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ASSET PROTECTION TRUSTS

-What They Are-

-How They Work-

by

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ASSET PROTECTION TRUSTS

INTRODUCTION	5
I. WHAT IS AN ASSET PROTECTION TRUST?	6
A. Definition	6
B. Settlement of the trust.	9
C. Practical uses of asset protection trusts	14
1. Supplement or replacement to insurance	14
2. A tool to settle or discourage litigation	16
3. To keep the ownership of assets confidential	17
4. An alternative to traditional pre-nuptial agreements.	18
5. A hedge against potential exchange controls	18
6. Miscellaneous uses of asset protection trusts	18
(a) To protect pension assets	19
(b) To give an insolvent debtor a fresh start	19
(c) To avoid forced heirship laws	19
(d) A hedge against governmental instability	19
D. What are the legal characteristics of a typical Asset Protection Trust?	19
1. Creditor protection - derived from situs	20
2. Creditor protection - derived from structure of trust	20
3. Tax neutral	21
4. No criminal or civil violations	22
5. Withdrawal of funds	23
6. Will substitute	23
7. Assets safe and either managed by settlor or professional management approved by the settlor	24
8. Duress provisions	27
a. Automatic extension	27
b. Removal of assets	27
c. Selection of alternate trustee and jurisdiction	27
9. Settlor protected from contempt	28
10. Trust treated as valid legal entity	28
II. SELECTION OF JURISDICTION IN WHICH TO FORM TRUST	29
A. General Considerations	29
1. Common Law heritage	30
2. Creditor protection	30
3. Tax consequences	30
4. Transfer Statute	30

B. Jurisdictional overview	31
III. HOW TO ATTACK AN ASSET PROTECTION TRUST	31
A. United States Courts	31
1. The	31
(a) Discovering the trust - State Courts	34
(b) Seizing non-trust United States situs assets	36
(i) Traditional court ordered execution	36
(ii) Charging order - the family limited partnership	36
(c) Attacks against the offshore trust - State Courts	38
(d) Attaching Debtor's reversionary interest	39
(e) Attacking the	40
2. The Pre-nuptial asset protection trust	41
3. Trust settled with fraudulent conveyance	42
(a) Discovering the trust - Federal Bankruptcy Court	43
(b) Dischargeability of debt	47
(c) Contempt for failing to retrieve fraudulently transferred assets	47
(d) Contempt for establishing a trust which frustrates the Court's orders	48
(e) Civil claim against settlor's advisors	50
(f) Criminal sanctions against the settlor and his attorney	50
(i) Violations of Bankruptcy Code and other miscellaneous provisions	50
(ii) Violations of money laundering and related statutes	52
(g) State Bar disciplinary action	55
(h) Extraordinary remedies	56
(i) Mareva injunction	56
(ii) Attachment under Swiss Law	57
(iii) The turncoat custodian (usually a bank)	59
B. Challenge in Cook Islands Court	59
1. Retention and payment of a United States law firm to manage the litigation	61
2. Accessibility	61
3. Retention and payment of a Cook Islands law firm (plus	62
4. Procedural barriers	63
5. Substantive barriers	64
6. The disappearing trust	65

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-What They Are-

-How They Work-

-Tax Aspects-

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INTRODUCTION:

This article is driven by the rapidly developing and largely unevaluated emergence in the United States of the offshore asset protection trust. Section I of this article explains what an asset protection trust is, section II deals with jurisdiction selection and particularly analyzes the laws of the Cook Islands, section III evaluates the effectiveness of an asset protection trust assumed to be settled on the Cook Islands and; finally, section IV discusses the tax aspects of a typical asset protection trust. Just as important as what this article will discuss is what it will not. It will not discuss,

except in passing, (1) the state and federal fraudulent conveyancing laws, (2) other asset protection techniques or (3) the laws of any jurisdiction,¹ other than the Cook Islands, which fosters asset protection trusts. Appendix A is a consolidation of the Cook Islands International Trusts Act, 1984, as amended.²

I. WHAT IS AN ASSET PROTECTION TRUST?

A. Definition³

¹ For a listing of the jurisdictions known to this author which have enacted or announced an intention to consider legislation relating to offshore asset protection oriented trusts *see*, section II.B. *infra*.

² At the present time there is little published material on asset protection trusts. The domestic sources which have been the most helpful to the author are: Grey and Luria, *Protection of Asset Trusts*, 130 *Trusts and Estates* 32 (1991); speaker's notes entitled *Asset Protection Planning - The Concept, the Trends & the Tools* by Engel at the May 1993 New York University School of Law Tax Institute; speakers' notes entitled *Use and Abuses of Foreign Asset Protection Trusts* by Leinwand, Norman and Warner at the February 1993 University of Southern California School of Law Annual Tax Institute and speaker's notes entitled *Asset Protection Techniques* by Henkel at the February 5, 1993 meeting of the American Bar Association Section of Taxation, Small Business Committee (all available at the New York University School of Law Library).

³ An asset protection trust could be defined as any trust settled in a jurisdiction which offers enhanced protection from creditor attacks. The definition utilized in this article is somewhat artificial but is reflective of how most trusts formed for asset protection purposes are structured.

An asset protection trust is any trust formed for a term of years in a foreign jurisdiction which:

1. either does not recognize or imposes significant barriers to the recognition of United States judgments,⁴
2. has enacted a Statute of Elizabeth override provision,⁵ and

⁴ Some jurisdictions simply do not recognize United States judgements and require a trial *de novo*. Other jurisdictions have a procedure whereby certain United States judgements can be recognized (usually not penal or fiscal in nature) provided certain procedural hurdles (which may amount to a mini-trial) are met. No country in the world automatically enforces judgements from any United States court. This is probably because all other nations are worried about one aspect or another of our anti-trust, environmental, securities and tort laws. For an excellent overview of the law in this area *see*, Lowenfeld, *International Litigation and Arbitration* (West 1993) particularly chapter 5 entitled *Enforcement of Foreign Judgements*.

⁵ The terms "Statute of Elizabeth override provision" or "anti-Statute of Elizabeth provision" refers to a modification to traditional U.K. fraudulent conveyance laws eliminating or reducing the protection afforded future unanticipated creditors. These terms are often loosely and somewhat imprecisely applied to refer to laws enacted in foreign jurisdictions which make it very difficult or impossible to have the courts of that jurisdiction recognize and enforce a judgement from a different jurisdiction. The laws in these jurisdictions usually require a trial *de novo*, applying their own fraudulent conveyancing laws. Usually the burden of proof for the aggrieved creditor will be higher (*e.g.*, "beyond a reasonable doubt"), the statute of limitations will be very short and, sometimes, the new jurisdiction will only allow creditors existing at the time of the transfer (and not creditors coming into existence after the transfer) to bring claims. For a detailed discussion of fraudulent conveyances and the Statute of Elizabeth *see* Debtor Creditor Law chapter 22. For a detailed discussion of the procedural barriers which creditors must overcome to reach the assets of a trust settled on the Cook Islands *see* Section II.C. *infra*.

3. imposes strict procedural barriers to actions brought in that jurisdiction attacking trusts settled in that jurisdiction.

Normally, at least if the settlor of this trust is a United States resident, the trust will also:

4. be irrevocable for a period of years,⁶
5. have beneficiaries other than the settlor,⁷ and
6. position the settlor as a contingent remainderman.⁸

At the termination of the trust all undistributed trust assets, including the original *res* and all income earned thereon, is returned to the settlor. Distributions are normally

⁶ The term of the trust is extended if the assets are in jeopardy. *See* section I.D.8. *infra*.

⁷ The beneficiaries will be designated by the settlor and can normally be changed at any time by the settlor to anybody other than the settlor. Sometimes when domestic creditor protection is not required for the entire life of the trust (*e.g.*, when the settlor is expatriating and has no other assets subject to the jurisdiction of any United States court) this prohibition on the settlor naming himself as a beneficiary is structured to be temporary or to terminate upon the occurrence of certain specified events. *See* section I.D.7. *infra*.

⁸ These last three trust characteristics are generic to most asset protection trusts but are not technically "requirements." These factors are important from a domestic asset protection point of view only because they are typical steps taken to prevent the settlor's interest in the trust from being available to creditors of the settlor under United States law simply because of the trust structure itself. It is widely accepted under domestic law that the settlor's interest in a trust structured with these three characteristics is so contingent and undefinable that it is unreachable by the settlor's creditors. *See*, section III.A.1(d) *infra* and Debtor Creditor Law Section 37.03.

discretionary with the trustee whose actions will be guided by a Committee of Trust Advisors (often chaired by the settlor).⁹ In the event of a creditor attack threatening the assets in any way, the termination of the trust will be delayed until the assets can be safely distributed to the settlor or the beneficiaries of his choice. In the event that the trust or its assets are subject to aggressive attack in the foreign jurisdiction, the situs of the trust will be changed (perhaps automatically) to a new and undisclosed jurisdiction. A properly settled asset protection trust is very difficult to penetrate.

B. Settlement of the trust.

An asset protection trust is best thought of as a legitimate and internationally recognized vehicle for a solvent and substantial person to place a portion of his wealth into a secure entity which allows that person substantial control over the assets yet protects these assets from future unanticipated creditors.¹⁰ Where the settlement of the trust occurs long before any significant creditors or liabilities materialize and where the

⁹ Sometimes the trustee will be a corporation controlled directly or indirectly by the settlor. *See*, sections I.D.7., II.B.2. and II.C.8. *infra*.

¹⁰ The Ethics Advisory Committee of the South Carolina Bar has ruled that an attorney can participate in a transfer of a clients property where the sole purpose of the transfer is to avoid the possibility of a deficiency judgement from an identified creditor provided that there is no "immediate reasonable prospect" of a judgement being entered. Opinion 84-02 (May 25, 1984) The Committee on Professional Responsibility and Conduct of the State Bar of California has refused on two occasions to take a stand on this matter deciding that the question was a "legal" and not an "ethics" issue. *See*, Ethics Opinion 92-0005. *See also* California Ethics

transfer involves only a portion of the settlor's assets, leaving him patently solvent after the transfer, the asset protection trust is a very effective tool. It is rarely this simple in practice.

One overriding concern for the settlor and his advisors is that no transfers to the trust be violative of any state or Federal fraudulent conveyancing laws.¹¹ Often a prospective settlor will defer asset protection planning, including the settlement of an asset protection trust, until he is beset with liabilities, lawsuits and sometimes judgment creditors. Advisors must be very careful in these circumstances because, even though the planning might be effective to protect the asset from creditors,¹² all participants in the transaction, including the advisors to the debtor, may be subjected to civil and criminal liability.¹³

A thorough discussion of the fraudulent conveyancing provisions of the various jurisdictions is beyond the scope of this article and covered well in other sources.¹⁴

Opinion 91-0004.

¹¹ See, Debtor Creditor Law chapter 22.

¹² See, section II.A.3. *infra*.

¹³ See, sections III.A.3.(c)-(g) *infra*.

¹⁴ For a good comparison of the fraudulent transfer provisions of The Bankruptcy Code of 1978, as amended (11 U.S.C. sections 101 to 1330) [hereinafter Bankruptcy Code] with the Uniform Fraudulent Conveyance Act (the basis of law in New York) and the Uniform Fraudulent Transfer Act (the basis of

However, it is worth analyzing whether or not the simple act of settling an asset protection trust, the sole admitted purpose of which is to insulate the transferred assets from creditor attack, is, in and of itself, sufficient to cause the transfer to the trust to be vulnerable in domestic courts as a *per se* fraudulent transfer.

The problem arises because all of the sets of domestic fraudulent conveyancing laws¹⁵ under which a transfer to an asset protection trust might be analyzed have one thing in common. Every transfer with the "actual intent" to delay, hinder or defraud creditors is subject to attack, even if the creditor is a future unanticipated creditor at the time of the transfer. There are no cases directly on point although some authority exists for the proposition that a transfer to a single purpose trust designed to protect assets from future unanticipated creditors is permissible.¹⁶

law in California) *see* Debtor Creditor Law chapter 22 and Collier on Bankruptcy, section 548 (Lawrence P. King, Editor-in-Chief, Matthew Bender) [hereinafter Colliers]. *See also*, Cook & Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 Am. Bankr. L.J. 87 (1988); Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 Vand. L. Rev. 829 (1985) and Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 Bankr. Dev. J. 55 (1991).

¹⁵ A transfer may be analyzed under the section 544 of the Bankruptcy Code or state law. All states have either a version of the Uniform Fraudulent Transfer Act, The Uniform Fraudulent Conveyance Act or a modernized Statute of Elizabeth. *See*, Debtor Creditor Law section 22.01.

¹⁶ *See, re Oberst* 91 B.R. 97, 101, B. L. R. (CCH) Paragraph 72,462 (Bankr. C.D. Cal 1988) in which the court, holding against the debtor, stated in *dicta* that "If the debtor has a particular creditor or series of creditors in mind and is trying to

Historically, because of the difficulty in proving actual subjective intent to defraud a creditor, common law courts have pointed to "badges" of fraud as evidence of the settlor's subjective intent.¹⁷ Any asset protection planner should be familiar with these "badges" and should document any transfer to minimize these factors. The badges identified by the Uniform Fraudulent Transfer Act which may be utilized to infer actual subjective intent are whether or not:

- "1. the transfer or obligation was to an insider;
2. the debtor retained possession or control of the property transferred after the transfer;
3. the transfer or obligation was disclosed or concealed;

remove his assets from their reach, this would be grounds to deny the discharge. If the debtor is merely looking to his future well-being, [the conveyance would not be fraudulent and] the discharge will be granted." *See also, Klein v. Klein et al.* 122 N.Y.S.2d 546 (1952), *Wantulok et al. v. Wantulok* 214 P.2d 477 (1950). In *Hurlbert v. Shackleton* 560 So. 2d 1276 (1990) Dr. Shackleton, an obstetrician, transferred assets "[b]ecause I wasn't able to get malpractice insurance, and I wanted to cover all the bases" (at 1278). Dr. Shackleton committed an act of alleged malpractice and suite was brought. Dr. Shackleton made transfers both before and after the suit was filed. The transfers were complete before the judgement was entered. The judgement creditor was found on appeal to not be subject to protection unless Dr. Shackleton was found to have harbored actual fraudulent intent. The court cited the trial court with approval noting "[t]he trial court drew a distinction between "probable" and possible" future creditors. Classifying appellant as a "possible" future creditor, the court said that it found no cases holding a transfer of assets to be fraudulent as to "possible" future creditors" (at 1279). The appellate court remanded for a finding of fact on Dr. Shackleton's actual intent.

¹⁷ *See*, Debtor Creditor Law sections 22.02 and 22.04[A].

4. before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
5. the transfer was of substantially all of the debtor's assets;
6. the debtor absconded;
7. the debtor removed or concealed assets;
8. the value or the consideration received by the debtor was reasonable equivalent to the value of the asset transferred or the amount of the obligation incurred;
9. the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
10. the transfer occurred shortly before or shortly after a substantial debt was incurred; and
11. the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor."¹⁸

In addition to minimizing these "badges", a careful planner should emphasize the other business justifications for the settlement of a foreign trust. Provided a trust is properly crafted and careful settlement procedures are followed, the issue of whether or not a trust formed with the sole purpose of protecting assets from creditors is *per se* fraudulent should never come up because any carefully conceived plan will document substantial and independent business justifications for the trust. Careful justification of the independent business reasons for the foreign trust should make it difficult for an

¹⁸ See, Debtor Creditor Law chapter 22.

aggrieved creditor to effectively argue that a transfer which was not fraudulent under any objective criteria was nevertheless fraudulent because the transferor harbored some internal subjective actual fraudulent intent.¹⁹

C. Practical uses of asset protection trusts

The following is a partial list of some of the uses of foreign trusts with asset protection characteristics. Some relate to asset protection and some relate to general business considerations. When documenting the trust the business oriented justifications for settlement of the trust should be emphasized.

1. Supplement or replacement to insurance

An important motivating factor for the settlement of an asset protection trust is the dramatic rise in the United States of both the number of lawsuits and the magnitude

¹⁹ A highly analogous area is taxation (particularly corporate reorganizations and international) where a taxpayer may structure a complex transaction which, because of its form, saves taxes. The Internal Revenue Service attacks these transactions on a "substance over form" basis. The best defense to a substance over form attack is to carefully document the business purpose for the seemingly awkward form. On the occasions where a valid business purpose is documented, the Internal Revenue Service has met with only limited success in unwinding transactions. *See*, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (WGL 1993). Although no cases are on point in the asset protection area, the same reasoning applies.

of verdicts.²⁰ New theories of liability are being created everyday²¹ and suits are being brought more often. "More than 18 million civil suits were filed in this country in 1989 - one for every 10 American adults...."²²

²⁰ There are literally countless examples, a few of which follow:

Annually, there are 13.9 malpractice claims for each 100 doctors. Four out of ten medical doctors have been sued. The average Obstetrician in New York has been sued eight times and many are leaving the field. Nationwide the average verdict against doctors is \$1.33 million and in New York it is three times larger. *See, Gastel, Medical Malpractice, Insurance Information Institute Reports (June, 1993).*

The same is true in many other professions. Currently there are over 3000 suits against accountants in the United States seeking more than \$13 billion in damages. Huge judgements, like the recent \$338 million judgement against Price Waterhouse are being obtained. Several large regional firms have gone bankrupt. *See, Lee, Ex-Firm Returns to Haunt Partners, Los Angeles Times, February 16, 1993, (Business), at 3.*

Investors are also beset by uninsured risk. A group of the now senior partners in an international consulting firm bought a large parcel of raw land in the 1970's which they held for development. These people, all in their 60's, recently received a notification under CERCLA that their anticipated joint and several liability for toxic clean-up costs is estimated to be \$72 Million. CERCLA did not even exist at the time these people acquired the land. These partners had errors and omissions insurance for their practice and liability insurance on their real estate and vehicles. They were very passive investors and assumed they were completely safe and protected. None had implemented an effective asset protection program.

²¹ For example, new legal theories are developing which hold lawyers, accountants and other similar professionals liable for their client's malfeasance in circumstances where the professional has the depth and length of relationship with that client so that any reasonable person should suspect that something was amiss. In actual practice, these precedents are being utilized with substantial success to frame complaints where the advisor has little or no relationship with the client. When faced with a jury trial, settlement is often the result, even with baseless claims. *See, International Mortgage Company v. Butler Accountancy Corporation,*

Some professionals utilize asset protection trusts as an adjunct²³ or replacement to insurance.²⁴ As malpractice rates rise, many professionals are reducing their coverage but still preserving their right to a defense under their policy, and implementing asset protection trusts. On occasion, these professionals go completely bare, particularly once all of the relevant statute of limitation periods have expired. Many individuals believe that heavy insurance in the current judicial climate serves to draw litigation and that by reducing or eliminating the size of the potential recovery the incentive of any claimant to institute and pursue litigation is likewise reduced.

2. A tool to settle or discourage litigation

Few lawsuits are brought on principle, particularly if the lawyer for the plaintiff is being compensated on a contingent fee basis. Once the plaintiff and his attorney discover that a properly settled²⁵ and implemented asset protection plan²⁶ is in place

177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986). *See also, Attorney's Liability to One Other than his Immediate Client, for Consequences of Negligence in Carrying out his Legal Duties*, 45 ALR 3d 1181 (1991) and *Liability of Public Accountant to Third Parties*, 46 ALR 3d 979 (1972).

²² Vice President Dan Quayle, Prepared Remarks at the Annual Meeting of the American Bar Association (August 13, 1991).

²³ Most policies are found to be quite porous when they are actually reviewed.

²⁴ The insurance may be any type, including professional malpractice (errors and omissions), tail or director's and officer's liability.

²⁵ This is normally an "old and cold" trust. Note, however, it is possible in many

and that any judgment will be difficult or impossible to collect, their motivation to proceed with litigation fades. One principal effect of a carefully crafted plan is the destruction of the plaintiff's economic incentive to litigate.

3. To keep the ownership of assets confidential²⁷

The confidentiality and secrecy laws of many offshore jurisdictions are taken very seriously and in fact impose criminal penalties for their violation. Notwithstanding the near absolute secrecy permitted by some jurisdiction the settlor should be aware that the settlement of an offshore trust normally does not result in any tax savings²⁸ or mean that the United States government utilizing the resources of FinCEN²⁹ cannot discover the trust pursuant to a governmental investigation.

situations to still implement asset protection plans involving foreign trusts even after a claim has been made or a lawsuit has been filed provided the fraudulent conveyancing laws and related statutes are not violated. *See*, section III.A.3. *infra*.

²⁶ This plan will normally involve entities other than an asset protection trust (*e.g.*, the family limited partnerships discussed in section III.A.1.(b)(ii) *infra*, the emerging limited liability company and perhaps foreign corporate or *quasi* corporate entities) and often more than one foreign jurisdiction.

²⁷ Secrecy laws and traditions developed during the days of the Third Reich, beginning before World War II, to counteract the Nazi's near omniscient presence in Germany. *See*, Crawford, *Who Needs Offshore Centers?*, International Herald Tribune, April 24, 1993, (Money Report) [herein Crawford].

²⁸ *See*, section IV. *infra*.

²⁹ *See*, section III.A.3(f) *infra*.

4. An alternative to traditional pre-nuptial agreements.

An unmarried person may normally settle an offshore trust without the consent of his prospective spouse. The offshore trust will normally protect the transferred assets in the event of a divorce. The primary difference is that the prospective spouse does not need to consent to the transfer (in fact, the spouse need not even know of the transfer).³⁰ Offshore trusts are also sometimes useful in pre-divorce planning (e.g. to keep an expected inheritance segregated as separate property). In all cases, an asset protection trust is an estate planning instrument with the same dispositive effect of a traditional domestic trust.

5. A hedge against potential exchange controls

One managing director of a substantial bank in the Cayman Islands recently remarked, "Exchange controls were firmly in place in the United Kingdom before [former Prime Minister] Margaret Thatcher, and one can't be certain that they will never be reintroduced. In the U.S., with the shape of its national debt, I would not be surprised at all if limits on foreign investment were adopted. The U.S. has had such limits before, in certain forms."³¹

6. Miscellaneous uses of asset protection trusts

³⁰ See, section III.A.2. *infra*.

³¹ See, Crawford, *supra*.

Asset protection trusts can in certain circumstances be utilized:

(a) To protect pension assets: Certain assets in certain types of pension plans are not accorded protection under state or Federal law.³² An asset protection trust can be utilized to protect assets otherwise exposed.

(b) To give an insolvent debtor a fresh start: On occasion, particularly when bankruptcy is not a currently valid option, an insolvent debtor who is entrepreneurially minded may separate and insulate future start-up business ventures which are unrelated to his current activities from past creditors by the use of offshore trusts. Extreme care must be taken to analyze the fraudulent conveyancing issues.

(c) To avoid forced heirship laws: Certain jurisdictions, particularly in Europe, have forced heirship laws. Offshore trusts have traditionally been utilized to avoid the impact of these laws.

(d) A hedge against governmental instability.

D. What are the legal characteristics of a typical Asset Protection Trust?

A carefully designed asset protection trust should achieve the following legal results:

³² See, Debtor Creditor Law section 37.03[B].

1. Creditor protection - derived from situs: This is achieved by subjecting the trust to the laws of an offshore jurisdiction with specifically enacted asset protection legislation.³³

2. Creditor protection - derived from structure of trust: Asset protection trusts, even though they are foreign trusts, are often structured to divorce the settlor from all indicia of ownership. The settlor will not be the trustee, he will often be prohibited from ever becoming a beneficiary and the trust will be irrevocable for a substantial number of years. Normally, applying domestic law, as long as the trust is irrevocable for a period of years and the settlor is not a beneficiary but merely retains a contingent reversionary interest, the trust assets should be unassailable during the period of irrevocability provided that the trust is not formed in violation of any fraudulent conveyancing laws.³⁴ Judgment creditors stand in the same relationship to the trust assets as does the settlor/debtor.

This structure is traditionally adopted for evidentiary reasons to minimize one of the traditional "badges" of fraud which is the debtor's "continuance in possession and

³³ See, section II.B. *infra*.

³⁴ See, Debtor Creditor Law chapters 22 and 22A as well as section 37.03; See also, Note, *Creditors' Rights Against Trust Assets*, 22 Real Prop. Prob. & Tr. J. 735 (1987).

ability to represent the goods as his own."³⁵ By structuring the trust so that the debtor is nothing but a "mere contingent remainderman" under domestic trust law it is thought that the transfer is less likely to be characterized as fraudulent. This form of structure is usually not required for a trust to provide effective asset protection.³⁶ It is also not normally required by the jurisdiction in which the trust is settled. For example, the settlor can usually be the beneficiary under the law of the jurisdiction of settlement

3. Tax neutral: An asset protection trust with a United States citizen or resident as the settlor should normally be structured to be tax neutral.³⁷ The principal additional burden, which is triggered in the cases where the trust is classified as "foreign" (for tax purposes), is that the trust should not be the shareholder of a Subchapter S corporation and it must comply with specified reporting requirements.³⁸ Utilization of an asset protection trust does not increase nor decrease the tax burden on the settlor of the trust who is treated, for tax purposes alone, as the owner of the assets and grantor of the

³⁵ See, Debtor Creditor Law section 22.02.

³⁶ See, section III.A.3 *infra* which illustrates that an asset protection trust can provide effective protection even if settled in violation of a domestic fraudulent conveyancing statute.

³⁷ See, section IV. *infra*.

³⁸ See, section IV.F. *infra*.

trust.³⁹ The United States tax treatment of an offshore asset protection trust, where the "mere remainderman" is treated as the owner of the trust assets and is taxed on all of the income therefrom, is completely opposite from his treatment under domestic debtor creditor law, where the "mere remainderman" is technically divorced from ownership with the result that the assets placed in trust are not subject to attachment by his creditors.

4. No criminal or civil violations: The provisions of the trust and the circumstances surrounding its formation must not violate any criminal provisions or create civil liability.⁴⁰ There are criminal penalties applied against the settlor, and his attorney, for certain types of fraudulent transfers to a trust⁴¹ and for failing to meet certain Federal filing requirements.⁴²

³⁹ See, B. Bittker and L. Lokken, *Federal Taxation of Income, Estates and Gifts* (WGL) particularly chapters 65-79 [hereinafter Bittker & Lokken]; Zaritsky, *Foreign Trusts, Estates and Beneficiaries*, T.M. (BNA 1993) [hereinafter Zaritsky].

⁴⁰ There are at least two jurisdictions involved, the jurisdiction of the settlor and the jurisdiction in which the trust is established. Ideally neither criminal nor civil liability are created in either. Nevertheless the trust may survive and the assets may be protected even if criminal or civil liability is created in the jurisdiction of the settlor, as long as the laws of the jurisdiction in which the trust is established are scrupulously observed. See, section III.A.3. *infra*.

⁴¹ See, section III.A.3(f) *infra*.

⁴² See, section IV.F. *infra*.

5. Withdrawal of funds: In certain circumstances, particularly where the settlor is rendering substantial services to the Committee of Trust Advisors or working for a corporation or partnership owned by the trust, the settlor may, in his or her capacity as consultant or employee, be able to extract funds from the trust as compensation. Of course, the compensation must be reasonable in light of the particular services provided.⁴³ The extraction of funds from the trust by the settlor is evidence of "continuance in possession and ability to represent the goods as his own," one of the traditional "badges of fraud."⁴⁴

6. Will substitute: The asset protection trust is a will substitute. It should contain all of the appropriate estate planning devices which would be contained in a domestic trust and be coordinated with a comprehensive estate plan. The trust often

⁴³ This problem concerning unreasonable compensation usually arose in old tax cases where taxpayers tried to avoid the double tax on dividends by taking the money out as deductible salary. *See, Compensation of Corporate Officers who as Directors Determine Own Compensation*, 53 A.L.R. 3d 358. Any salary, particularly if it is large in light of the services rendered, is strong evidence that the settlor/remainderman may have undisclosed powers over assets which may make assets reachable by creditors. In such case the settlor's assets in a domestic trust may be reachable by a judgement creditor. *See*, section III.A.1(d) *infra*. If the same debtor had a properly crafted foreign asset protection trust the assets in the trust would be difficult or impossible to reach. *See*, section III.A.3. *infra*.

⁴⁴ *See*, Debtor Creditor Law section 22.02.

will, and indeed should for important gift tax considerations,⁴⁵ provide that the Settlor has the power to change the beneficiaries of the trust; usually also providing that he does not have the power to designate himself as a beneficiary. In addition, the trust will usually provide that the trustee may make distributions of income or principle to the designated beneficiaries, subject perhaps to a veto by the Committee of Trust Advisors. The trust may also provide for distributions for charitable purposes or for certain non-charitable purposes.⁴⁶

7. Assets safe and either managed by settlor or professional management approved by the settlor: There are many techniques to achieve this result without subjecting the settlor or assets to collateral attack. In the case of a trust holding liquid assets it can, in many circumstances, be as simple a matter as holding the assets in a limited partnership in which the trust is the limited partner and the general partner is a

⁴⁵ See, section IV.C.1. *infra*.

⁴⁶ It is a general principal of common law that every trust must have a human beneficiary to enforce it and it must be for a proper purpose. Most jurisdictions with asset protection legislation specifically authorize both charitable trusts (often applying a much looser definition than that traditionally provided by I.R.C. Section 501(C)(3)) and purpose trusts set-up for non-charitable purposes such as to benefit an animal or class of animals, a building or a tomb. See, section 12 of the Cook Islands International Trust Act 1984, as amended [hereinafter Cook Act] which specifically authorizes charitable trusts and purpose trusts which "may benefit privately one or more persons or objects or persons within a class of persons." See, section II.C. *infra* and Appendix A.

corporation controlled⁴⁷ indirectly or perhaps even directly by the settlor. Alternatively, the trust might keep its liquid assets with a bank or brokerage firm. For example, dollar denominated investments, such as U.S. stocks and bonds, could be held in non-certificated form usually by an institutional custodian and be accounted for in the books of the custodian. In many cases, particularly where the settlor is satisfied with specifying both the type of investment (*e.g.*, a category of municipal bonds) and the classification of the custodian (*i.e.*, banks meeting certain criteria),⁴⁸ the settlor may be satisfied with only a "blind trust" type of report in which only the performance of the portfolio and not the location of assets or the identity of the manager or assets, is actually reported. This type of custodial service is offered by substantial institutional custodians in most offshore centers.⁴⁹

⁴⁷ *See*, section III.A.b. *infra*.

⁴⁸ Great care must be taken in selecting this pre-approved list. The pre-approved institutions should be substantial but, ideally (at least once an event of duress occurs), should not have a presence in the United States. *See*, sections I.D.8. and III.A.3(h)(iii) *infra*.

⁴⁹ For example, Stephen B. Breed, Chief Executive, International Trust Corporation Limited, Rarotonga, Cook Islands points out that "Often the signatory provisions on the fund management accounts require the joint signatures of the trustee and the ...protector. Thus, the settlor has the comfort ...[that the trustee] cannot do anything without his approval. Equally, it is not possible, if an event of duress has occurred, for the settlor to require the trustee to do anything." Personal communication (June 22, 1993).

In addition, it has become traditional for asset protection trusts to provide for "Protectors" or a "Committee of Trust Advisors." These committees are normally composed of the settlor, his or her attorney or trusted advisor, such as an accountant, as well as an attorney in the jurisdiction where the trust is established.⁵⁰ This committee will have veto power over all investment and distribution decisions of the trustee and will have power to replace the trustee. Often the trustee is guided by a non-binding "letter of wishes" delivered to the trustee by the settlor upon the settlement of the trust. Trustees will traditionally not depart from the non-binding instructions contained in the letter of wishes. In addition, in certain jurisdictions there are companies which are full time professional "protectors."

Some jurisdictions (*e.g.*, the Cook Islands and Bermuda⁵¹) permit the settlor to establish a privately owned trustee company to serve as trustee of the trust. Normally, such a company will have provisions in its Articles of Association similar to duress provisions so that on the occurrence of specified events the ownership of the company is specifically transferred away from the settlor or anybody associated with the settlor. In some jurisdictions it may be possible to structure the ownership of the trustee

⁵⁰ *See*, section 13D(i) of the Cook Act which specifically contemplates the involvement of such persons and specifically makes any foreign judgement against such person unenforceable in the Cook Islands.

⁵¹ *See*, section II.B.4 *infra*.

company so that the settlor retains basic control of the trustee company (perhaps by the use of bearer warrants) but does not retain legal ownership as a shareholder.⁵²

8. Duress provisions: The trust will contain "duress" provisions. If the trustee or the trust assets are threatened in any way whatsoever, the duress provisions will be triggered. The key duress provisions are as follows:

a. Automatic extension. In duress, the term of the trust is extended, automatically or at the discretion of the trustee, if creditors appear near the end of the term of the trust or an event constituting "duress" occurs.

b. Removal of assets. In duress, the trustee is directed to remove the assets from any jurisdiction in which the trustee believes that they may be subject to seizure.

c. Selection of alternate trustee and jurisdiction. In duress, the trustee may be instructed to appoint a different trustee in another, or any one of several, enumerated asset protection oriented jurisdictions and arrange to have the trust become

⁵² Section 228B of the Cook Islands International Companies Act specifically contemplates duress provisions in Articles of Association which automatically transfer ownership. Stephen B. Breed, Chief Executive, International Trust Corporation Limited, Rarotonga, Cook Islands, notes "[T]he holder of...[a bearer] warrant is deemed [under Cook Islands law] not to have any shareholding interest but has an entitlement to convert to a shareholding interest if he so wishes. This sort of facility maybe useful when used in conjunction with Section 228B [of the International Companies Act.]" Personal communication (June 22, 1993).

subject to the laws of that jurisdiction. Under some types of provision this can happen automatically. For example, if a court in the offshore situs of the trust was petitioned to order a trustee subject to the jurisdiction of that court to surrender assets, the trustee could be automatically removed as trustee and the jurisdiction of the trust switched to a different jurisdiction. Each of these duress provisions is specifically designed to frustrate collection efforts. A United States court would most probably find these provisions to be evidence ("badges") of an intent to defraud creditors under the various fraudulent transfer acts.⁵³ These types of clauses are known as "Cuba clauses" and are authorized by statute in many jurisdictions.

9. Settlor protected from contempt. The trust is structured so that any instructions received by the trustee from the settlor or any beneficiaries which are delivered pursuant to court order are deemed given under duress and are to be disregarded. Any act taken by the settlor under duress will be ineffective to bring the assets within the ordering court's jurisdiction. As a result, the settlor can fully comply with any court orders to instruct the trustee to deliver assets.⁵⁴

10. Trust treated as valid legal entity. The trust and the transfer of assets to the trust should be regarded as a transaction worthy of judicial respect, having legal

⁵³ See, section I.B. *supra*.

⁵⁴ See, section III.A.3(c) *infra*.

substance, and not a mere sham. All formalities required by the United States and the foreign jurisdiction, including registration, are observed, with the expectation that this will start the running of any statute of limitations, at least in the foreign jurisdiction.⁵⁵

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SECTION II

II. SELECTION OF JURISDICTION IN WHICH TO FORM TRUST

A. General Considerations:

Many factors must be considered before selecting a jurisdiction in which to establish an asset protection trust. The decision must be based upon a review of the relevant statutory law, the case law if any, the availability of trustworthy co-counsel and the existence of an acceptable trust company. Great care should be taken to choose a jurisdiction which allows the settlor to best achieve his or her goals. The specific laws of the jurisdiction should be checked with respect to the following factors:

⁵⁵ See, section II.A.1(d) *infra*.

1. Common Law heritage: Does the jurisdiction have a common law heritage with a specific history of recognizing trusts? Civil law jurisdictions which recognize trusts (i.e. Liechtenstein) create their trust law by statute and do not deal with them in the manner in which we are accustomed in the United States. In addition, certain United States tax provisions regarding the classification of trusts⁵⁶ may require that the jurisdiction apply the principles of chancery courts.

2. Creditor protection: Does the statute provide adequate insulation against creditors? Each jurisdiction has different Statute of Elizabeth override provisions and has different procedures and standards of proof to enforce judgments within its jurisdiction.

3. Tax consequences: The tax consequences of settlement in a specific jurisdiction should be verified. Normally there is not a tax treaty. Most jurisdictions have little or no tax initially but some jurisdictions impose higher taxes once a tax holiday is over.

4. Transfer Statute: The transfer statute of the host jurisdiction must be checked to verify that the domicile can be quickly and automatically transferred in the event of an event of Duress.⁵⁷

⁵⁶ See, section IV.B. *infra*.

⁵⁷ In many jurisdictions (*e.g.*, Switzerland or the Netherlands), an attempted

In addition, other factors such as cost and availability of international communication links and the jurisdiction's history of political stability should be considered.

B. Jurisdictional overview Omitted.

SECTION III

III. HOW TO ATTACK AN ASSET PROTECTION TRUST

This section of the article will analyze the various techniques available to attack the assets of an asset protection trust. This section, via a hypothetical, first analyzes an attack in the United States courts and then abroad in a jurisdiction assumed, for the sake of discussion, to be the Cook Islands.

A. United States Courts

1. The "Old and Cold" asset protection trust

Hypothetical 1

The settlor of our hypothetical trust currently is a surgical resident in New York. In 1985 he inherited \$8 million of high grade tax free municipal bonds. He has never touched his principal or interest. He has no debts at all except

transfer of jurisdiction will not be given legal effect in the absence of a transfer statute.

current living expenses such as his telephone and electricity and one credit card, which he pays off each month. The settlor is currently unmarried but is engaged. His fiancée does not know of the invested funds, now worth substantially more than \$12 Million dollars. Assume in 1993 Settlor establishes an asset protection trust in the Cook Islands. The money is kept invested in the same class of mutual bonds with major New York bank serving as custodian and holding the bonds for the trust's account under a street name. The settlor, his attorney and a foreign attorney compose the Committee of Trust Advisors. Assume further that the settlor gets married later in 1993 and finishes his surgical residency. He opens an orthopaedic surgery practice in New York specializing in sports medicine. By 1999 he has his own operating suite at his office on Park Avenue.

The settlor's first big mistake: He works hard and builds a good practice. He has bought a house in Westchester and by 1999 has two small children, a nanny (illegal), a full time maid (also illegal), 6 secretaries and nurses (legal) and a poolman (part-time). He is netting \$800,000 to \$900,000 per year, working 16 hour days. So far, he has no financial problems, his marriage is rocky and he "drinks a little." Assume further that a principal ballet dancer for the New York City Ballet ("the judgment creditor") has developed arthritis of his hip and comes in to the settlor for what is by then routine hip replacement surgery. On the night before

the surgery, January 3, 2000, the settlor has a terrible fight with his wife. He leaves home, calls the Athletic Club to book a room and, after he arrives, pours himself into a bottle. The next day after breakfast and "a small bite of the dog that bit me" he walks to his own hip replacement facility, drunk but able to hide it. He does the surgery on the wrong hip, it gets infected and ten days later the wrong leg has to be amputated at the hip. Finally, assume that the settlor is sued and four years later on January 3, 2004, the judgment debtor receives a judgment of \$25,000,000, one million of which is covered by the settlor's errors and omissions insurance. At the time of the judgment the only United States situs assets of the settlor are small accounts receivable, the equity in his house and a four unit apartment house owned by a family limited partnership. Immediately after the judgment the settlor's medical license is revoked.

Analysis:

In hypothetical 1 we have a situation where the settlor of the asset protection trust has committed a grievous tort, has a substantial judgment against him personally

and adequate funds in his asset protection trust to satisfy a major portion of the judgment. The trust is "old and cold," all formalities have been observed and the trust was settled with a transfer which is clearly not fraudulent.

(a) Discovering the trust - State Courts:

The judgment creditor, through his highly motivated lawyers, will immediately proceed to execute upon the judgment.⁵⁸ One of the first things that the judgment creditor's attorneys will do as part of this collection process⁵⁹ is to compel a debtor's examination under state law.⁶⁰ At this examination the judgment creditor's attorneys will possibly, but not definitely, depending on their experience and motivation (often the least experienced attorneys are given this ignoble job), ask a question which would require the settlor to disclose the 11 year old asset protection trust in which he is nothing but a "mere remainderman." The settlor has not and should not under generally accepted accounting principles put his contingent remainderman's interest on his financial statements. By this time, if the settlor has only gotten "blind accountings" he may not even know where the assets are situated or what they specifically are. Often an

⁵⁸ *See*, Debtor Creditor Law chapter 37.

⁵⁹ *See*, Debtor Creditor Law chapter 37.

⁶⁰ The law is similar in most States. *See*, New York C.P.L.R. section 5101 *et seq.*.

attorney conducting a debtor's exam will focus on tracking assets and totally miss the big picture.

We will assume that the attorney conducting the exam was able to discover the asset protection trust. Further, the settlor's attorney, in furtherance of his responsibilities as a Member of the Committee of Trust Advisors (aka "Protectors") has already notified the trustee in the Cook Islands of the judgment which automatically triggered the duress provisions of the trust.⁶¹ Even if the settlor's attorney did not notify the trustee, all that it would take to possibly trigger the duress provisions is a call or letter from the judgment creditor's attorneys to the Cook Islands trustee requesting information.⁶² When this happens, because of the duress provisions the settlor's attorney drafted 11 years before, the settlor's attorney and the settlor were probably removed from the Committee of Trust Advisors, and the New York bank acting as custodian was instructed by the trustee in the Cook Islands to immediately transfer the entire portfolio to a different institutional custodian outside of the jurisdiction of the United States courts.⁶³ The assets were then most likely placed in a blind trust custodial arrangement with a major bank in some other stable jurisdiction comparable to New

⁶¹ See sections I.D.8 *supra* and III.B. *infra*.

⁶² See section I.B.8. *supra*.

⁶³ The Cook Islands currently has satellite offices of at least 6 major banks.

York.⁶⁴ Neither the settlor nor his attorney will be told where the assets are or how they are held. Finally, the trustee knows that any instructions from the settlor or his attorney delivered pursuant to a court order are to be disregarded.

(b) Seizing non-trust United States situs assets

(i) Traditional court ordered execution: The United States situs house, accounts receivable and personal property, to the extent that they are not exempt from execution,⁶⁵ have been seized. The proceeds from these assets are inadequate to satisfy the judgment.

(ii) Charging order - the family limited partnership:⁶⁶ The settlor and his wife have a family limited partnership. This was included in the hypothetical because the use of a family limited partnership is a popular way to turn attractive assets (i.e. an apartment house) into unattractive assets. It is also a technique whereby the asset protection trust may own U.S. situs assets. The asset becomes unattractive to a creditor because, by placing the apartment house into the limited partnership the judgment creditor's remedy changes. The judgment creditor cannot execute directly

⁶⁴ If the Cook Islands trustee puts the assets in Switzerland and you are somehow able to find out this fact you may be able to seize them under the special *Attachment* provision in the Swiss code. *See*, section III.A.3(h)(ii) *infra*.

⁶⁵ *See*, Debtor Creditor Law section 37.03.

⁶⁶ *See*, Debtor Creditor Law section 37.03[A][7].

upon the apartment house and force its sale. Instead, the remedy is outlined by the Uniform Limited Partnership Act which provides that "On application to a court...by a judgment creditor, the court may charge the partnership interest of the partner with payment of the judgment...[T]he judgment creditor has only the rights of an assignee of the partnership interest."⁶⁷ This act also provides that "An assignment entitles the assignee to receive...only the distribution to which the assignor would be entitled."⁶⁸ The drafters of the Uniform Limited Partnership Act inserted this charging order concept into the act to prevent the creditors of a partner from disrupting the partnership business. However, these same provisions can be utilized in the family limited partnership context to prevent the distribution of funds to the judgment creditor. This is because under relevant partnership law the general partner,⁶⁹ who is likely to be a family member or a corporation controlled by family members, can prevent distributions. The Internal Revenue Service has also held in Revenue Ruling 77-137⁷⁰ that the creditor with a charging order is treated as a substituted limited partner for tax

⁶⁷ U.L.P.A. section 703.

⁶⁸ U.L.P.A. section 702.

⁶⁹ The general partner should never be the settlor of the trust because it is possible that a judgement creditor could then dissolve the partnership and force distribution of the assets. *See, Henkel, How Family Limited Partnerships Can Protect Assets*, 20 Estate Planning 3 (1993).

⁷⁰ Rev. Rul. 77-137, 1977-1 C.B. 178.

purposes. As a result the judgment creditor is saddled with the tax consequences resulting from ownership without the capacity to force dissolution of the partnership or distributions from the partnership.⁷¹

The asset protection trust is sometimes positioned as a limited partner. Care should be taken to make sure that the asset protection trust does nothing to potentially avail itself of the jurisdiction of any United States court. It is the author's opinion that the asset protection trust should never be the general partner of a limited partnership because to do so runs the risk of subjecting the asset protection trust to the jurisdiction of a United States court. It is always preferable that the asset protection trust own no United States situs assets.

(c) Attacks against the offshore trust - State Courts

The judgment debtor's attorneys first tried to satisfy the judgment from traditional United States situs assets. After that failed and the attorneys for the judgment debtor heard of the trust the judgment creditor's attorneys had their

⁷¹ The California courts have departed from the charging order provisions in the Uniform Limited Partnership Act and permitted actual attachment and sale of a partnership interest provided that this does not disrupt the business of the partnership. *See, Crocker National Bank v. Jon R. Perroton* 208 Cal. App. 3d 1; 255 Cal. Rptr. 794 (1989). Disagreed with by the court in *Hellman v. Anderson* 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (3d Dist. 1991)

expectations rise since there was a substantial sum to satisfy the judgment. It is likely that the attorneys for the judgment creditor went through the following analysis:

(d) Attaching Debtor's reversionary interest: Does the settlor have a sufficient interest in the trust to enable it to be attached? The simple answer is that he does not. The trust has been carefully crafted to avoid exposure, even if it were a domestic trust, on these grounds. The settlor does not have a sufficient interest in the trust to make it reachable. The settlor is a "mere remainderman."⁷²

With respect to this issue in a bankruptcy proceeding, the settlor might advance an argument pursuant to section 541 of the Bankruptcy Code that the trust proceeds are not properly included in the estate. This section provides in pertinent part that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable under this title." The United States Supreme Court has recently held that "applicable nonbankruptcy law" includes both state law (e.g. spendthrift clauses) and federal law (e.g. ERISA - qualified pension plans including anti-alienation provisions).⁷³ The Court did not decide whether this phrase encompasses the laws of foreign countries, such as England, France and the Cook Islands. This type of analysis often comes up when

⁷² See, Debtor Creditor Law section 37.03[A].

⁷³ *Patterson v. Shumate* 112 S. Ct. 2242, 119 L. Ed. 2d 519, 60 U.S.L.W. 4550

courts in the United States are called upon to enforce judgments obtained in other countries. Traditionally, United States courts respect the laws of foreign jurisdictions even if such laws appear to violate certain of our fundamental rights.⁷⁴

(e) Attacking the "Old and Cold" transfer as fraudulent: If the settlor's interest in the trust cannot be attacked, can the transfer to the trust be set aside as a fraudulent conveyance? New York law would apply and, in the instant case, this eleven year old transfer made at a time when the settlor had no debts and more than adequate income to meet his needs was clearly not fraudulent. Most courts would have no alternative but to hold that the original settlement of the asset protection trust was not fraudulent and that the trust was worthy of respect, particularly if the business justifications for the trust⁷⁵ were emphasized in the documentation. Further, even if a United States court were to find the transfer fraudulent it is unlikely that the judgment creditor could reach them.⁷⁶ Under the facts of this hypothetical, the poor judgment

(1992) *reh'g denied* 120 L. Ed. 2d 940, 113 S. Ct. 13, 61 U.S.L.W. 3149 (1992).

⁷⁴ *See, Somportex Limited v. Philadelphia Chewing Gum Corporation*, 453 F.2d 435 (3rd cir. 1971), *cert. denied* 405 U.S. 1017, 92 S.Ct. 1294, 31 L.Ed.2d 479 (1972) in which a United States court enforced a judgement from an English court against a United States company which would have violated the defendant's due process rights if the case had been tried in the United States. *See, Lowenfeld, supra.*

⁷⁵ *See, section I.C. supra.*

⁷⁶ *See, section III.A.3. infra.*

creditor will likely spend the rest of his life attempting to garnish the wages of an unemployable alcoholic former doctor.

Until the asset protection trust terminates and proceeds are distributed to the settlor, the judgment creditor does not have any significant assets to attach. Even upon distribution, the judgment creditor will only be able to attach the assets if (1) he knows where they are and (2) they are subject to the jurisdiction of a court which will enforce his judgment.⁷⁷ Finally, the judgment creditor might make an effort to reach other assets (i.e. the errors and omissions policy and personal assets of the settlor's attorney). These attacks are unlikely to be successful provided the transfer to the trust was not fraudulent.⁷⁸

2. The Pre-nuptial asset protection trust

Hypothetical 2

Assume at the time of the debtors examination, the settlor's wife discovers that the alcoholic former doctor that she is married to has a great deal of money that he has been hiding from her. This infuriates her and she files for divorce.

The settlor's soon to be former spouse does not stand in any better position than the injured judgment creditor. Even if she were to get a judgment against the settlor for

⁷⁷ In order for the assets to be safely distributed to the settlor the settlor may have to take certain extraordinary steps. The judgement debtor might move abroad (perhaps to one of the many places like Monaco where the judgement will not be automatically recognized and there are no income taxes) and perhaps even expatriate. On occasion expatriation, if carefully managed, can produce a substantial tax savings. *See*, I.R.C. Section 877.

⁷⁸ *See*, section III.A.3(e) *infra*.

a portion of the assets held in the Cook Islands she can not enforce it.⁷⁹ The only potential difference is that child support and alimony obligations are not dischargeable in bankruptcy⁸⁰ and sometimes courts will use their contempt power to endeavor to enforce these obligations.⁸¹ The only reason to include this hypothetical is to point out that an asset protection trust can often achieve the same result as a pre-nuptial agreement except that the prospective spouse with the money does not have to obtain the agreement of the other prospective spouse.

3. Trust settled with fraudulent conveyance -

Hypothetical 3

This hypothetical assumes that the asset protection trust was settled in the weeks immediately following the surgery and after the malpractice action was filed. The sole purpose of the trust was to put assets out of the reach of the probable judgment creditor. The transfer to the trust is fraudulent on its face under both state and Federal Bankruptcy law. Assume further that on the day after the verdict the settlor filed a petition under Chapter 7 in the Southern

⁷⁹ See, section III.B. *infra*.

⁸⁰ See, Bankruptcy Code section 523.

⁸¹ See, Section III.A.3(d) *infra*.

District of New York. During the pendency of this bankruptcy the settlor receives \$5,000 per month from the Trustee for investment advice.

The remainder of this section of this article analyzes the techniques available to reach the assets of an offshore trust settled with a patently fraudulent conveyance of liquid assets. The article first assumes the judgment creditor is proceeding against the settlor in a United States Bankruptcy Court. The article next assumes that the judgment creditor is proceeding in the jurisdiction where the trust is settled, in this case assumed to be the Cook Islands.

(a) Discovering the trust - Federal Bankruptcy Court: At the outset of the settlor's bankruptcy case, he is required to file a Form 1 Voluntary Petition which, on Exhibit A, has a single line where he would disclose his "Total Assets."⁸² The value of his "mere contingent remainderman's" interest would be very small indeed.⁸³ The settlor is also required to file a Summary within 15 days of filing the voluntary petition, which in category 18 of the Personal Property Schedule requests information

⁸² See, Collier, *supra*, Form 1-112.

⁸³ *Query*, might some bankrupts reason *lex non curat deminimus* and simply not disclose the trust? There is a substantial body of literature in the tax area which supports the proposition that certain types of remainder interests are incapable of being valued. Before the bankrupt or his advisors take this position they should be aware of the substantial civil and criminal liability this could generate. See, sections III.A.3(e)-(g) *infra*.

on "future interests."⁸⁴ At the same time the settlor must file a Statement of Financial Affairs which, in question 9, requires the disclosure of all transfers made within one year of the date of the petition.⁸⁵ The settlor should disclose his remainder interest on the Personal Property Schedule although the value might be very small and on the Statement of Financial Affairs. The attorneys for the judgment creditor may realize something is up and could obtain a Rule 2004 examination which is like a debtor's examination under state law in that the scope of this examination is very broad, encompassing anything that relates to the "liabilities and financial condition of the debtor." The examination is done under oath.

Once the Bankruptcy court is aware of the transfer to the foreign trust for the express purpose of putting assets out of the reach of the judgment creditor, the transfer will be classified as a fraudulent transfer under Bankruptcy Code 548 as well as the fraudulent conveyancing laws of New York⁸⁶ or any other state in which the matter

⁸⁴ See, Collier, *supra*, Form 2-103.

⁸⁵ See, Collier, *supra*, Form 2-105.

⁸⁶ A relatively new (1962) section to the New York version of the Uniform Fraudulent Conveyances Act squarely catches the settlor in our hypothetical. This section provides: "Every conveyance made without fair consideration when the person making it is in an action for money damages or a judgement has been docketed against him, is fraudulent as to the plaintiff in that action without regard to the actual intent of the defendant if, after final judgement for the plaintiff, the defendant fails to satisfy the judgement." N. Y. Debt. & Cred. Law Section 273-a (McKinney 1993).

was heard.⁸⁷ Once the transfer is classified as fraudulent it is possible that the court will order the settlor to instruct the trustee in the Cook Islands to return to the United States the assets which were fraudulently transferred abroad. The Cook Islands trustee would not respond to this "suggestion" issued under "duress" and the assets would stay abroad, in a blind trust, information about which would be available only to the trustee in the Cook Islands.

At this stage the bankruptcy judge has determined that a fraudulent transfer has been made to an offshore trust. An order has been issued to the settlor and possibly his attorney, both of whom were Member of the Committee of Trust Advisors,⁸⁸ to demand that the trustee return all assets to the United States.⁸⁹ The assets have not been returned. What are the ramifications of this finding by the bankruptcy court that the trust was funded with a fraudulent conveyance? The next section of this article analyzes the issues presented by this finding. They are:

*Is the debt dischargeable?

⁸⁷ See, Debtor Creditor Law chapter 22.

⁸⁸ Remember the United States citizens or residents who are Members of the Committee of Trust Advisors were probably removed from the Committee of Trust Advisors upon the happening of any event of duress. See, section I.D.8. *supra*.

⁸⁹ The assets are possibly currently located in the United States, only in an untraceable account or invested in United States securities perhaps with a foreign institutional custodian. See, section I.D. *supra*.

*Is the settlor (and perhaps also his attorney) subject to imprisonment for contempt for failing to obey the court's order?

*Is the settlor (and perhaps also his attorney) subject to contempt for designing the trust in such a way that the trustee is compelled to ignore instructions from the settlor if such instructions are given pursuant to court order?

*Does the judgment creditor have any civil remedy against the settlor's attorney as the creator of this asset protection trust - the specific purpose of which was to shield the judgment debtor's assets from attachment after a potential malpractice verdict in favor of the judgment creditor?

*Has the settlor (and perhaps also his attorney) violated any criminal provisions in constructing a trust designed to both frustrate court orders and defraud creditors?

*Is the settlor's attorney, as the creator of this trust and engineer of the scheme, subject to discipline under the rules regulating professional conduct issued pursuant to the authority of his State Bar Act?

*Are there any extraordinary remedies which may be available to the judgment creditor to expedite seizure of the assets notwithstanding the existence of the asset protection trust?

(b) Dischargeability of debt: The bankruptcy court will not permit the discharge of the judgment in favor of the judgment creditor.⁹⁰ This is of little current utility to the judgment creditor because he cannot reach the money.

Use of contempt power

(c) Contempt for failing to retrieve fraudulently transferred assets: Can the bankruptcy court hold the settlor in contempt for failing to succeed in arranging for a return of the fraudulently conveyed assets? The leading case in the United States is *Maggio v. Zeitz, Trustee in Bankruptcy*.⁹¹ In that case a turnover order was issued to Joseph Maggio to return merchandise which he no longer had. Mr. Maggio was held in contempt by the referee, the District Court affirmed and ordered Mr. Maggio jailed. The Circuit Court also confirmed, even though it found that "Maggio cannot comply with the order." The Supreme Court, Speaking through Justice Jackson, held that "if the Court is satisfied...that the bankrupt has not the present ability to comply, the commitment order should not issue."⁹² The Justice also noted that "the fact that he has been under the shadow of prison gates may be enough...to convince the court that his is

⁹⁰ See, Bankruptcy Code section 523.

⁹¹ 333 U.S. 56, 68 S.Ct. 401, 92 L.Ed. 476 (1948).

⁹² *Id* at 74.

not a willful disobedience which will yield to coercion."⁹³ This case, which is still good law, stands for the proposition that the settlor (and his attorney) should not be jailed for failing to effect a return of the assets, an act which is beyond either's power to perform.

(d) Contempt for establishing a trust which frustrates the Court's orders: A separate issue is whether or not the settlor (and perhaps his attorney) are nevertheless responsible if the settlor has (with his attorney's guidance) "voluntarily and contumaciously disabled himself" from complying with a court order.⁹⁴ There are many cases on point and each is heavily fact based.⁹⁵ In the instant case it is hard for either the settlor or his attorney to argue that they are not responsible for the refusal of the trustee to return assets when it is clear that the trustee is acting pursuant to instructions prepared by the settlor's attorney on behalf of the settlor, several weeks after the ill-fated surgery and the filing of a malpractice action, with the specific intent (probably inferred from the "badges of fraud")⁹⁶ of keeping assets from the reach of the grievously injured judgment creditor. Under these facts both the settlor and his attorney

⁹³ *Id.* at 76.

⁹⁴ *See, Galland v. Galland*, 44 Cal. 475, 478 (1872).

⁹⁵ *See*, Debtor Creditor Law chapter 22.

⁹⁶ *See*, Debtor Creditor Law chapter 22.

have a serious chance of being imprisoned for contempt simply because each, particularly the attorney, created the scenario with full knowledge of its consequences.

California provides that the maximum time of imprisonment for this "criminal" type of contempt is 5 days.⁹⁷ However, the California code provides further that "when the contempt consists of the omission to perform an act which is yet in the power of the person to perform, he or she may be imprisoned until he or she has performed it."⁹⁸ If this were California I think that the duration of the punishment for contempt for both the settlor and his attorney would be five days in jail since it is truly impossible for either to effect a return of the assets.⁹⁹ Most states do not have a statutory limitation on the duration of certain contempt orders. There are, however, many constitutional limits on imprisoning a debtor for non-payment of a debt or failing to obey an order which is beyond his capacity to obey.¹⁰⁰

⁹⁷ Cal. C.C.P. Section 1218 (West's 1993).

⁹⁸ Cal. C.C.P. section 1219. Imprisoning the settlor of an asset protection trust under this section would likely be "anticipatory contempt" which is subject to substantial constitutional limitations. *See, Contempt: State Court's Power to Order Indefinite Coercive Fine or Imprisonment to Exact Promise of Future Compliance with Court's Order -Anticipatory Contempt*, 81 A.L.R. 4th 1008 (1992).

⁹⁹ This is not the only type of punishment they may be subjected to. *See*, sections III.A.3(e)-(g) *infra*.

¹⁰⁰ *See*, section III.A.3(f) *infra*.

(e) Civil claim against settlor's advisors: The settlor's advisors are potentially liable to the judgment creditor for engineering on behalf of the settlor a fraudulent transfer which deprived the judgment creditor of a fund from which to satisfy his judgment. See for example *McElhanon v. Hing*¹⁰¹ in which a creditor obtained a judgment against an attorney for \$286,000 for assisting in a stock transfer which was a fraudulent transfer *vis a vis* an individual who was a judgment creditor of his client. Finally, unless the judgment creditor is careful in how he frames his civil complaint against the settlor's attorney, an eventual judgment in the judgment creditor's favor may not be covered by the attorney's errors and omissions insurance based on the exclusion found in many policies for intentional *quasi* criminal acts such as "civil" fraud.

(f) Criminal sanctions against the settlor and his attorney:

(i) Violations of Bankruptcy Code and other miscellaneous provisions:

Section 152 of the Bankruptcy Code provides that a fraudulent transfer of property in contemplation of a bankruptcy or with intention to defeat the provisions of the Bankruptcy Code is a crime punishable by a fine of not more than \$5,000 nor more

¹⁰¹ 151 Az. 386, 728 P.2d 256 (1985), *aff'd in part and vacated in part*, 151 Az 403, 728 P.2d 273 (1986) *cert. den.*, 481 U.S. 1030, 107 S.Ct. 1956, 95 L.Ed 2d 529 (1987). *See also FDIC v. Porco*, 75 N.Y.2d 840, 552 N.Y.S. 2d 910 (1990).

than five years of imprisonment.¹⁰² A new section of the United States Code was added in 1990 which imposes similar fines and imprisonment for knowingly concealing assets from the Federal Deposit Insurance Corporation, the Resolution Trust Company or the National Credit Union Administration Board.¹⁰³ Further under I.R.C. section 7206(4), a transfer to prevent the collection of a tax is punishable by a fine of \$100,000 and three years in prison.¹⁰⁴ Several states have enacted criminal fines for fraudulent

¹⁰² This section provides in pertinent part:

"Whoever, either individually or as an agent or officer of any person or corporation, in contemplation of a bankruptcy proceeding by or against him or any other person or corporation, or with intent to defeat the bankruptcy law, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation...[s]hall be fined not more than \$5,000 or imprisoned not more than five years, or both."

This section covers both the settlor and his attorney in the case of any fraudulent transfer done specifically in contemplation of a bankruptcy filing. No cases concerning asset protection trusts have been brought under this provision of the Bankruptcy Code.

¹⁰³ *See*, 18 U.S.C. section 1032 This section is entitled "Concealment of Assets from Conservator, or Liquidating Agent of Financial Institution" imposes criminal penalties on anyone who "corruptly places or endeavors to place an asset or property beyond the reach of such Corporation, Board or conservator." 18 U.S.C. section 1032(3).

¹⁰⁴ Most asset protection trusts specifically instruct the trustee to pay all taxes relating to or in any way connected with the transfer.

conveyances.¹⁰⁵ It might also be possible to bring a civil Racketeer Influenced and Corrupt Organizations Act (RICO) action.¹⁰⁶

(ii) Violations of money laundering and related statutes

The final set of statutes which might impose criminal liability on the settlor and his attorney are the principal money laundering acts. The first of these is The Bank Secrecy Act of 1970.¹⁰⁷ This act requires "persons"¹⁰⁸ acting on behalf of any "financial institution"¹⁰⁹ (very broadly defined) to report large cash transactions to the government. This is accomplished by filing Form 4789¹¹⁰ known by the shorthand

¹⁰⁵ *See*, for example Cal. Penal Code sections 155 and 154. Although these code sections on their face would only apply to the settlor, the co-conspirator provisions could also be utilized to involve the settlor's attorney and other advisors.

¹⁰⁶ *See*, 18 U.S.C. section 1961. The RICO Act is very broad. Note that this act specifically covers any indictable act under Title 18 of the United States Code relating to mail fraud (Section 1341), obstruction of justice (Section 1503), obstruction of state or local law enforcement (Section 1511), interference with commerce (Section 1951) and any case involving fraud under Title 11.

¹⁰⁷ 31 U.S.C. sections 5311-5324.

¹⁰⁸ "Person" is specifically defined to mean "a trustee [probably encompassing all Member of the Committee of Trust Advisors (aka Protectors)]... [and] a representative of an estate [*i.e.*, an attorney]...". 31 U.S.C. section 5312(4).

¹⁰⁹ *See*, 31 U.S.C. section 5312(2).

¹¹⁰ *See*, I.R.C. section 6060I which requires anyone engaged in a "trade or business" to report any receipt of cash of \$10,000 received in one or more related transactions. Violation of this is punishable by up to five years imprisonment and a \$25,000 fine. *See also*, I.R.C. section 7203.

Cash Transaction Report (or CTR) for any transaction involving more than \$10,000. The Bank Secrecy act imposes penalties which apply to a "partner, director, officer, or employee of a domestic financial institution" which violates the Act. The civil fine is a minimum of \$25,000 or the amount of money involved, not to exceed \$100,000.¹¹¹ The criminal penalties can be a fine of up to \$500,000 and ten years imprisonment.¹¹² Compliance with this provision is excellent. The problem is that it applies primarily to financial institutions and does not reach the individuals requesting the financial institution's help in moving money.

To expand the reach of the Bank Secrecy Act of 1970, Congress passed the Money Laundering Control Act of 1986.¹¹³ This act is extraordinarily broad and covers virtually any person engaging in an act to disguise the ownership of funds (allegedly derived from unlawful activity) or to avoid the Cash Transaction Report filing requirement. Violation of this Act is punishable by a fine of up to the greater of \$500,000 or twice the amount of money involved or imprisonment for up to 20 years,

¹¹¹ *See*, 31 U.S.C. section 5321(a)(1).

¹¹² *See*, 31 U.S.C. section 5322(b).

¹¹³ This Act is scattered throughout the code at 18 U.S.C. sections 981, 982, 1956, 1957 and 31 U.S.C. sections 5321 and 5324.

or both.¹¹⁴ In addition, the funds involved in the transaction are subject to civil forfeiture for violation of the Act.¹¹⁵

The Internal Revenue Service has recently established the Financial Crimes Enforcement Network ("FinCEN").¹¹⁶ This new office of the Treasury department is to provide "government-wide, multi source intelligence and analytical network in support of the detection, investigation, and prosecution...of financial crimes."¹¹⁷ All information so developed will be "appropriately" disseminated by "FinCEN" "in accordance with applicable legal requirements."¹¹⁸

FinCEN has a total staff compliment of 200 and a budget of approximately \$ 16 Million. FinCEN has representatives from the Federal Bureau of Alcohol, Tobacco and Firearms, the Secret Service, the Postal Inspectors, the Federal Bureau of Investigation as well as "liaisons" with the Defense Intelligence Agency and Central Intelligence Agency.¹¹⁹ As computer analysis capacities expand and get more

¹¹⁴ See, 18 U.S.C. section 1956(a)(2).

¹¹⁵ 18 U.S.C. section 981.

¹¹⁶ Announced by Treasury Secretary Nicholas Brady on April 9, 1990. Treasury Order 105-08.

¹¹⁷ Treasury Order 105-08.

¹¹⁸ Treasury Order 105-08.

¹¹⁹ See, *Abuse of International Exchange Program a Concern to Federal*

sophisticated (and as the IRS expertise - augmented by former CIA and FBI agents - grows) it can be expected that the government will, in appropriate instances, be able to get detailed information on any foreign trust. An asset protection trust is not an effective tool to keep assets secret from the United States government in an aggressively pursued investigation.

(g) State Bar disciplinary action: The California Supreme Court has specifically held that "[p]articipating in a scheme to defraud creditors is a crime...and properly subjects an attorney to disciplinary action."¹²⁰ The Lawyer's Code of Professional Responsibility promulgated by the New York State Bar Association similarly provides "A lawyer shall not:...counsel or assist the client in conduct that the lawyer knows to be illegal or fraudulent."¹²¹ I have spoken with an attorney in California who specializes in representing attorneys in disbarment proceedings. It is clear, at least in California, that the Bar would try for disbarment. The specialist thinks

Enforcement Official, Daily Report for Executives, (BNA March 19, 1992). See also, Hearing of the Treasury, Postal Service and General Government Subcommittee of the Senate Appropriations Committee, Federal News Service, (Federal Information Systems Corporation March 20, 1990), (Testimony by Treasury Secretary Nicholas Brady) and Money Laundering Alert, Alert International, April 1990, Vol. 1, No. 7, Page 3.

¹²⁰ *Allen v. State Bar*, 20 Cal.3d 172, 178, 570 P.2d 1226, 1229, 141 Cal. Rptr. 808, 811 (1977).

¹²¹ *See, D.R. 7-102A.7. See also American Bar Association Model Rules of Professional Conduct rule 1.2(d).*

that the minimum penalty would be a three year suspension with restitution as a condition to restatement. I have no reason to believe that the Bar Association of any other State would be significantly less severe.

(h) Extraordinary remedies:

(i) *Mareva* injunction¹²²

If the judgment creditor is able to pierce the veil of secrecy surrounding the settlor's asset protection trust¹²³ the judgment creditor may be able to get a *Mareva*¹²⁴ injunction. In that case an English court froze money of a foreign debtor in an English Bank upon the showing that there was a great danger that the assets would be disposed of so as to frustrate the payment of a valid obligation. The petitioner had to satisfy the court that an obligation did indeed exist. The standard is simply what is "just

¹²² An *ex parte Mareva* injunction has been the vehicle utilized by aggrieved creditors to attempt to reach assets held in a Cook Islands trust. *See*, section III.B.4. *infra*.

¹²³ Whomever divulges the information faces a large fine (up to U.S. \$10,000) and up to one year in imprisonment under Section 23 of the Cook Act and related provisions of the Trustee Companies Act. Further, if one of the trustees divulged information he is likely a solicitor and might be breaching the attorney client privilege and his duties as a trustee under the terms of the trust and Cook Islands law. He could be immediately disbarred.

¹²⁴ *Mareva Compania Naviera S.A. v. International Bulkcarriers S.A.*, U.K. Court of Appeal, 2 Lloyd's L.Rep. 509.

and right." This is a rapidly expanding area of the law. In the instant case, provided the judgment debtor has a formal judgment from a United States Court labeling the transfer as "fraudulent," the judgment creditor should not have any problem establishing to a court's satisfaction that the assets are at risk of being removed from the jurisdiction. However, in Hypothetical 1, where there is no fraudulent conveyance, the judgment creditor has a very hard burden in that the transfer to the foreign trust has been respected by the United States court. Provided the assets are trust assets and not the personal assets of the settlor the judgment creditor will not succeed in obtaining a *Mareva* injunction where the transfer is clearly not fraudulent. The traditional rule is that no jurisdiction protects a creditor before he gets a judgment and the judgment creditor will not have a judgment against the trust.¹²⁵ Finally, procuring the *Mareva* injunction is no guarantee that the judgment creditor will be able to reach the assets or prevent the automatic implementation of duress provisions.¹²⁶

(ii) *Attachment under Swiss Law*

¹²⁵ The judgement creditor may have a charging order against the trust. *Quere*, will a court in a civil law jurisdiction attempt to exercise equitable type powers to justify disregarding the trust or to force the trustee to deliver trust assets. No cases have dealt with this issue. See Lowenfeld, *supra* and Hetherington, *Mareva Injunctions* (The Law Book Company (Australia) 1983).

¹²⁶ *See*, section III.B.4. *infra*.

Switzerland now allows for the *Attachment*¹²⁷ of property. This remedy is available to both Swiss and foreign creditors. It is enforceable against debtors who are non-residents of Switzerland. Most importantly, this remedy is available against any property in Switzerland for claims unassociated with Switzerland and not based on Swiss law. In other words, this is a remedy which is available to non-Swiss against non-Swiss on claims completely unassociated with Switzerland.

Attachment is available upon a showing that an unsecured debt is due and unpaid, that the debtor is not domiciled in Switzerland, that the debt is in connection with pending litigation outside Switzerland and that the property inside Switzerland would be immediately subject to *attachment* if the judgment creditor were successful in the related action. Such an *attachment* may be had by *ex parte* order (thereby keeping the Cook Island trustee in the dark until it is possibly too late to take any action). In the event that the judgment creditor does not know which bank is holding the assets all he need do is file separate petitions until he finds the money. Any bank served with a writ of *attachment* must disclose whether it holds assets of the debtor.¹²⁸

¹²⁷ The procedure is authorized by Section 271 of the Swiss Federal Statute of Debt Collection and Bankruptcy (*Bundesgesetz über Schuldbetreibung und Konkurs*).

¹²⁸ See, Wirth, *Attachment of Swiss Bank Accounts: A Remedy for International Debt Collection*, 36 *Business Lawyer* 1029 (1981). And to think, in 1981 we all thought Swiss Bank accounts were confidential!

(iii) The turncoat custodian (usually a bank)

Care should be taken in the selection of the custodian (normally a bank). The preferred entities (at least, once an event of duress occurs) have no business contact at all with the United States or, at a minimum, have so little contact that they are unlikely to become subject to the jurisdiction of a court in the United States. There are several reported examples of banks or trust companies abrogating confidentiality laws when the banks or trust company's assets were put at risk. For example, in one well known case¹²⁹ the Miami branch of the Bank of Nova Scotia was directed to cause its related Bahamian subsidiary to deliver information on certain Bahamian accounts to the United States in violation of the Bahamian bank disclosure laws. The Bank faced fines of \$25,000 per day and quickly complied. There is some authority that the bank may be liable to the customer for breach of its duty of confidentiality.¹³⁰

B. Challenge in Cook Islands Court

¹²⁹ *Re Grand Jury Proceedings*, 691 F.2d 1384 (11th Cir. Fla. 1982), *cert denied Bank of Nova Scotia v. United States*, 462 U.S. 1119, 103 S.Ct. 3086, 77 L.Ed.2d 1348 (1983).

¹³⁰ *See, Young v. Chemical Bank, N.A.*, N.Y.L.J. August 7, 1992 at 21 (N.Y. Co. Sup. Ct. 1992) and Angello and Potti, *Crime Prevention and Customer Confidentiality*, N. Y. Law J., January 14, 1993, page 5. *See also*, Lowenfeld, *supra*.

The judgment creditor could also try to attack the trust in the Cook Islands before a local Cook Islands judge.¹³¹ For the purposes of this section we are still assuming that the trust was formed in blatant violation of both state and Federal fraudulent conveyancing laws and that the United States Bankruptcy Court has ordered the settlor and his attorney to effect a return of the assets held in the asset protection trust.¹³² We know that no attacks against "international trusts" settled in the Cook Islands have succeeded to date. We also know that no cases are reported because of the secrecy requirement of the Cook Act.¹³³ Nevertheless, the judgment creditor decides to proceed on principle, a tactic almost always a mistake in business litigation. Here are the barriers he will have to overcome.

¹³¹ The Cook Islands has a three tier court system. The court of original jurisdiction is known as the High Court. Its judges are drawn largely from the ranks of the New Zealand judiciary and are thus of a high calibre. Appeals from decisions of the High Court lie with the Cook Islands Court of Appeal. This again, typically comprises judges of New Zealand's High Court and Court of Appeal, appointed to the Cook Islands bench by the Cook Islands Government. Appeals from the Cook Islands Court of Appeal lie to the Privy Council in London. Personal communication from Timothy Arnold, Partner, Clarkes, Barristers & Solicitors, Rarotonga, Cook Islands. *See also*, Frame, *The Cook Islands and the Privy Council*, 14 Vict. Well. L.R. 311 (1984).

¹³² The United States has been known to place great pressure on foreign states or domestic courts to change laws which, in the opinion of the State Department, impeded commerce. *See, Jackson v. Peoples Republic of China*, 794 F.2d 1490 (11th Cir. Ala. 1986) *reh'g denied, en banc*, 801 F.2d. 404 (11th Cir. Ala. 1986) and *cert. denied*, 480 U.S. 917, 94 L.Ed.2d 687, 107 S.Ct. 1371 (1987).

¹³³ Cook Act section 23.

1. Retention and payment of a United States law firm to manage the litigation: The judgment creditor will likely have to retain a firm experienced in international litigation to attack the trust in the Cook Islands. It is highly unlikely that the matter will be taken on a contingent or reduced fee basis, thus the judgment creditor will likely have to pay whichever firm he hires to manage this proceeding its normal hourly rates. This firm will undoubtedly require a substantial retainer. It is also probable that this firm will advise the judgment creditor in writing that his case is very difficult and that it is against their better judgment and his best interests to pursue it. It could be malpractice or even unethical to take money for this case without such an exculpatory letter. The judgment creditor's new lawyers will also require that the judgment creditor hire another lawyer to represent him in connection with his execution of this exculpatory letter.

2. Accessibility: Once retained, the United States lawyers supervising the litigation have the problem of getting a copy of the Cook Islands law. Until the publication of this article, neither NYU, Columbia, Yale, Harvard, Boalt, USC, UCLA, lexis, or westlaw have a copy of the Cook Islands Trust Act.¹³⁴ To simply find the law could require a substantial amount of work.

¹³⁴ This problem of inaccessible law is true with many of the jurisdictions listed in section II.B. *infra*.

3. Retention and payment of a Cook Islands law firm (plus "Security for Costs"): Martindale-Hubbell does not list even one lawyer in the Cook Islands. No lawyer in New Zealand states a specialization in Cook Islands Law. It is difficult to find a lawyer. However, after many expensive calls and substantial time, the judgment creditor's United States lawyers will locate a Cook Island lawyer. Almost undoubtedly he works for one of the five licensed trust companies. This Cook Islands lawyer would inform the United States lawyers supervising the domestic aspects of the collection effort that it is unethical in the Cook Islands to take a matter on a contingency. Thus, he will ask for a substantial retainer up front. In addition, under the English system adopted in the Cook Islands, the losing party will most probably have to pay for the legal fees of the winner. In this case, the judgment creditor would, as a condition to proceeding with his case, very possibly have to post security (normally cash) for the full amount of the defendant's projected fees and costs.¹³⁵ This fund will be available to pay the defendant's cost of defense in the event that the defendant prevails.

¹³⁵ Rule 37 of the Cook Islands Code of Civil Procedure provides:

- "(1) If the plaintiff in any proceedings is resident out of the Cook Islands, the Court, on the application of the defendant, may order security to be given for the costs of the proceeding to the satisfaction of the Registrar, and may order the proceedings to be stayed until such security has been given. The defendant shall apply promptly after the fact of such residence out of the Cook Islands has come to his knowledge.

4. Procedural barriers:¹³⁶ In every case which has come before the Cook Islands courts, the judgment creditor has obtained a copy of the international trust¹³⁷ often *via* discovery in the United States. Armed with a copy of the international trust, the attorneys for the aggrieved creditors have brought suit in the Cook Islands alleging fraud and contemporaneously seeking a *Mareva* injunction to freeze the assets of the trust and preclude the Cook Islands trustee from activating the Cuba clause flight provisions.¹³⁸ In each case the application for the *Mareva* injunction has been made *ex parte* without notice to the Cook Islands trustee.

Several *ex parte Mareva* injunctions have been granted but no creditors have managed to reach the trust assets. "The judges of the High Court are now familiar with the provisions of section 13K(3) and (4) [of the Cook Act]¹³⁹ such that judgment

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- (2) A person ordinarily resident out of the Cook Islands may be ordered to give security though he may be temporarily resident in the Cook Islands."

¹³⁶ The following history of attacks on asset protection trusts on the Cook Islands was provided by Timothy Arnold, Partner, Clarkes, Barristers & Solicitors, Rarotonga, Cook Islands.

¹³⁷ The actual trust document is not filed with the Cook Islands Registrar of International Trusts.

¹³⁸ *See*, section III.A.3(h)(i) *supra*.

¹³⁹ These sections deal with the conditions precedent to implementing an action and basically require the filing of affidavits in the *in camera* proceeding

creditors are finding it increasingly difficult to gain a tactical advantage in the Cook Islands High Court."¹⁴⁰ Furthermore, since a *Mareva* injunction is normally not granted without security for costs, judgment creditors are routinely required to pay substantial security. "In view of the procedural hurdles faced by judgment creditors in a jurisdiction which promotes itself as specializing in asset protection trust work, plaintiffs in the few cases filed in the Cook Islands High Court have in each case chosen to settle their claims or leave them inactive, in frustration, choosing instead to return to the United States in an attempt to pursue trustees, protectors or beneficiaries there.¹⁴¹ Any proceedings will be heard *in camera* and no formal or published records will be kept.¹⁴²

5. Substantive barriers: If the judgment creditor survives the procedural attack, his lawyers still have the overwhelming burden of the clear language of the statute specifically validating trusts exactly like the one set up by the settlor. It is important, in this context, to realize that the Cook Act has been enacted to encourage the registration

establishing that the statute of limitations has not run and, if fraud is alleged, evidence that it can be established under the standards of the Cook Act.

¹⁴⁰ Timothy P. Arnold, Partner, Clarkes, Barristers & Solicitors, Rarotonga, Cook Islands, personal communication (June 22, 1993).

¹⁴¹ Personal communication from Timothy Arnold, Partner, Clarkes, Barristers & Solicitors, Rarotonga, Cook Islands (June 22, 1993).

¹⁴² *See*, section II.B. *supra*.

of international trusts and thus any possible ambiguity in the legislation will be considered by the court giving the statute such "fair large and liberal constructions and interpretations as will best ensure the attainment of the object of the Act and of such provision or enactment according to its true meaning and spirit."¹⁴³

6. The disappearing trust: Assume the judgment creditor posted his security for costs, assume he survived the procedural attack, assume a Cook Islands court decided to hold in his favor (thereby ruining a major industry of the jurisdiction within which the court is established), then the judgment creditor will still have the same problem all over in another jurisdiction. In particular, the trustee will have resigned and another trustee will have taken its place in an entirely different jurisdiction. This can happen automatically in certain circumstances. Most frustrating of all, the Cook Islands trustee cannot be compelled, and indeed must not, under pain of criminal penalties, disclose the jurisdiction to which the trust situs was changed.¹⁴⁴ It is probable that

¹⁴³ Acts Interpretation Act 1924.

¹⁴⁴ If at this time the judgement creditor's lawyers start thinking that the trustee on the Cook Islands and the settlor are somehow plotting or conspiring against the judgement creditor to defraud him they should examine Section 13D of the Cook Act insulating the trustee from the impact of a foreign judgement, and the entire Cook Act, particularly Article 13, specifically authorizing, and in fact requiring, that the trustee do what he has done.

A thornier issue arises if a trustee or officer of a Cook Islands trust Company is "tagged" with service of process while visiting the United States. Most nations of the world will not enforce a judgement based on "tag" service, particularly if the

neither the settlor nor his lawyer will have information at this time concerning the new situs of the trust or the situs of the assets. Of course, upon request, the settlor would be given a blind accounting and would probably be told details of the new situs as long as the trust document permitted the disclosure of this information under the current circumstances.

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defendant does not appear and defend on the merits. *See, Lowenfeld, supra.*