Has Offshore Trust Litigation Spoiled the Fun? Recent Decisions Regarding Offshore Trusts

by Gideon Rothschild and Daniel S. Rubin

The effectiveness of the so-called "spendthrift trust" in protecting an individual's beneficial trust interest from his creditors has been firmly established in the United States ever since the Supreme Court's 1875 landmark decision in *Nichols v. Eaton*. The *Nichols* case, however, involved a spendthrift trust created for the benefit of a third party beneficiary rather than for the settlor herself. With limited exceptions, the laws of the U.S. do not permit an individual to place assets in trust for her own benefit (a "self-settled trust"), and effectively place those assets beyond the reach of creditors. This is true whether the settlor's creditors are present or future, reasonably anticipated or impossible to foresee. For this reason, U.S. residents must look to the laws of select off-shore jurisdictions which, seeking to generate trust business and attract U.S. capital, have statutorily extended common law spendthrift protections to self-settled trusts provided that the trust was not created or funded in fraud of existing creditors.

In the abstract, at least, a self-settled spendthrift trust, if valid under the law designated by the settlor as governing the trust, should also be held valid by a United States court. The domestic law of trusts provides that a settlor may designate the law of any jurisdiction as governing the settlement notwithstanding conflict between the designated law and the law of the settlor's residence. Practically speaking, however, a self-settled spendthrift trust will still have to pass what may euphemistically be called the "smell test" if the settlor may ultimately have to obtain judicial sanction of the protections afforded by the trust.

Obviously, the smell test is an amorphous one and may mean different things to different courts depending on the varying predilections of the individual judge that is presiding. Moreover, pursuant to the axiom that "the squeaky wheel gets the grease", the majority of those few courts that have ruled so far on creditor challenges to offshore, self-settled spendthrift trusts have been forced to adjudicate cases involving egregious facts. Of course, this undermines the value of their rulings as precedent for future settlors who engage in permissibly prudent asset protection planning using a similar vehicle. Nevertheless, if only by negative implication, a review of those cases may help to delineate the circumstances in which an offshore, self-settled spendthrift trust will be upheld by a U.S. court, and the circumstances in which it will not.

In the first instance, it should surprise no one that courts will not sanction a trust if funded in a manner which has been, or likely will be, found to be one or more of a series of fraudulent transfers. In this regard, a triad of recent United States Bankruptcy Court cases serves to emphasize the point.

In the 1996 United States Bankruptcy Court case of *In re Portnoy*, the court summarized the pertinent facts by stating that at the heart of the case lay an irrevocable offshore trust into which the debtor placed " . . . virtually all of his assets at a time when he knew that his personal guarantee of his corporation's indebtedness was about to be called." Against this backdrop, the court considered whether it should rule on the Bankruptcy Code's spendthrift trust exemption by applying New York law (which does not allow self-settled spendthrift trusts), or by applying the law of Jersey, Channel Islands. The court, in a result-oriented analysis of conflict of law issues, found New York law applicable and on public policy grounds held the trust's assets includable in the debtor's bankruptcy estate.

In the 1998 Bankruptcy Court case of *In re B.V. Brooks*, the issue before the court was again whether to apply domestic (in this case, Connecticut) law, or foreign law to the spendthrift trust exemption under the Bankruptcy Code. Citing *Portnoy* as precedent, and following another seemingly result-oriented analysis of conflict of law rules, the court found the assets of the debtor's two trusts includable in the bankruptcy estate notwithstanding the fact that they were valid spendthrift trusts under the laws of Bermuda and the Jersey, Channel Islands. Although very little of the case's factual background was actually reported, the Bankruptcy Court did note that the debtor/settlor was the primary beneficiary of each of the trusts and had the right to receive all of the income. In addition, the unreported facts apparently caused the court to perceive the funding of the trusts as fraudulent since the Court twice characterized the debtor's acts in creating the trusts as a "scheme". This perception was likely buttressed by the timing of the case, since the trusts were funded in 1990 and an involuntary bankruptcy petition was filed against the debtor the following year.

In a later 1998 Bankruptcy Court case, *In re Stephan Jay Lawrence*, following a forty-two month arbitration and

just sixty-six days before an award in excess of US $20 million was entered against him, the debtor funded an offshore trust citing first the law of Jersey, Channel Islands, and about a month later, the law of Mauritius, as governing. Citing both *Portnoy* and *B.V. Brooks,* the Bankruptcy Court found that the sole purpose of the trust was to shield the debtor's assets from a creditor which "was about to obtain a staggering $20 million arbitration award against him" and that "[t]he timing of the trust's creation is further evidence of this intent." The court also found the debtor's testimony before the court not to have not been credible (and on several occasions perjurious), and that the debtor was "shockingly less than candid" with the court. The court, therefore, entered judgment against the debtor, thereby denying him a discharge in bankruptcy.

Other cases with egregious fact patterns will likely garner similar results, although sometimes based on different legal theories. For example, the courts will not uphold a trust funded with illegally obtained assets. In *Grupo Torras, Grupo Torras, S.A. v. S.F.M. Al Sabah, Chemical Bank & Trust (Bahamas) and Private Trust Corp.*, the plaintiffs challenged a Bahamian trust on various grounds, including the fact that it was funded with assets obtained by the settlor through defrauding the plaintiffs. Citing long-standing principles of English common law, the Bahamian Supreme Court held that the spendthrift trust protections afforded by Bahamian law do not apply to illegally obtained assets.

In stark contrast to the foregoing cases, the factual background of *Riechers v. Riechers*, a New York matrimonial action, allowed the court to perceive the trust in a much more favorable light. In 1992, following several medical malpractice suits against him, the settlor established a self-settled spendthrift trust under the law of the Cook Islands to guard against the likelihood of future medical malpractice claims. At the same time, the settlor and his wife were having marital difficulties, but the wife was aware that the trust was being established. In 1994, the wife commenced an action for divorce and sought to have the trust included in computing an equitable distribution award. The court noted that since it was established "for the legitimate purpose of protecting family assets", the court did not have jurisdiction over the trust and that issues such as whether the wife would be entitled to any trust property should be left to a Cook Islands court to decide.

The *Riechers* decision, perhaps more than anything else, proves the adage that "bad facts make bad law" and strongly suggests that U.S. courts are not inclined to uphold the protections afforded by an offshore, self-settled spendthrift trust, provided that the trust was created and funded under appropriate circumstances. First, the trust should be as separate as possible from its settlor. This requires an independent, if friendly, trustee, who has control of the trust's assets exclusive of the settlor. By wrapping the assets within a limited partnership of which the settlor is a one percent general partner and the trust is a ninety-nine percent limited partner, the settlor can actually retain effective control of the assets without affecting the independent control of the trust. Additionally, it would be advisable to give the trustee discretion to distribute trust assets to persons in addition to the settlor (called a "sprinkling power"), such as the settlor's spouse and descendants. Second, the circumstances surrounding the creation or funding of the trust must be as distant as possible from a potential creditor's claim. What this means is that the trust should be set up as early as possible for the purpose of guarding against future, rather than current, creditors.

At the end of the day, however, the offshore trust's effectiveness as a tool to thwart future creditors will most likely not depend on whether a U.S. court gives credence to the application of foreign trust law when adjudicating a claim against the settlor. Provided that the trust's assets are located offshore (whether that be in the jurisdiction of the trust's governing law or an established financial center such as Switzerland or Luxembourg), a creditor with a U.S. judgment will still be faced with significant hurdles before actually being able to levy on any of the trust's assets.

The best evidence of the practical impediments to enforcing a U.S. judgment against an offshore trust is the fact that since the Cook Islands enacted the world's first asset protection trust legislation in 1989, and notwithstanding the creation of thousands of such trusts since that time, there has only been one reported case in that jurisdiction, *515 S. Orange Grove Owners Association v. Orange Grove Partners*, which deals with an asset protection trust. Furthermore, although *Orange Grove* is sometimes suggested to be a creditor victory because the trust was restrained and the creditor's claims were allowed to proceed, no Cook Islands judgment was ever entered other than on the aforementioned procedural issues. This supports the purported result that the creditor ultimately settled its claim for a fraction of the trust's assets. Moreover, since the court's holding was wholly based upon an ambiguity in the governing statute— an ambiguity that was subsequently clarified by statutory amendment— future creditors who make it as far as the Cook Islands will not be able to follow in the footsteps of the *Orange Grove* creditors.

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

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