (1979) (holding that property interests are created and defined by state law unless some federal interest requires a different result).

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(4) political turmoil or upheaval in his home country or offshore jurisdiction that makes it difficult or impossible for him effectively to oversee the U.S. assets; and

(5) bankruptcy in his home country and its effect on the U.S. assets.

An asset protection trust can provide protection against the consequences of each of these emergency events, but the degree of insulation varies with the situs of the trust and the type of emergency event.

[2] Situs of Trust for Foreign Person

Most of the considerations for the choice of trust situs are the same as those for U.S. persons. See § 9.03, above. However, there are additional factors. A U.S. trust certainly offers more protection against expropriation than does a trust created in the home country (if the law of the home country even permits the creation of a trust), but its weaknesses are in the areas of bankruptcy and United States vesting orders on contingent remainder interests. An offshore trust gives the maximum protection at the risk of adding another jurisdiction whose laws and political climate must be considered. However, since the offshore country has no jurisdictional "hook" in the investor (he is not a citizen or resident thereof) and the underlying assets are in the United States, it should be possible to shift the trust situs to another country in the event of need, despite any objections the original trust situs may raise.

A sufficient nexus with the offshore jurisdiction may be obtained by locating trust assets within that jurisdiction through the use of a local holding company. If the holding company strategy is used, the jurisdiction of incorporation should have the following characteristics:

- zero taxation;
- flexible company law; and
- express provisions for domestication of local companies in other jurisdictions.[2]

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[2] *See generally* W. Diamond, Tax Havens of the World (Matthew Bender) for complete discussion of the relative merits of various offshore jurisdictions.

§ 9.15 Protection Against Expropriation

Under Act of State Doctrine, United States does not interfere with foreign country's expropriation of property located within its territory. Even if expropriated property is located within United States, foreign law is applied in most cases unless application of such law would violate U.S. public policy. Trust may protect U.S. assets from expropriation.

This section deals with attempted expropriation of the U.S. assets of a foreign person. A taking of those assets by the United States is covered in § 9.17, below. Expropriation encompasses more than a formal taking. It covers any governmental action that has the effect of depriving a foreign person of the fruits of owning U.S. assets. For example, it would include a new law changing the legal tender for discharging obligations such as bank accounts.[1]

If a foreign person owns U.S. assets directly, home country expropriation can take the form of laws vesting title to the assets in the home country government or agency thereof. If the U.S. assets are owned by a holding company formed under the laws of the expropriating country (whether it be the home or a third country), that country can declare the holding company dissolved and expropriate the liquidating distribution. Alternatively, the home country could expropriate the shares, regardless of where the company was formed (including the United States), and install its own officers and directors who would attempt to deal with the U.S. assets directly in the guise of corporate action.

The power to take the property of a national and to set the terms of that taking are implicit in the concept of sovereignty.[2] Consequently, international law can offer no protection against a country expropriating the property of its nationals that is situated in the expropriating country. Where the property is situated elsewhere, international law does provide protection (in the form of denying the extraterritorial effect of the expropriating decree) under certain circumstances.[3]

[1] Act of State Doctrine

To judge the efficacy of any protective structure, an understanding of the relevant international law principles is necessary. The applicable international law is founded on international agreements and treaties,[4]the statutes and constitutions of the respective nations, the customs of individual nations, judicial precedents, and legal treatises.[5]

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§ 9.15

[1] Callejo v. Bancomer, S.A., 764 F.2d 1101 (5th Cir. 1985). For a broad discussion of currency controls and the Act of State Doctrine, see Ebenroth & Teitz, *Winning (or Losing) by Default: The Act of State Doctrine, Sovereign Immunity and Comity in International Business Transactions,* 19 Int'l Law. 225 (1985).

[2] *See* De Sanchez v. Banco Central de Nicaragua, 770 F.2d 1385, 1396 (5th Cir. 1985); F. Palicio y Compania, S.A. v. Brush, 256 F. Supp. 481, 487 (S.D.N.Y. 1966), *aff'd per curiam,* 375 F.2d 1011 (2d Cir. 1967).

[3] *See* Restatement (Third) of Foreign Relations Law of the United States § 712 n.1 (1986).

[4] *See* Restatement (Third) of the Foreign Relations Law of the United States §§ 301–339 (1986).

[5] *See, e.g.,* Jiminez v. Aristeguieta, 311 F.2d 547 (5th Cir. 1962); Banco Nacional de Cuba v.

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The validity of an expropriation of property situated in another country is subject to the review of the courts of that other country pursuant to the *lex situs* principle (a state can control the ownership of property within its boundaries) and under the related concepts of state sovereignty and sovereign immunity. Consequently, the title to any U.S. situs assets will be determined by U.S. courts. The question is how they will react on the investor's challenge to the validity of the expropriating country's actions as they relate to U.S. assets. The United States version of the international law principles that these courts will apply is called the Act of State Doctrine. If the Doctrine applies, the U.S. courts will refuse to act. The result is the enforcement, by default, of the foreign government's act.

The Act of State Doctrine originated in late 19th century notions of sovereign immunity and comity.[6]Even so, it did not prevent U.S. courts from denying extraterritorial effect of expropriation decrees.[7] However, in *Banco Nacional de Cuba v. Sabbatino*,[8]the Supreme Court shifted the basis of the Doctrine to that of judicial abstention based on separation of powers, concluding that courts have little competence in foreign affairs and should not restrict the executive branch's conduct of foreign policy.[9]The Court held that:

> [T]he Judicial Branch will not examine the validity of a taking of property within its own territory by a foreign sovereign government, extant and recognized by this country at the time of suit, in the absence of a treaty or other unambiguous agreement regarding controlling legal principles, even if the complaint alleges that the taking violates customary international law.[10]

The Court's refusal to review the acts of the Cuban government even though those acts allegedly violated international law drew severe criticism. Within a few months, Congress passed the so-called Second Hickenlooper Amendment.[11]It requires adjudication of certain claims where the expropriation violates international law. The statute is of little relevance to the foreign investor because the actions of a government with respect to the property of one of its nationals is not an international law issue unless the property is situated outside that state, in which case the Act of State Doctrine does not apply.[12]See § 9.15[2], below.

The Act of State Doctrine may be inapplicable under the "Bernstein Exception."

Sabbatino, 307 F.2d 845 (2d Cir. 1962). *See* Restatement (Third) of the Foreign Relations Law of the United States §§ 711–712 (1986).

[6] *See* Underhill v. Hernandez, 168 U.S. 250, 252 (1897).

[7] *See* Salimoff & Co. v. Standard Oil Co., 262 N.Y. 220, 186 N.E 679 (1933); Fred S. James & Co. v. Rossia Ins. Co., 247 N.Y. 262, 160 N.E. 364 (1928).

[8] 376 U.S. 398 (1964).

[9] 376 U.S. at 421–427 (1964).

[10] 376 U.S. at 428 (1964).

[11] Foreign Assistance Act of 1964, Pub. L. No. 88-633, 88th Cong., 2d Sess., § 301(d)(4), 78 Stat. 1009 (current version at 22 U.S.C. § 2370(e)(2)).

[12] *See* Empresa Cubana Exportadora, Inc. v. Lamborn & Co., 652 F.2d 231 (2d Cir. 1981).

Where the Executive Branch indicates that application of the Act of State Doctrine would not advance U.S. foreign policy interests, the Supreme Court has held that it should not be applied.[13]Usually the Executive Branch does this by submitting a "Bernstein Letter" to the court. However, where the State Department had clearly made public its position that U.S. courts should have jurisdiction over the acts of the foreign government in question, this exception has been applied even when no such letter has been sent.[14]

[2] Expropriation of U.S. Assets

Under *Banco Nacional de Cuba v. Sabbatino*,[15] the principal exception to the Act of State Doctrine is territorial. The Doctrine does not apply to the taking by a foreign state of property located outside of its territory at the time of taking.[16] Despite scholarly arguments to the contrary,[17] the lower courts have been unanimous in holding that *Sabbatino* means what it says. However, the Second Circuit has twice suggested that an action in a U.S. court can be dismissed on "comity" grounds even where a foreign act of state involves property situated outside its territory.[18] Alternatively, these two cases may be read as applying conflict-of-law principles to situations in which the situs test is failed.

Sabbatino listed two other exceptions to the Act of State Doctrine for instances where: (1) the expropriating foreign government is not recognized by the U.S. at the time of suit; and (2) there is a treaty or other unambiguous agreement which covers the foreign state's act. The nonrecognition exception has very little utility, based on historical precedent. Until a new government is recognized, the courts assume that the former government continues to exist, and therefore will not apply the Doctrine to acts of the new government.[19]Also, severance of diplomatic relations with a still recognized government does not affect the application of the Doctrine to acts of that government.[20]The treaty exception is of uncertain meaning (how precise must the treaty or agreement be to qualify as unambiguous?) and effect (does it render the Act of State Doctrine inapplicable or is it one factor to be considered in deciding whether

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[13] First Nat'l City Bank v. Banco Nacional de Cuba, 406 U.S. 759 (1972).

[14] Banco Nacional de Cuba v. Chemical Bank, 594 F. Supp. 1553 (S.D.N.Y. 1984).

[15] 376 U.S. 398 (1964).

[16] *See, e.g.,* Tchacosh Co. v. Rockwell Int'l Corp., 766 F.2d 1333 (9th Cir. 1985); Airline Pilots Ass'n v. TACA Int'l Airlines, 748 F.2d 965 (5th Cir. 1984).

[17] *See* Crockett, *Extraterritorial Expropriations,* 13 Ind. L. Rev. 655 (1980); Henkin, *The Foreign Affairs Power of the Federal Courts:* Sabbatino, 64 Colum. L. Rev. 805, 828 (1964).

[18] Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir.), *cert. dismissed,* 473 U.S. 934 (1985); Drexel Burnham Lambert Group v. Galadari, 777 F.2d 877 (2d Cir. 1985).

[19] Blanco v. Pan-American Life Ins. Co., 221 F. Supp. 219 (S.D. Fla. 1963), *aff'd,* 362 F.2d 167 (1966).

[20] Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398 (1964).

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to apply the Doctrine?).[21]

While it may at first appear that the foreign investor obtains significant protection from the territorial exception to the Act of State Doctrine, reflection shows it to be largely illusory. The first problem is determining that the property has a U.S. situs. In the context of the Act of State Doctrine situs differs from the ordinary concept. It depends in large part on whether the purported taking can be said to have come to complete fruition within the dominion of the foreign government.[22]The only easy case is real or tangible personal property located in the United States. Even there, if the property is owned by a corporation rather than an individual investor, there may be difficulty in defeating the actions of the representatives of the expropriating foreign government acting in their capacities as corporate officials. However, the directors and the shareholders of a Cuban company expropriated by the government of Cuba were entitled to hold a directors' meeting and a shareholders' meeting in the United States, and to vote to continue in business, and to bring suit to obtain control of company assets held in the United States.[23] Similar conclusions have been reached where the holding company was formed outside the expropriating country.[24] English courts have been equally reluctant to permit indirect expropriations in the guise of corporate action.[25]

In the case of indebtedness, the courts have not formulated a consistent standard for making locational decisions.[26] Where the expropriating country does not have jurisdiction over the debtor, and cannot enforce or collect the debt, U.S.courts have found that the situs of the debt was not in the expropriating country so that the Act of State Doctrine did not apply.[27] However, where both the U.S. and the expropriating country have jurisdiction over the debtor, conflicting answers to the situs question have been given. A deposit in a foreign branch of a U.S. bank (a debt by the bank to the depositor) provides an illustration. One court found the situs to be in the foreign country (because it could enforce its expropriation order against the branch) so that the Doctrine applied.[28] A second court found the situs to be outside that country so that it did not.[29]

Even if the property is located in the United States, the normal choice-of-law rule

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[21] *See* Note, *Putting Meaning into the Treaty Exception to the Act of State Doctrine,* 17 Case W. Res. J. Int'l L. 107 (1985).

[22] Tabacalera Severiano Jorge, S.A. v. Standard Cigar Co., 392 F.2d 706, 715–16 (5th Cir.), *cert. denied,* 393 U.S. 924 (1968).

[23] Compania Ron Bacardi v. Bank of Nova Scotia, 193 F. Supp. 814 (S.D.N.Y. 1961).

[24] *See, e.g.,* Zwack v. Krause Bros. & Co., 237 F.2d 255, 259 (2d Cir. 1956).

[25] *See* Banco de Bilbao v. Rey, [1938] 2 All. E.R. 253 (C.A.).

[26] Many of the cases are collected in Note, *The Act of State Doctrine: Resolving Debt Situs Confusion,* 86 Colum. L. Rev. 594 (1986).

[27] *See, e.g.,* Mendez v. Saks & Co., 485 F.2d 1355, 1364 (2d Cir. 1973), *rev'd on other grounds sub nom.,* Alfred Dunhill of London, Inc. v. Republic of Cuba, 425 U.S. 682 (1976).

[28] Perez v. Chase Manhattan Bank, N.A., 463 N.E.2d 5 (N.Y.), *cert. denied,* 105 S. Ct. 366 (1984).

[29] Garcia v. Chase Manhattan Bank, N.A., 735 F.2d 645, 649 (2d Cir. 1984).

in most act of state cases would point to application of the law of the state where the act took place, that is, the foreign expropriation law.[30] That normal choice-of-law rule may be disregarded where the law thus chosen would violate the strong public policy of the forum.[31]U.S. public policy is in general strongly opposed to expropriation without compensation.[32]The standard for just compensation, also known as the Hull rule,[33]provides that just compensation is:

(1) equivalent to the value of the property taken;

(2) paid at the time of taking, or within a reasonable time thereafter with interest from the date of taking; and

(3) convertible into U.S. dollars without restriction.[34]

However, U.S. courts have given effect to the expropriation of U.S. assets without compensation where it serves the policy aims of the United States to do so.[35]Thus, the public policy element can make the territorial exception of uncertain protection to the foreign investor.

Even if the expropriated property is in the United States and the expropriation violates U.S. public policy, the litigation necessary to establish these conclusions will, at best, cloud the title to the property (and hence the ability to manage or dispose of the property) until the issue is decided, and at worst, not be brought because the foreign investor cannot reach a U.S. court (due to arrest, closing of the borders or the like) to challenge a foreign government's assertion of ownership.

The use of an offshore country holding company does not, by itself, solve these problems. See the discussion at § 9.10[3], above. The foreign relations law of the offshore country may well give no added measure of protection and, in any event, the delay in the effective administration of the underlying assets is not likely to be reduced by litigation in the courts of the offshore country. The law in most offshore jurisdictions is heavily influenced by the English decisions in which the territoriality principle (expropriation decrees are not automatically enforced outside the expropriating country) is well established.[36]Even so, English courts have shown extraordinary

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[30] *See* Restatement (Second) of Conflict of Laws § 6 (1971).

[31] *See, e.g.,* Republic of Iraq v. First Nat'l City Bank, 353 F.2d 47, 51 (2d Cir. 1965), *cert. denied,* 382 U.S. 1027 (1966); Restatement (Second) of Conflict of Laws § 90 (1971).

[32] *See, e.g.,* United Bank v. Cosmic Int'l Inc., 542 F.2d 868 (2d Cir. 1976); Maltina Corp. v. Cawy Bottling Co., 462 F.2d 1021 (5th Cir.), *cert. denied,* 409 U.S. 1060 (1972). *Accord,* Restatement (Third) Foreign Relations Law of the United States § 712 (1986).

[33] Letter from Secretary of State Hull to the Minister of Foreign Relations of Mexico (July 21, 1938), reprinted in part in G. Hackworth, 3 Digest of International Law 655–657 (1942).

[34] Restatement (Third) of Foreign Relations Law of the United States § 712 (1986).

[35] *See* United States v. Pink, 315 U.S. 203 (1942); United States v. Belmont, 301 U.S. 324 (1937).

[36] Bank voor Handel en Scheepvart NV v. Slatford, [1953] 1 Q.B. 248, 260.

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deference to the acts of foreign states.[37] Their present view is similar to the U.S. Act of State Doctrine.[38]

[3] Difficulty of Expropriating U.S. Assets Owned by Asset Protection Trust

An asset protection trust, as opposed to an offshore holding company, can provide a measure of protection against expropriation. If the foreign investor's rights with respect to the trust terminate or become dormant upon a home country expropriation, the argument over whether the home government has validly expropriated those rights should be immaterial since they no longer have any bearing on the operation of the trust or the distribution of its assets. This statement assumes that the termination or hibernation of the investor's rights in the trust is valid under the law of the trust-situs jurisdiction. That law must be examined carefully on this point and the analysis can be complex.

Under general international law principles, a judgment obtained in a country is not automatically enforceable in a second country.[39]However, all legal systems have a strong policy against repetitive litigation of claims and issues.[40]Consequently, courts generally choose to enforce foreign judgments, if they do not violate the public policy of the forum. The point here is that the expropriatinggovernment does not appear in the situs jurisdiction simply as a creditor enforcing a judgment (even though it may be loosely referred to as a judgment creditor). This is a critical distinction because restraints on alienation in trusts created by a settlor for his own benefit are generally invalid as against creditors of the settlor. It is the fact that the holder of the foreign judgment is not such a creditor that permits the forum courts to uphold the restraint against such holder.

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[37] *See, e.g.,* Kahler v. Midland Bank, [1950] App. Cas. 24 (H.L. Eng.).

[38] Williams & Humbert Ltd. v. W & H Trade Marks (Jersey) Ltd., [1986] App. Cas. 368, 431 (H.L. Eng.).

[39] *See, e.g.,* Hilton v. Guyot, 159 U.S. 113 (1895).

[40] *See, e.g.,* Baldwin v. Iowa State Traveling Men's Ass'n, 283 U.S. 522, 525 (1931).

§ 9.16 Freezing Assets by United States—International Emergency Economic Powers Act

United States can freeze U.S. assets of foreign investors in cases of national emergency. Foreign investor can retrieve U.S. assets if he leaves country affected by freeze for country unaffected by freeze. Foreign corporations cannot retrieve U.S. assets during freeze because they cannot leave affected country. Trust can benefit those beneficiaries who leave affected country.

Under the International Emergency Economic Powers Act,[1] if the President declares a national emergency[2] the U.S. assets of designated foreign owners can be frozen. When assets are frozen, they cannot be transferred to or at the direction of the foreign owners unless a special permit (or license) is obtained. Freezing orders are used when the United States wishes to prevent assets from returning to the designated country and to preserve those assets for possible vesting and use in the future settlement of U.S. claims against that government and its citizens.[3]Examples of this occurred in 1991 and 1992, freezing the assets in which the governments of Iraq[4]and Haiti,[5]respectively, have an interest. A freezing order does not affect title to the assets; it simply deprives the affected foreign investor of the use of his U.S. assets. The statutory authority is almost unlimited since the President may prevent or prohibit any dealing in or transactions involving any property in which any foreign national has any interest, by any person, or with respect to any property, subject to the jurisdiction of the United States.[6]For example, during World War II, U.S. bank accounts of some neutral nationals (Swiss and Swedish) were frozen.[7]

If a foreign investor leaves the country affected by a freeze, the United States has generally issued licenses allowing assets to be paid to legitimate refugees from such a country when ownership is clear.[8] Thus, freezing of assets is a problem that can be solved if the foreign investor immigrates to a country unaffected by the U.S. asset freeze and the U.S. maintains its historic licensingpolicy. For licensing purposes, the foreign investor must demonstrate that he is the beneficial owner, or a representative of the beneficial owner, of the assets and not just a holder of legal title to the assets.[9]Freezing may even be helpful to the foreign investor by providing an additional

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§ 9.16

[1] 50 U.S.C. §§ 1701–1706.

[2] The manner in which the President can declare and continue in effect a national emergency is regulated by the National Emergencies Act, 50 U.S.C. §§ 1601, 1621–1622, 1631, 1641, 1651.

[3] Miranda v. Secretary of Treasury, 766 F.2d 1 (1st Cir. 1985); *see also* Sardino v. Federal Reserve Bank, 361 F.2d 106 (2d Cir. 1966).

[4] 31 C.F.R. § 575.101 *et seq.* (July 1, 1993).

[5] 31 C.F.R. § 580.101 *et seq.* (July 1, 1993).

[6] 50 U.S.C. § 1702(a)(1).

[7] Exec. Order No. 8,785, 6 Fed. Reg. 2,897 (1941).

[8] *See* Reeves, *The Control of Foreign Funds by the United States Treasury,* 11 Law & Contemp. Probs. 17, 38 (1945). *See also* 31 C.F.R. § 500.505(b) (July 1, 1993).

[9] *See* Gen. Ruling No. 17, 8 Fed. Reg. 14,341 (1943).

defense against U.S. recognition of the investor's home country government's expropriation of U.S. assets (because they cannot be transferred from the foreign investor). On the other hand, freezing often results in economic losses because of a lack of proper asset management while the assets are frozen.

If the affected investor is unable to leave his home country, there is no effective remedy to restore the use of his U.S. assets to him. The U.S. courts generally do not recognize a transfer of frozen U.S. assets to another person from a legal owner who does not have a license;[10]and no person can obtain a license to receive (unfreeze) the assets without first leaving the country to which the freeze applies and showing that no affected foreign national has any interest in the assets.[11]

Foreign corporations are particularly vulnerable because they generally cannot leave their country of incorporation. A foreign corporation probably cannot avoid the effect of a freeze order by "domesticating" (as permitted under Delaware law, for example) because it would still exist as a corporation under the laws of the original jurisdiction.[12]In such a case, the foreign corporation's foreign shareholders who come to the United States generally cannot obtain the U.S. assets of the corporation.[13]Courts take a more sympathetic approach toward foreign shareholders seeking the U.S. assets of a foreign corporation where no freeze order exists.[14]

A similar problem occurs when an individual who owns frozen U.S. assets dies before being able to leave his home country. By regulation, a deceased foreign national has an interest in his own estate sufficient to permit the United States to freeze the estate's U.S. assets;[15] therefore, those heirs who reach the United States may find it impossible to obtain a license to receive the U.S. assets. The two Circuits considering this regulation reached opposite results. In one Fifth Circuit case all the *intestate* heirs of a deceased Cuban national were U.S. citizens or residents and the court held that the regulation imputing an interest to the decedent was arbitrary and without basis.[16] On similar facts, the Second Circuit upheld the regulation, in part on the theory that it prevented targeted foreign nationals from using transfers at death to U.S. persons to affect the U.S. citizen's stand on certain policies towards Cuba.[17] Subsequently, another Fifth Circuit case held that even if all of the *intestate* heirs were not U.S. citizens or residents, those that were entitled to licenses to unblock their shares of a deceased Cuban national's assets. The court expressly excluded testate and donative

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[10] *See, e.g.,* Cheng Yih-Chun v. Federal Reserve Bank, 442 F.2d 460 (2d Cir. 1971).

[11] 31 C.F.R. § 500.802 (July 1, 1993).

[12] *See* Tran Qui Than v. Regan, 658 F.2d 1296 (9th Cir. 1981), *cert. denied,* 459 U.S. 1069 (1982).

[13] *See* Tran Qui Than v. Regan, 658 F.2d 1296 (9th Cir. 1981), *cert. denied,* 459 U.S. 1069 (1982); Nielsen v. Secretary of Treasury, 424 F.2d 833 (2d Cir. 1970).

[14] *See, e.g.,* Compania Ron Bacardi v. Bank of Nova Scotia, 193 F. Supp. 814 (S.D.N.Y. 1961).

[15] 31 C.F.R. § 500.327 (July 1, 1993).

[16] Real v. Simon, 510 F.2d 557 (5th Cir. 1975).

[17] Richardson v. Simon, 560 F.2d 500, 505 (2d Cir. 1977), *appeal dismissed,* 435 U.S. 939 (1978).

transfers from the scope of its ruling.[18]

If the foreign investor does no advance planning for a U.S. asset freeze, either he has been poorly advised or he believes that he (and his family) can afford to give up control of the U.S. assets during the freeze period and the assets are of a type that will not lose value due to the lack of management by the investor.

Caution: mThe freeze period can be long. The existing freeze of U.S. assets owned by Cuban resident nationals began on July 8, 1963.[19]If the freeze lasts long enough a court might hold it to be the equivalent of a vesting of title in the U.S. government.[20]Even if there is no actual vesting, a temporary freeze to a government may be a constructive vesting to an individual whose life may end before the end of the freeze.[21]

To plan for a the contingency of a U.S. asset freeze, the foreign investor has some options. He could plan to flee his home country, establish residency in a state friendly to the United States, establish his legal rights to the U.S. assets, and obtain a license, unblocking the assets.

If he wants to plan a more positive reaction to a freeze, he can set up an investment structure that has some chance of invalidating a blocking order and will, in any event, provide for effective management of the U.S. assets while the freeze is in effect.

A holding company organized in the U.S. or a foreign jurisdiction not included in the blocking order normally provides a mechanism for management because historically freezes have only prevented transfers of shares of the holding company and transactions by it with the targeted foreign nationals. Otherwisethe company is free to carry on its business. A freeze order could be aimed at blocking the company's regular business activities because the statute authorizes orders preventing the exercise of any right, power, or privilege with respect to any U.S. property in which any foreign national has any interest.[22]No such orders have been issued though, probably because it would destroy the company's business and thus lower its value. A holding company, however, contributes nothing towards solving the problem of the foreign investor's access to the U.S. assets if he cannot leave his home country.

A trust can provide at least a partial answer. A domestic trustee, being a U.S. person, cannot make any distributions to the foreign investor, even out of non-U.S. assets. A foreign trustee can make distributions to the affected foreign national out of non-U.S. assets, but is prohibited by the blocking order from making such distributions out of U.S. assets. However, those beneficiaries who leave (or who are already out of) the affected country can obtain licenses to receive distributions, under historical U.S. practice. While this does not directly benefit the foreign investor who establishes the

[18] Tagle v. Regan, 643 F.2d 1058 (5th Cir. Unit B 1981).

[19] 28 Fed. Reg. 6,974 (1963).

[20] *See* Restatement (Third) of Foreign Relations Law of the United States § 712 cmt. g, n6 (1986).

[21] Nielsen v. Secretary of Treasury, 424 F.2d 833 (2d Cir. 1970).

[22] 50 U.S.C. § 1702(a)(1).

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trust, it does help the refugee members of his family who are beneficiaries.

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§ 9.17 Vesting Assets by United States—Trading With the Enemy Act

United States can seize property belonging to or controlled by enemy during war. If beneficiary's interest in trust vests while he is enemy, United States can seize his interest. If beneficiary's interest in trust does not vest while he is enemy, United States cannot seize his interest. Trust assets may be further protected if trust situs is non-enemy foreign jurisdiction.

The Trading with the Enemy Act[1] permits the Custodian, during a declared war, to seize property in the United States belonging to or controlled by an enemy. The role of Custodian has been filled at different times by: an Alien Property Custodian; various officials in the Department of Justice; and (currently) by the Office of Foreign Assets Control within the Treasury Department. For convenience the title of "Custodian" is used regardless of the designation of the official at the time. Enemies include: (1) individuals (of whatever nationality) resident in and corporations incorporated in any country with which the United States is at war or which is occupied by such a country (thus a Dutch corporation was an enemy for this purpose after the German invasion of the Netherlands in World War II);[2]and (2) corporations or foreign individuals doing business with or within the territory of the enemy country.[3]The term also includes nationals of an enemy state that are not resident in the enemy state, to the extent provided for in a Presidential proclamation. No President has ever issued such a proclamation, however. A seizure under the Trading with the Enemy Act in effect vests title to the property in the Custodian and a sale of vested property by the Custodian conveys valid title.[4]

The operation of the Act is not as straightforward as the above summary would indicate. Section 5(b) authorizes the Custodian to vest (take) any property or interest of *any* foreign national. Thus, the vesting power is not limited to property of the enemy. Section 9(a) of the Act permits any claimant to the property who is not an enemy or ally of an enemy to sue for return of the property. Read literally, the net effect is that the seizure of property belonging to a non-enemy foreign national would be fruitless since it would have to be returned. Notice, however, what has happened to the burden of proof. Instead of the Custodian having to establish that the property belongs to an enemy, the foreign person has to establish that he is not an enemy. The Fifth Amendment to the U.S. Constitution prohibits the taking of property without just compensation. Theprohibition under this amendment compels the return of property taken (or just compensation for the property) to "friends" of the United States,[5] but not to "enemies" of the United States.[6]

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§ 9.17

[1] 50 U.S.C. app. §§ 1–44.

[2] Meijer v. General Cigar Co., 81 N.Y.S.2d 488 (Sup. Ct. 1948).

[3] 50 U.S.C. app. § 2.

[4] Cummings v. Deutsche Bank, 300 U.S. 115 (1937).

[5] Russian Volunteer Fleet v. United States, 282 U.S. 481 (1931).

[6] Sardino v. Federal Reserve Bank, 361 F.2d 106 (2d Cir. 1966); Silesian-American Corp. v. Clark, 332 U.S. 469 (1947).

In an attempt to conceal ownership of U.S. assets, enemies have often utilized sham transactions. If discovered, these are ineffective as the enemy transferor is treated as continuing to be the beneficial owner of the property. Sham transactions have been identified in the following situations:

- An enemy transfers U.S. assets without reasonable business motives;[7]
- An enemy retains an option to repurchase the transferred property;[8]
- An enemy sells property for inadequate consideration;[9]and
- An enemy transferor restricts the transferee's use of the property.[10]

Circumstantial evidence may be used to infer that a seemingly arm's-length transaction is really a sham.[11]

[1] Defense—Not an Enemy

Technically, there is no defense to a vesting order, in the sense of obtaining judicial protection against its implementation. Where the owner is neither an enemy nor an ally of an enemy, the vesting is wrongful and the remedy is a return of the property.[12]However, in *Clark v. Uebersee-Finanz Korp.*,[13]the Custodian argued that a return was available only if the vesting was unauthorized and since the statute clearly permitted the vesting of property of any foreign national or corporation (no matter how friendly), no foreign person ever had any remedy. In that case, a Swiss company sought the return of vested corporate assets on the ground that it was not within the statutory definition of an enemy or an ally of an enemy. The Court took an intermediate position and held that the vesting power was not intended to appropriate friendly or neutral assets but only to reach enemy interests, including those which masqueraded under those innocent fronts.[14] In other words, neutral corporations *tainted* by enemy ownership or control are not allowed to obtain the return of vested assets. However, non-enemy ("innocent") shareholders of a *tainted* neutral corporation have an interest apart from the corporation. Therefore, innocent shareholders are allowed a return of assets proportionate to their stock holdings in the *tainted* neutral corporation.[15]While the scope of the taint doctrine has never been clearly delineated, it is clear that the use of U.S. or neutral holding companies does not shield U.S. assets against vesting under the Act.

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[7] Kind v. Clark, 161 F.2d 36 (2d Cir. 1947).

[8] Beck v. McGrath, 182 F.2d 315 (2d Cir. 1950)

[9] Stoehr v. Wallace, 255 U.S. 239 (1921).

[10] Vort v. McGrath, 99 F. Supp. 57 (D.D.C 1951), *aff'd,* 199 F.2d 782 (D.C. Cir. 1952).

[11] Feller v. McGrath, 106 F. Supp. 147 (W.D. Pa. 1952).

[12] 50 U.S.C. app. § 9(a).

[13] 332 U.S. 480 (1947).

[14] 332 U.S. at 485.

[15] Kaufman v. Societe Internationale pour Participations Industrielles et Commerciales, S.A., 343 U.S. 156 (1952).

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[2] Use of Trust—Limit Rights of Enemy Beneficiary of Trust

An asset protection trust may provide a large measure of protection against an attempted taking by the Custodian. While the cases dealing with the reach of the Custodian's vesting power in the context of trusts are not always consistent, the following principle seems to emerge: the Custodian has no greater rights in the trust than the enemy beneficiary.[16]If the enemy is a beneficiary of a discretionary trust, the trustee cannot be compelled to exercise its discretion so as to distribute trust property to the Custodian.[17]A trust provision terminating the interest of a beneficiary if he is or becomes an enemy is effective and the Custodian cannot obtain any of the trust assets.[18]

When the interest of any enemy beneficiary is not terminated but merely delayed until such time as he ceases to be an enemy, whether the Custodian may succeed to the trust interest depends on whether the enemy beneficiary has a vested interest in the trust. The Custodian can take only those interests that the remaindermen have while they are enemy nationals. If the remainder interest is vested subject to defeasance on a condition subsequent, the Custodian succeeds to that interest. Thus, if the interest is vested in the enemy beneficiary, even though payment may be delayed, the Custodian is entitled to the distribution when made.[19]However, if the remainder interest is not vested, and vests only on the condition precedent of the termination of hostilities, then the remaindermen have no interests under the trust while they are enemies, and there is nothing for the Custodian to take.[20] However, if the condition precedent (contingency) occurswhile the Custodian's vesting order is still in effect, the Custodian would then succeed to the enemy beneficiary's interest. Hence the contingency must be carefully described.

> **Example 1:** A trust provision providing that no payment is to be made to the beneficiary until the beneficiary is "in a position to receive the benefits" from the payment is construed as making that beneficiary's ability to derive personal benefit from the payment a condition precedent to the vesting of any interest in the beneficiary. Since a vesting by the Custodian of the beneficiary's interest in the trust prevents the beneficiary's personal enjoyment of the payment, the enemy beneficiary has no present interest with the result that the Custodian is not entitled

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[16] Central Hanover Bank & Trust Co. v. Markham, 68 F. Supp. 829 (S.D.N.Y. 1946); *In re* Drey (Bendit), 214 A.D. 446, 212 N.Y.S. 526 (App. Div. 1st Dept. 1925).

[17] Brownell v. Mercantile Trust Co., 139 F. Supp. 834 (E.D. Mo. 1956).

[18] Security-First Nat'l Bank v. Rogers, 330 P.2d 811 (Cal. 1958); Harvard Trust Co. v. Attorney General, 106 N.E.2d 269 (Mass. 1952).

[19] Rogers v. Hartford-Connecticut Trust Co., 165 F. Supp. 116 (D. Conn. 1958); *In re* Estate of Zuber, 304 P.2d 247 (Cal. Ct. App. 1956).

[20] Brownell v. Hartford-Connecticut Trust Co., 147 F. Supp. 929 (D. Conn. 1956); *In re* Willof Schmidt, 97 N.W.2d 441 (Minn. 1959). *See* Note, *Control of Alien Property in Time of War or National Emergency: Avoidance of Vesting under the Trading with the Enemy Act,* 37 Cornell L.Q. 110, 116–19 (1951).

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to recover anything from the trust.[21]

Example 2: Under the terms of a trust, the income of the trust is to be accumulated during the lifetime of the settlor, unless he should direct the trustee to apply it for the use of his children, and on his death be distributed to his children. The settlor and his children are enemies. Until the trust assets are distributed on the settlor's death, the Custodian cannot reach any interest under the trust.[22]

Example 3: A testator bequeathed property to his brother and sister, who were enemies, and provided that if they were not entitled to receive the legacies, trustees should hold the property for three years after the "Armistice of World War II," and if they were not then entitled to receive the money it should be held in trust for certain charitable purposes. The court viewed the bequests as not being vested in the German beneficiaries until the condition was met. Since it was not, the alternative charitable trust inherited the property and the Custodian was not entitled to anything.[23]

Example 4: A testator left property in trust for two residents of Germany to hold the income for them and on the termination of hostilities to pay them the principal but if they should die before the termination of hostilities to pay the principal to a third person. The court upheld the validity of the gift to the third person and determined that the Custodian took nothing.[24]

The Custodian has frequently argued that he is not a successor to the beneficiary since he is not acting by or on behalf of the enemy beneficiary, but is simply substituted for him in all respects under the trust, occupying as to all the property rights vested in him precisely the same position the enemy would have had had the vesting orders not issued.[25]The Custodian's reasoning is as follows: since the Custodian is not an enemy alien, the beneficiary is therefore not an enemy and the prohibition against distributions to enemy aliens does not apply. The courts have not accepted this argument.[26]

Caution: In *Kammholz v. Allen*,[27]the court concluded that it would be against public policy to sanction a testator's circumvention of the intent of Congress by deferring the payment in favor of enemy aliens until such payments once again become legal. There is some doubt whether this public policy really exists, however. In affirming *Kammholz* the Second Circuit did not refer to it. Only two other cases have made

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[21] McGrath v. Ward, 91 F. Supp. 636 (D. Mass. 1950).

[22] Chase Nat'l Bank v. Reinicke, 76 N.Y.S.2d 63 (Sup. Ct. 1947), *aff'd mem. sub nom.,* Chase Nat'l Bank v. McGrath, 276 A.D. 831, 93 N.Y.S.2d 724 (App. Div. 1st Dept. 1949), *aff'd without opinion,* 301 N.Y. 602, 93 N.E.2d 495 (1950).

[23] Monarski v. Greb, 95 N.E.2d 433 (Ill. 1950).

[24] *In re* Paszotta's Trust, 172 N.E.2d 904 (Ind. Ct. App. 1961).

[25] Security-First Nat'l Bank v. Rogers, 324 P.2d 908, 916 (1958), *aff'd,* 330 P.2d 811 (Cal. 1958).

[26] *See* Bishop, *Judicial Construction of the Trading with the Enemy Act,* 62 Harv. L. Rev. 721, 738–39 (1949).

[27] 155 F. Supp. 511, 515–516 (S.D.N.Y. 1957), *aff'd,* 256 F.2d 437 (2d Cir. 1958).

public policy the basis for a decision.[28]The other cases that have cited Kammholz on the issue of public policy have concluded (on generally tenuous grounds) that the settlor did not intend to avoid the Act by the delayed payment or vesting provision.[29]It would be a peculiar public policy that rested on the intent of the settlor and not on the intent of Congress. In any event, there is no public policy against providing a gift over to a non-enemy beneficiary to avoid vesting under the Act.[30]

[3] Situs of Trust Factor

The likelihood of defeating the Custodian's claim to a contingent remainder interest may be greater if the trust is created in a non-enemy foreign jurisdiction and the trustee is a resident of that jurisdiction. There are several reasons for this conclusion. Under English principles, the enforcement by a court in that jurisdiction of the Custodian's vesting order generally requires a determination that the U.S. law is neither penal in nature nor against the public policy of the forum.[31]Neither of these defenses would be available in a U.S. court with respectto a U.S. trust. Moreover, that jurisdiction will recognize the difference between a vested interest that is subject to divestment upon a condition subsequent and an interest that vests upon a condition precedent, as discussed above. The English law is clear that the latter does not give the beneficiary anything that a Custodian can take.[32] Drafting a contingent interest under the local law (presumably derived from English law) requires care if the desired result is to be achieved.

> **Example 1:** Trust *A* provides for the conversion of an income interest to a discretionary interest if an event happens that deprives the beneficiary of the right to receive the income. This provision was sufficient to prevent the U.K. from taking the income interest when the beneficiary became an enemy alien.[33]

> **Example 2:** Trust *B* provides for conversion of an income interest to a discretionary interest if the beneficiary does anything to make the income payable to another. This provision did not prevent the U.K. from taking the income interest upon the beneficiary becoming an enemy alien since that circumstance did not occur as the result of any act of the beneficiary.[34]

The Custodian could try to circumvent these obstacles by vesting the trust assets

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[28] *In re* Reiner's Estate, 44 N.Y.S.2d 282 (Sur. Ct. 1943); Thee's Estate, 49 Pa. D. & C. 362 (Orphans' Ct. 1943) (however, this result may be explained on the basis that a trust may not have been created).

[29] *See, e.g., In re* Will of Schmidt, 97 N.W.2d 441 (Minn. 1959).

[30] Kammholz v. Allen, 155 F. Supp. 511, 515–516 (S.D.N.Y. 1957), *aff'd,* 256 F.2d 437 (2d Cir. 1958); *In re* Reuss' Estate, 91 N.Y.S.2d 479 (Sur. Ct. 1949).

[31] *See* A. Dicey & J. Morris, 2 Conflict of Laws 972–979 (11th ed. 1987). *Cf.* Attorney-Generalof New Zealand v. Ortiz, [1982] 3 All. E.R. 432 (C.A.), *aff'd on other grounds,* [1984] App. Cas. 1 (H.L. Eng.) (denying enforcement, against an English defendant possessing an ancient Maori woodcarving, of a New Zealand law forfeiting historic objects exported without permission, on the theory that such laws were ejusdem generis with penal and revenue laws which were unenforceable abroad).

[32] *In re* Schiff, [1921] 1 Ch. 149 (1920).

[33] Gourju v. Custodian of Enemy Property, [1942] 2 All. E.R. 605 (Ch.).

[34] Hall v. Montgomery, [1943] 2 All. E.R. 753 (Ch.).

(since their legal title is in a foreign national, the trustee) and force the trustee to sue for their return in a U.S. court. A U.S. court could refuse to apply the usual choice-of-law rules (which would look to the law of the trust situs to determine questions relating to interests in the trust) on the ground that strong U.S. public policy—the Trading with the Enemy Act—would be violated if foreign law were applied. Alternatively, the U.S. court could view the issue as relating to the ownership of trust assets and apply U.S. law directly. In either case, if the court found that the trust was "tainted" with enemy ownership or control it could refuse to order the return of the assets, analogizing the trust to the corporation in *Clark v. Uebersee-Finanz Korp*.[35]

Caution: While the case law demonstrates the decided benefits of a trust in preventing the Custodian's vesting order from actually reaching U.S. assets, a note of caution is warranted. All but one[36]of the cases dealing with trusts involved trusts created by third parties, although it was reasonably clear that the termination or delayed vesting provisions were aimed at avoiding a vesting by the Custodian. When an enemy beneficiary creates the trust it is possible that public policy of the type enunciated in *Kammholz* could be used either to deny the validity of the contingent remainder (in effect converting it into a termination so that the enemy could never receive any benefit from the trust) or to replace the enemy beneficiary with the Custodian (so that the restriction on distributions to enemy aliens would not apply). Neither of these appears likely, however, since the first amounts to a tampering with (as opposed to an override of) local property law and the second requires a fiction more metaphysical than legal.

The trustee has a fiduciary duty to initiate proceedings to recover seized trust assets.[37]This fiduciary duty creates a tension between the requirement that the trustee disclose information about the trust and its beneficiaries before trust assets can be returned and the trustee's fiduciary duty to keep such information confidential.[38]

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[35] 332 U.S. 480 (1947).

[36] Chase Nat'l Bank v. Reinicke, 76 N.Y.S.2d 63 (Sup. Ct. 1947), *aff'd mem. sub nom.,* Chase Nat'l Bank v. McGrath, 276 A.D. 831, 93 N.Y.S.2d 724 (1949), *aff'd mem.,* 301 N.Y. 602, 93 N.E.2d 495 (1950).

[37] Isenberg v. Trent Trust Co., 26 F.2d 609 (9th Cir. 1928).

[38] United States v. Field, 532 F.2d 404 (5th Cir. 1976); United States v. Burbank, 525 F.2d 9 (2d Cir. 1975).

§ 9.18 Drafting Elements of Asset Protection Trust

Asset protection trust should be created under laws of a jurisdiction providing that contingent remainder interests in personal property do not vest until occurrence of contingency. Trust instrument should contain escape clause and provide for Protector. Trust instrument should give trustee discretion to make distributions of income and principal and should give settlor limited power of appointment.

In summary, the ultimate asset protection trust should have the following elements:

- The trust should be created under the laws of a jurisdiction, onshore or offshore, which give statutory protection from creditors' claims to self-settled asset protection trusts.
- For additional practical protection from creditors, if organized offshore, the trust should have as its trustee a corporation organized in and having its only offices in that offshore jurisdiction. This will prevent other countries (*e.g.,* the United States) from exerting economic pressure on the trustee by levying fines on a local branch or affiliate.[1]
- The beneficiaries consist of the settlor and such others as he wished. These could be prioritized, for example, the settlor and his immediate family might be the primary beneficiaries and more distant relatives the secondary beneficiaries. If none of these are resident in the United States or a jurisdiction thought highly unlikely to become the object of a freezing or vesting order, a large, recognized charity in the United States might be a third-level beneficiary. This provides an alternative to a government as the final recipient of the trust assets if none of the other beneficiaries is ever able (within the term of the trust) to leave the country that expropriates the property or is at war with the United States. Such a charity, being tax-exempt, would avoid a U.S. taking of part of the assets in the form of taxes on an accumulation distribution.
- The trust instrument should give the trustee the discretion, subject to the veto of the Protector, to make current distributions of income (current and accumulated) and of principal.
- The trust instrument should give the settlor a limited power of appointment (excluding the settlor, his creditors, his estate, or the creditors of his estate) over the trust assets upon termination of the trust, so as to make the transfer an incomplete gift for United States tax purposes.
- The settlor should otherwise have as few rights as possible over the trust and only a discretionary interest in trust income or principal which may be extinguished upon the occurrence of certain events.
- The trust instrument should expressly authorize the trustee to hold investments to the full extent allowed by the law of the situs jurisdiction (whatever that may be from time to time), while expressly prohibiting investments not so

§ 9.18

[1] *See* United States v. Bank of Nova Scotia, 740 F.2d 817 (11th Cir. 1984).

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authorized.

- The trust should contain an escape clause (including the trigger mechanism) authorizing the change of trustee, applicable law and place of administration.
- The trust should provide for a Protector and his replacement (including any special provisions necessary if the Protector is initially the settlor), and provide broad indemnification against liability for a hasty exercise of the situs change power.
- The trust term should be for a specified period of time, with the trustee having the right (subject to the concurrence of the Protector, which could require the consent of the settlor or other primary beneficiaries) to terminate the trust earlier. An override provision should terminate the trust on the last day of the shortest permitted period of delayed vesting under the perpetuities law of the original jurisdiction and the situs jurisdiction (whatever that may be from time to time).

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§ 9.19 Suggested Clauses for Asset Protection Trust

Trust instrument should define emergency events and provide terms for appointment of trustee and Protector. Trust instrument should designate which country's law governs trust administration and provide for change of governing law under certain circumstances.

The suggested clauses presented here are only examples of possible language, not models of what should be included in any asset protection trust. The clauses are numbered to show the cross-reference possibilities. Brackets generally indicate choices, which must be made only after very careful deliberation. Naturally, the law of the situs of the proposed trust must be consulted.

[1] Form: Definition and Effect of an Emergency Event

Form 9.1 Definition and Effect of an Emergency Event

1. *Emergency Event.* An "Emergency Event" shall mean any one of the following:

   (A) a declaration of a state of war between a Relevant Jurisdiction and any Country;

   (B) any attack upon, or invasion of, the territory of a Relevant Jurisdiction by the armed forces of or acknowledged agents of any other Country, which, in the opinion of the Trustee, cannot be fairly described as a "border incursion or incident";

   (C) any armed conflict in which the government of, or persons residing in, a Relevant Jurisdiction shall be actively involved which, in the opinion of the Trustee, creates or is likely to create a threat to peace, order and stability within such Relevant Jurisdiction;

   (D) any insurrection within a Relevant Jurisdiction which, in the opinion of the Trustee, creates or is likely to create a threat to peace, order and stability within such Relevant Jurisdiction;

   (E) the enactment, promulgation, publication, making or committing of any legislation, order, proclamation, statement or act of any government or of any governmental agency or governmental body of a Relevant Jurisdiction by reason of which:

      (i) any part (or all) of the Trust Estate [*defined elsewhere, generally being all trust assets, including accumulated income*] shall become (or shall be apprehended, in the opinion of the Trustee) liable to effective expropriation, confiscation, or compulsory acquisition [without compensation that, in the opinion of the [Trustee][Protector], will be (a) equivalent in value, (b) paid at the time of taking (or within a reasonable time thereafter, with reasonable interest), and (c) freely convertible into foreign currency];

      (ii) any part (or all) of the Trust Estate shall become (or shall be apprehended, in the opinion of the Trustee) liable to effective compulsory conversion into the currency or securities of any Country;

(iii) any part (or all) of the Trust Estate which does not consist of the currency securities of any Country shall become (or shall be apprehended, in the opinion of the Trustee) liable to be compulsorily sold or otherwise disposed of;

(iv) any interest (or power) of any person under this Trust shall become (or shall be apprehended, in the opinion of the Trustee) liable to effective expropriation confiscation, or compulsory acquisition; or

(v) any tax, duty, charge, fee or other exaction shall be imposed on or with respect to (or shall be apprehended, in the opinion of the Trustee) any part (or all) of the Trust Estate or the income or gains therefrom, or on the Settlor [*defined elsewhere*] or any Beneficiary [*defined elsewhere*] (whether it is imposed by reason of death, change of residence or domicile, distribution, the holding of a power, or otherwise);

(F) the enactment or imposition of any fiscal, social welfare, bankruptcy, creditor's-rights or other law of any government or of any governmental agency or governmental body of a Relevant Jurisdiction which, in the opinion of the Trustee, would significantly restrict or is likely to restrict the ability of any Beneficiary to retain, deal with, change the situs of, enjoy, bequeath, devise, transfer or dispose of any property of such Beneficiary or the income therefrom; and

(G) any giving of notice by the Protector or, at any time when there shall be no Protector, by a person who would be a Primary Beneficiary [*defined elsewhere but generally being the settlor and his immediate family*] at the time of the giving of such notice (whether or not such person is then a Disqualified Person), that any one or more of the events referred to in subclauses A, B, C, D, E and F of this clause has occurred, is threatened or is apprehended.

2. *Relevant Jurisdiction.* A "Relevant Jurisdiction" shall mean any Country in which the settlor, any other primary beneficiary, or the Trustee, is a national, resident, or is incorporated, or which shall be specified in a notice referred to in subclause 1(G). "Relevant Jurisdiction" also includes the Country where the trust is administered, the Country whose laws govern the administration of the trust and the Country where the assets are located.

3. *Country.* A "Country" shall mean any nation, state, province, colony, protectorate, territory or other geographic unit irrespective of its political structure or form of government.

4. *Time of Emergency.* A "Time of Emergency" shall mean the period which

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commences on the day on which an Emergency Event shall occur and which terminates on the Termination Date.

5. *Termination Date.* The "Termination Date" with respect to any Time of Emergency shall mean the earlier of the following:

    (A) the day on which notice of the termination of a Time of Emergency is given by the Protector or, at any time when there shall be no Protector, by a person who would be a Primary Beneficiary at the time of the giving of such notice (whether or not such person is then a Disqualified Person); and

    (B) the day on which the Trustee determines that the Emergency Event (other than that described in subclause 1(G)) giving rise to a Time of Emergency no longer presents a significant threat to the safety and security of the Trust Estate or to the ability of each Beneficiary and of each individual who, if the Time of Emergency had terminated, would be a Beneficiary to enjoy, deal with or dispose of any amounts of income or capital to which such Beneficiary or such individual might become entitled under this Trust as such individual might see fit.

6. *Disqualified Person.* A "Disqualified Person" at any time or times shall mean any person if, by reason of the situs, powers, discretions, rights or obligations of such person as the Settlor, the Protector, a Trustee or a Beneficiary, or by reason of the citizenship or nationality or domicile of such person, or by reason of the physical presence or the residence or the incorporation of such person in any Country, or by reason of the relationship of such person to any Beneficiary, an Emergency Event has occurred and the ensuing Time of Emergency has not terminated or an Emergency Event would occur if such person were to be or to continue to have the powers, discretions, rights, obligations, responsibilities or status of the Settlor, the Protector, a Trustee or a Beneficiary.

[2] Form: Appointment of Successor Protector

Form 9.2 Appointment of Successor Protector

1. *Appointment.* The power of appointing a successor Protector [(who shall not be required to remain in or be resident of [*jurisdiction*] or any other specific jurisdiction)] hereof in the place and stead of any Protector ceasing to act hereunder (for any reason, including resignation) shall be vested in the Protector and may, from time to time, be exercised by the Protector by notice.

2. *Resignation.* Any Protector may at any time resign from the office of Protector hereof on giving not less than thirty (30) days' notice addressed to the Trustee or Trustees, which resignation shall be effective on the appointment of and acceptance of such appointment by a successor Protector in the place and stead of the resigning Protector.

3. *Automatic vacation of office.* The office of Protector shall be vacated if such

Protector shall become a Disqualified Person or if such Protector, being an individual, shall die, be found mentally incapacitated, or be declared bankrupt or insolvent, or if such Protector, being a corporation, shall enter into liquidation, whether compulsory or voluntary, and not being merely a voluntary liquidation for the purposes of amalgamation or reconstruction.

4. *Failure of Protector.* If at anytime, for any reason whatsoever, a Protector shall cease being the Protector hereof without having validly appointed a successor Protector, [the Protector shall be [the senior partner for the time being of [*name*]] or [the Trustee or Trustees] [the Chief Justice of the [*court*] Court acting as an individual and not in his or her official capacity] may appoint any person not being one of the Trustees to be the Protector.

5. *Notice of changes.* Notices of all changes in the protectorship hereunder shall be endorsed on or attached to this Trust and shall be signed by the Trustee or Trustees and the Protector and every such notice shall be sufficient evidence to any person having dealings with the Protector for the time being hereof as to the facts to which it relates.

6. *Indemnity.* The Protector shall not be liable for any loss to the Trust Estate arising from any mistake or omission or any matter or other thing except willful fraud or wrongdoing on the part of the Protector [and this clause shall apply whether or not the Protector had or should have had notice of the matter causing loss].

[3] Form: Appointment and Removal of Trustees

Form 9.3 Appointment and Removal of Trustees

1. *Appointment.* The power of appointing [additional Trustees up to any number subject to such limit (if any) as may for the time being be imposed by any governing law or] substitute Trustees [(who shall not be required to remain in or be residents of [*jurisdiction*] or any other specific jurisdiction)] hereof shall be vested in the Protector and may, from time to time, be exercised by the Protector (this assumes that if the Settlor is not the Protector, the Settlor has no independent power) by notice, [and such power shall extend, but shall not be restricted,][but such power shall be limited] to the appointment of a new Trustee or Trustees in the place and stead of any Trustee ceasing to act hereunder (for any reason, including removal) or resigning his or her or its trusteeship.

2. *Removal.* The Protector or, at any time when there shall be no Protector, a person who would be a primary beneficiary at the time of the giving of such notice (whether or not such person is then a disqualified person), shall have an absolute and uncontrolled discretion, exercisable by notice, to remove any Trustee or Trustees for any reason whatsoever [at any time or times] [at any time or times during a Time of Emergency or with the consent of the Settlor.]

3. *Resignation.* Any Trustee may at any time resign from the office of Trustee

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hereof on giving not less than thirty (30) days notice addressed to the Protector and to the other Trustees (if any) but if there be no other Trustees, then on the appointment of and acceptance of such appointment by a new Trustee or Trustees in the place and stead of the resigning Trustee.

4. *Automatic vacation of office.* The office of a Trustee shall be vacated if such Trustee shall become a disqualified person or if such Trustee, being an individual, shall die, be found mentally incapacitated, or be declared bankrupt or insolvent, or if such Trustee, being a corporation, shall enter into liquidation, whether compulsory or voluntary, and not being merely a voluntary liquidation for the purposes of amalgamation or reconstruction.

5. *Residence of trustees.* No person who from time to time may be a Trustee hereof whether original or substituted [or additional] shall at any time be required to remain in or be a resident of any particular jurisdiction.

6. *Failure of trustees.* If at any time, for any reason whatsoever, there shall be no Trustee hereof, and, if at such time, there shall be no Protector under this Trust, a majority of such of the Beneficiaries as shall then be alive and not under any legal disability may appoint one or more substitute Trustees.

7. *Notice of changes.* Notice of all changes in the trusteeship hereunder shall be endorsed on or attached to this Trust and shall be signed by the surviving or continuing or substitute or additional Trustee or Trustees (and the Protector or any primary beneficiary who issued a notice under Clause 2) and every such notice shall be sufficient evidence to any person having dealings with the Trustees for the time being hereof as to the facts to which it relates.

[4] Form: Transfer of Trust Assets to Another Trust

Form 9.4 Transfer of Trust Assets to Another Trust

Transfer of trust estate to another trust. Notwithstanding any of the trusts, powers and provisions herein contained, the Protector shall have an absolute and uncontrolled discretion [at any time or times when the Settlor is the Protector by notice][to cause the automatic transfer and conveyance of or to direct the Trustees to transfer and convey] the whole or any share, portion, part or parts of the Trust Estate (except that which shall have indefeasibly vested in possession in one or more of the Beneficiaries), to any other trust established under or pursuant to the laws any jurisdiction, to be held by the trustees of such other trust with and subject to the powers and provisions of such other trust provided that none of the provisions of such other trust shall infringe the rule against perpetuities applicable to this Trust, that one of the Beneficiaries shall have the same beneficial interests, rights, powers, discretions and responsibilities under such other trust as are conferred upon the Settlor under the provisions of this Trust and that such trust shall contain provisions which in the unfettered opinion of the Protector would be substantially identical to the provisions of paragraphs [*refer to the clauses that set out the distribution patterns during the term of the Trust and upon its termination*] if any references to the Settlor in the such paragraphs referred to such one of the Beneficiaries, and upon such [notice being given] [transfer and conveyance

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being made] the trusts herein declared concerning the property comprised in such transfer and conveyance shall cease and terminate and such property shall for all purposes be subject to the trusts, powers and provisions contained in such other trust and be subject to and governed by the law of such other trust whether or not such law shall be the proper law of this Trust.

[5] Form: Change of Situs Provisions

Form 9.5 Change of Situs Provisions

Alternative 1: The original situs of the trusts created hereunder shall be [X]. The situs of any trust created hereunder may be maintained in any jurisdiction (including outside the United States) by the Trustee and thereafter transferred at any time or times to any jurisdiction selected by the Trustee with the consent of or upon the direction of the Protector, if one shall then be acting, by written instrument effecting such transfer. Upon any such transfer of situs, the trust estate of such trust may thereafter, at the election of the Trustee, be administered exclusively under the laws of (and subject, as required, to the exclusive supervision of the courts of) the jurisdiction to which it has been transferred. Accordingly, if the Trustee, with the consent of or upon the direction of the Protector, if one shall then be acting, elects to change the situs of any such trust, the Trustee is hereby relieved of any requirement of having to qualify in any other jurisdiction and of any requirement of having to account in any court of such other jurisdiction.

Alternative 2: The situs of the property of any trust created hereunder may be maintained in any jurisdiction, in the discretion of the Trustees (other than an Interested Trustee), and thereafter transferred at any time or times to any jurisdiction selected by the Trustees (other than an Interested Trustee), by written instrument effecting such transfer. Upon any such transfer of situs, the trust estate may thereafter, at the election of the Trustees (other than an Interested Trustee) of said trust, be administered exclusively under the laws of (and subject, as required, to the exclusive supervision of the courts of) the jurisdiction to which it has been transferred. Accordingly, if the Trustees (other than an Interested Trustee) on any trust created hereunder elects to change the situs of any such trust, said Trustees are hereby relieved of any requirement of having to qualify in any other jurisdiction and of any requirement of having to account in any court of such other jurisdiction.

[6] Form: Termination

Form 9.6 Termination

Power to terminate early. At any time before the expiration of [the perpetuities period, typically twenty-one (21) years after the date of the death of the last survivor of the Settlor, the spouse of the Settlor and the issue of the Settlor as shall be alive at the date of the execution of the Trust], the Protector in his absolute and uncontrolled discretion may by notice designate the day on which the Distribution Date shall occur; provided, however, that [if the Settlor shall not be the Protector then] such notice shall be ineffective unless consented to by such other or others of the primary beneficiaries, if any, as are then alive.

[7] Form: Amendment and Revocation

Form 9.7 Amendment and Revocation

[*Power to amend and to revoke.* At any time and from time to time during the lifetime of the Settlor if the Settlor is not then a disqualified person, the Settlor in his personal capacity may by notice vary, amend, alter or revoke this Trust and each and every provision thereof.]

[8] Form: Proper Law

Form 9.8 Proper Law

1. *Initial proper law.* The proper law of this Trust shall be that of [*name jurisdiction*] and all rights under this Trust and its construction and effect shall be subject to and construed according to the laws of that jurisdiction.
2. *Forum for administration.* The courts of [*name jurisdiction*] shall be the forum for the administration of the Trust.
3. *Subsequent proper law.* Notwithstanding the provisions of clauses 1 and 2, the Trustee or Trustees may at any time with the consent of the Protector or, at any time when there shall be no Protector, of a person who would be a Primary Beneficiary at the time of giving of such consent (whether or not such person is then a Disqualified Person), declare in writing that from the date of such declaration the proper law of this Trust shall be that of any specified jurisdiction (not being a jurisdiction under the law of which this Trust would be capable of revocation) and all rights under this Trust and its construction and effect shall be subject to and construed according to the laws of that specified jurisdiction.
4. *Subsequent forum for administration.* Notwithstanding the provisions of clauses 1 and 2, the Trustee or Trustees may at any time with the consent of the Protector or, at any time when there shall be no Protector, of a person who would be a Primary Beneficiary at the time of giving of such consent (whether or not such person is then a Disqualified Person), declare in writing that from the date of such declaration the forum for the administration of the Trust shall be the courts of any specified jurisdiction.

[9] Form: Trust Term

Form 9.9 Trust Term

Trust term. The Trust Term shall mean the period ending on the earlier of:

(1) The last day of the period [*a fixed number of years, assuming the jurisdiction uses such a number in its perpetuities legislation*] from the date of this Trust;

(2) The last day of the period commencing on the date of this Trust and ending 21 years (less one day) after the death of the last survivor of the descendants living at the date of this Trust of His Late Majesty King George the Fifth; or

(3) Such day or date as the Trustees [with the written consent of the Protector]

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VER: [SC_00280-Local:18 Sep 09 13:17][MX-SECNDARY: 23 Sep 09 11:04][TT-: 25 Jun 09 10:01 loc=usa unit=00482-ch0009] 0

shall by deed specify (not being a date earlier than the date of execution of such deed).