Asset Protection Trusts: Impact of Recent Case Law

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Recent cases have allowed a party to penetrate the asset protection trust. Lawyers can accomplish much for their clients if they plan within the guidelines of case law as opposed to ignoring or dismissing the results.

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At least three cases lately, two in federal bankruptcy courts[1] and one in the Ninth Circuit,[2] have found for the party seeking to penetrate the asset protection structure. In response, the financial press has suggested that these decisions have sounded the death knell for offshore asset protection trusts.[3] Clients, however, continue to clamor for protection planning, motivated by the continued concern about *litigation lottery* and discouraged by the setbacks in tort reform.[4] An analysis of these recent cases will reveal that offshore planning is still available, and will guide practitioners much more specifically as to what can and cannot be done in the realm of asset protection.

The *Anderson* case,[5] has received the most attention. The Andersons, a Nevada couple, were operating a telemarketing venture that the Federal Trade Commission (FTC) attacked as a fraudulent investment scheme. The Andersons had previously established a Cook Islands trust and were putting their ill-gotten gains into it. The FTC argued that the Andersons were running a classic Ponzi scam and that the Andersons should repatriate the proceeds from it. Furthermore, the FTC moved that the Andersons be found in civil contempt and jailed for failing to repatriate the assets. (See the sidebar on page 25 for a brief explanation of civil and criminal contempt.) The district court agreed and on appeal the Ninth Circuit affirmed.

In *Brooks*,[6] the debtor set up an asset protection trust in Jersey, Channel Islands, a jurisdiction that honors self-settled spendthrift trusts. The bankruptcy court in Connecticut, however, had no trouble finding that Connecticut's long-standing public policy prohibiting its citizens from creating self-settled spendthrift trusts was such a strong tenet that Connecticut law should apply; thus, the assets of the trust were available to the trustee in bankruptcy. *Portnoy*,[7] a New York bankruptcy case more complicated than *Brooks*, also held that the law of the settlor's domicile (in this case, New York law) should apply rather than the law governing the trust (observing in passing that "Jersey does not claim to have exclusive jurisdiction over its trusts").[8]

The media's attention to the *Anderson* case lies, in large measure, in the fact that the settlors were jailed—for six months—for civil contempt. Proponents and advocates of asset protection trusts have long agonized, from their different perspectives, over this potential threat to settlors.[9]

Now there is a Ninth Circuit case holding that, in the proper circumstances, contempt and imprisonment are appropriate. Asset protection lawyers must adhere to the lessons in *Anderson* and not try to blithely dismiss it as "bad facts make bad law." It is a well-reasoned opinion and reaches a proper result. It does not, however, signify the end for offshore asset protection trust planning.

In the area of asset protection planning, concerns about imprisonment were often answered by the principle that the defense to civil contempt is impossibility. That is, an individual cannot be jailed for failing to perform an act that is impossible to perform. Thus, if a defendant is ordered to do an act, but he or she cannot comply (not will not comply, but cannot comply), jailing for contempt will not lie.[10] The unanswered question is, "What if the defendant created the impossibility by his or her own action?"

Interestingly, in *Anderson*, the court of appeals struggled with this issue, but did not resolve it. The court seemed to imply that a *self-imposed* impossibility might not be a defense, but avoided the question by determining that the Andersons *could* comply, and, therefore, the district court's decision stood. (In fact, the court discussed the Andersons' ability to control the trust at great length, and it was this analysis that led the court to the conclusion that the Andersons could repatriate the wealth.)

From *Anderson* flow several implications. Certainly, there is now precedent for civil contempt and for the penalty of confinement. There is also, at least in dicta, a suggestion that a self-imposed impossibility will not survive an attack. Finally, the creditors' rights bar will be encouraged by *Anderson* (and by *Portnoy* and *Brooks*) and will not as quickly settle cases where assets are in an offshore asset protection trust.

There are also, however, very helpful and very valuable lessons for the asset protection bar. First, in *Anderson*, the court's focus on the Andersons' control is very instructive. The Andersons were co-trustees and protectors. It is axiomatic that the more control a settlor has, the less asset protection he or she has.[11] Indeed, the only solid structure is one in which the settlor cedes total control. The settlor obviously should not be a trustee, co-trustee, protector, co-protector, or retain a power to appoint a trustee or protector. All trustees and all protectors should be independent and not subordinate to the will or control of the settlor. In addition, no U.S. person or entity should fill those roles. Otherwise, protection is sacrificed.

Nor should the settlor maintain control through some other device. For example, neither the settlor, nor a limited liability company (LLC) or corporation controlled by settlor, should be the general partner in a limited partnership, the interests of which are in an offshore trust. A close reading of the *Anderson* case will demonstrate that the court is not only persuaded, but moved by the issue of control. From an asset protection planner's perspective, understanding the court's analysis of control is as important as understanding that a settlor can be jailed for contempt. Settlors who want solid structures must be willing to forgo control.

Beyond the control issue and the contempt issue, *Anderson* holds a lesson on funding. Again, a close reading will reveal the court's focus on this issue. The court repeatedly mentions, and indeed seems preoccupied with the fact, that the Andersons put *all* of their wealth into an offshore trust. Asset protection planners

Contempt

Civil contempt is imposed solely to force the contemnor to do a particular act, such as to turn over assets. The contemnor must be released when he or she complies.

Criminal contempt is punitive; the contemnor is sentenced and must serve the term, much as in a criminal proceeding.

have long debated *in toto* planning versus nest egg[12] planning.

One significant failing of the Andersons' planning was that they put all of their wealth into the trust. Not only does that fact lend credence to the court's conclusion that the Andersons retained control, but it will always help support a fraudulent transfer claim. *In toto* planning by definition brings a settlor to the very margin of solvency. It is a foolish concession to the claimant to put the client at a zero net worth, thereby facilitating two vulnerabilities:

1. Charges of fraudulent transfer.
2. An argument that the settlor still has control.

There is now precedent for civil contempt and for the penalty of confinement.

A further lesson from *Anderson* concerns the use of a duress provision. A duress clause directs the trustee to refuse to make distributions to a beneficiary if the beneficiary is under a court order to repatriate the trust assets. Conservative planners have maintained that putting this clause into the trust document will result in enraging a judge and in gaining immediate judicial sympathy for the claimants.[13] Certainly *Anderson* bears out the merits of those concerns. Duress clauses are a form of lawyer trickery, and judges are not going to be patient with them.

Finally, from *Anderson*, as well as *Brooks* and *Portnoy*, it should be clear that timing is everything. Lawyers who do not engage in serious due diligence and who ignore pending claims, threats, and creditors—not to mention fraud—not only jeopardize their clients' plans, but they are playing professional Russian roulette.

These lessons are helpful. With judicial guidance, offshore asset protection trusts can and should be used. The plan begins with meticulous due diligence, which includes not only professional inquiry as to the client's reputation for business and financial dealings, but also financial statements and affidavits of solvency with professional inquiry to determine their accuracy. If claims, threats, or contingent liabilities are uncovered, the lawyer is not forced to halt planning, but reserves must be set aside or measures must be taken so that if the liabilities become liquidated, they can be satisfied.

Attorneys must also be prepared to convince clients to forgo control. Typically, this is best done by the maintenance of a network of highly regarded trustees to whom clients can be referred. Offshore trustees should be sufficiently capitalized, licensed, bonded, insured, and regulated to allay client concerns about loss or theft of wealth. In addition, settlors should meet with trustee candidates to make their own inquiries and to establish relationships independent of their U.S. attorneys.

In toto planning should be approached with extreme caution. Nest egg planning where only a limited percentage of the client's wealth is sent offshore will achieve several strategic goals. It will inevitably help defeat a fraudulent transfer claim because the client will necessarily remain solvent as to his or her U.S. assets, and it will reduce the potential concerns of the control issue raised in *Anderson*. That is, it will be much easier for a court to believe that the client does not have control if the client is only giving up a percent of his or her net wealth as opposed to all of it.

Finally, if the trust assets are actually physically offshore with the trust (and by that is meant the hard assets and not just the limited partnership interests), access to the assets will be governed by the law of the foreign jurisdiction, and U.S. *in rem* jurisdiction will be impossible to obtain. In *Brooks*, the assets were physically located in the U.S. and easily reached.[14] In *Portnoy*, they were offshore,[15] and despite the similarity of the reasoning of the two opinions, and despite the finding against the bankrupt in both cases, Brooks ultimately lost, while Portnoy was still able to settle at reasonable figures (10¢-15¢ on the dollar) because the creditor could not reach the assets.[16]

It is submitted that the following plan can and should be used, not as prohibited by *Brooks*, *Portnoy*, and *Anderson*, but as guided by those cases to achieve asset protection. After due diligence, a limited percentage of a client's wealth should fund an offshore asset protection trust in an export-the-assets structure.[17] (In an export-the-assets structure, the entire configuration is foreign as opposed to an import-the-law structure, where wealth is put into a domestic entity—a family limited partnership, for example—and the partnership interests are put into a foreign trust, but the hard assets remain in the U.S.)

The lawyer should assist the client in the selection of independent, highly reputable fiduciaries (trustees and protectors). All fiduciaries should be non-residents and non-citizens of the U.S. The "foreignness" of the structure is more enhanced if the custodian and the assets themselves are foreign. The assets should be kept in a foreign bank that has no U.S. presence (because a U.S. branch of the bank could be ordered to turn over the foreign assets under penalty of contempt), and the assets should be invested in foreign securities (stocks, bonds, and deposits).

The trust provisions should include distribution clauses that give total discretion to the fiduciaries, i.e., distributions are wholly discretionary. The trust should be for the benefit of multiple beneficiaries, including family members and preferably one or more charities. The trust should be irrevocable and contain comprehensive spendthrift language, a redomiciliation clause, provisions for shifts in beneficial enjoyment, and *no* duress clauses.

The trust should be part of an overall estate plan and should have purposes beyond asset protection. While the *Reichers* case[18] stands for the proposition that asset protection planning as the sole goal of an offshore trust is proper, additional valid and appropriate reasons or purposes substantially support an argument against a fraudulent transfer claim.

Fraudulent transfer claims are all about the *intent* of the transferor. If the transferor's intent is defensible, the settlor's actions are necessarily legitimate. Recurring motivations include international diversification of wealth, anonymity with respect to wealth or certain assets, tax planning (for example, to secure offshore private placement life insurance, to establish a dynasty trust, or to establish a foreign non-grantor trust on the death of the settlor), investing in funds not otherwise available to U.S. investors, pursuing foreign business opportunities, and achieving foreign tax planning. Lawyers should not manufacture purposes, but frequent careful exploration of a client's goals and agenda will uncover companion purposes to asset protection.

Finally, the trust should be operated in a wholly professional manner. The trustee should behave with due regard for its duties and should, at all times, honor the integrity of the structure. Communications with the beneficiaries should be circumspect, and a trustee should not act on the whim or instructions of a beneficiary regarding investments, distributions, or other aspects of the trust administration. The trustees, not the settlor and not the beneficiaries, are the decision makers. These procedures will support lack of client control and avoid the arguments that the trust is either a sham or alter ego of the client.

Lawyers can accomplish more for their clients if they plan within the guidelines of case law as opposed to ignoring or dismissing the results. In that context, *Anderson*, *Brooks*, *Portnoy*, and *Reichers* are all extremely useful. ■

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[1] In re B.V. Brooks, 217 Bkrptcy. Rptr. 98 (Bkrptcy. DC Conn., 1998); In re Larry Portnoy, 201 Bkrptcy. Rptr. 685 (Bkrptcy. DC N.Y., 1996).

[2] Federal Trade Commission v. Affordable Media, Inc., 179 F.3d 1228 (CA-9, 1999). This case is usually referred to as "the *Anderson* case" in asset protection circles and will be referred to in that manner in this article.

3 Symonds, "Offshore Trusts: Not So Watertight," Businessweek 100, (7/26/99); Asinof, "Ruling in West May Chill Use of Offshore Trusts," Wall St. J., 7/12/99, page A24.
4 Glaberson, "State Courts Sweeping Away Laws Curbing Suits for Injury," N.Y. Times, 7/16/99, page A1.
5 Note 2, *supra*.
6 In re B.V. Brooks, *supra* note 1.
7 In re Larry Portnoy, *supra* note 1.
8 *Id*.
9 Lee, "Offshore Asset Protection Trusts: Testing the Limits of Judicial Tolerance in Estate Planning," 15 Bankr. Dev. J. 451, (1999).
10 See United States v. Rylander, 460 U.S. 752 (1983); Lee, *Id*.
11 See, e.g., Osborne, *Asset Protection: Domestic and International Law and Tactics* (Clark Boardman Callaghan, 1995), §20:08.
12 Osborne, *Id*., §20:07.
13 Osborne, *Id*., §26:06.
14 Brooks, *supra* note 1.
15 Portnoy, *supra* note 1.
16 Comments by Gideon Rothschild, Program Chair, "Ethical Considerations and Attorney Liability in Asset Protection Planning," Ninth Annual Spring CLE and Committee Meeting, American Bar Association, 5/15/98.
17 *See* Osborne, *supra* note 12, §20:04.
18 Reichers v. Reichers, 679 N.Y.S.2d 233 (N.Y. Sup. Ct., 1998). In this case involving marital property, the asset protection trust was not penetrated.