KEY POINTS

What is the issue?

Notwithstanding improved firewall legislation and debtor-friendly provisions in typical offshore trust documents, self-settled offshore trusts are increasingly ineffective in protecting assets from creditors of US citizens, residents and those with significant US connections.

What does it mean for me?

Wealth planners are encouraged to pay close attention to ongoing US cases and statutory law involving the use of offshore trusts and to advise US clients of the risks and possible alternatives when considering these vehicles for asset protection.

What can I take away?

Careful drafting and alternative strategies are proving increasingly appropriate for US clients.

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Settlors unsettled

JOAN CRAIN ASKS WHETHER THE 'IMPOSSIBILITY DEFENCE' IS STILL VIABLE FOLLOWING SEVERAL RECENT US COURT CASES INVOLVING SELF-SETTLED OFFSHORE TRUSTS

Despite increasing reporting requirements and the heightened risk of government scrutiny, wealthy US citizens and residents continue to establish offshore trusts to protect their assets from creditors. In addition to the need for careful drafting, responsible administration and an informed choice of jurisdiction, yet another challenge threatens the effectiveness of these structures in shielding US settlors' nest eggs. This article explores current trends and offers suggestions for practitioners when drafting, administering and promoting offshore trusts for US persons.[1]

CASES OF CONTEMPT

Fuelled by a number of bad actors seeking to defraud innocent parties through the use of offshore trusts, US courts are increasingly inclined to disregard the standard protections in offshore trust documents in the pursuit of 'fairness'. Regardless of jurisdictional firewalls and anti-creditor provisions, US judges may hold settlors in contempt of court until creditors are paid.[2]

The bankruptcy cases of *In re B V Brooks*[3] and *In re Larry Portnoy*[4] provide early evidence of this trend. Although both cases involved choice-of-laws issues, they also revealed the strong public policy in many US states against self-settled trusts that shield beneficiary settlors from creditors. As cited by the judge in *Portnoy*:

> *'Under New York law: "when a person creates for his own benefit a discretionary trust, his creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit, even though the trustee in the exercise of his discretion wished to pay nothing to the beneficiary or to his creditors, and even though the beneficiary*

could not compel the trustee to pay him anything,"… [I]t is against public policy to permit the settlor-beneficiary to tie up her own property in such a way that she can still enjoy it but can prevent her creditors form [sic] reaching it."[5]

The 1999 case of *FTC* v *Affordable Media LLC* (often called the *Anderson* case in reference to Michael and Denyse Anderson, the owners of Affordable Media)[6] is notable for interpreting the contempt charge to warrant imprisonment for settlors of offshore trusts who claim they cannot comply with court orders to repatriate funds to satisfy judgment creditors. After being found guilty of operating a telemarketing scam, the Andersons claimed they could not refund their investors' money as all their assets were in a Cook Islands trust with a foreign trustee who would not make distributions to them when they were 'under duress'. However, given the fact they were the trust protectors with the power to appoint new trustees, the court deemed that they could, in fact, access the assets and found them in contempt of court. The Andersons spent over a year in jail before complying with the order to repatriate the assets.

Similarly, Stephen Lawrence, an options trader who incurred large debts during the financial crisis of 2008, claimed he was unable to obtain the funds in his Mauritius trust to satisfy a USD20 million judgment. After years of legal wrangling, Lawrence was held in contempt of court. He endured over six years in jail, maintaining that it was impossible for him to obtain any assets from the trust; although, like the Andersons, he had retained significant control over the trust through the power to remove and replace trustees.[7]

However, even if settlors retain no control and there are independent trustees, some US courts may dismiss the argument that settlors cannot access assets they placed in self-settled offshore trusts, noting that the 'impossibility defence' is not valid in contempt proceedings where the person charged with contempt created the inability to comply.[8] This was mentioned in the above cases but not fully developed, as the settlors' retained powers obviated the need to explore further.

The impossibility defence is a powerful way for US courts to seek equitable solutions when confronted with recalcitrant settlors of offshore trusts and is becoming a useful tool for some judges throughout the US. A recent estimate includes 30 reported US cases of offshore trusts that failed to protect the settlors from being held in contempt. Many of these had sought the impossibility defence.[9]

'As in most wealth planning, an offshore trust is best established as part of an overall estate plan, rather than purely for creditor protection'

In the recent example of *In re Marriage of Harnack*,[10] the judge viewed Steve Farady's behaviour as 'so egregious, so contemptuous of the law and the court' that he was found in indirect civil contempt, with the order to transfer approximately USD10 million worth of stock to his ex-wife Pamela Harnack as part of their divorce settlement. Farady's claim that it was impossible for him to comply because all his assets were held in a blind trust in Belize was disregarded, as he was deemed 'the architect of his own predicament'.[11] He was committed to Cook County Jail.

In summary, as noted by Circuit Judge Charles E Wiggins in *FTC*:

'In the asset protection trust context, moreover, the burden on the party asserting an impossibility defense will be particularly high because of the likelihood that any attempted compliance with the court's orders will be merely a charade rather than a good faith effort to comply. Foreign trusts are often designed to assist the settlor in avoiding being held in contempt of a domestic court while only feigning compliance with the court's orders."[12]

DILIGENT DRAFTING

Notwithstanding the increased scrutiny and even scepticism by US courts, self-settled offshore trusts remain attractive for some US persons in certain situations. They may still work when settlors, and preferably their families, sever connections with the US. This requires assuring that their assets are beyond the control of US courts and that their trustees, asset managers and all other office holders are non-US persons.

From a drafting perspective, a pot trust with multiple beneficiaries may be more likely to avoid being considered accessible to creditors than a trust with a single beneficiary. In addition, settlor/s should retain minimal to no control over the assets or administration. Further, settlors who place only a portion of their assets in an offshore trust stand a better chance of success, should creditors seek access. As in most wealth planning, an offshore trust is best established as part of an overall estate plan, rather than purely for creditor protection. Some planners also advise abandoning the use of duress clauses and flee clauses,[13] as these seem to provoke some US judges as red flags for trusts set up purely to thwart creditors.

It is important to highlight that there are some notable cases where offshore trusts succeeded in sheltering the settlor-beneficiary's assets.[14] These are fact-specific, typically involving a relatively small portion of settlors' assets and restricting settlors' control. Given the appeal of these vehicles among wealthy US clients and the related promotion by some wealth planners, there are likely a number of other self-settled offshore trusts for US clients that have not been challenged and so would also be considered successful.

CONCLUSION

In summary, self-settled offshore trusts may be useful as deterrents to US persons' creditors who are not willing or able to spend the resources or endure the lengthy time required to pursue offshore trustees or embark on lengthy litigation. However, when determined creditors seek access to the trust assets, the success of such vehicles for US settlors depends not only on the drafting and choice of offshore jurisdiction but also, increasingly, on the actions of the settlors themselves.

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1 'US persons' as used in this article includes US residents as well as US citizens. Some of these issues may also apply to non-US persons who own US assets and/or have other connections with the US. **2** The purpose of civil contempt in the US court system is to force a specific action. Once this action has been done, the contemptor must be released. **3** 217 Bkrptcy. Rptr. 98 (Bkrptcy. DC Conn., 1998) **4** 201 Bkrptcy. Rptr. 685 (Bkrptcy, DC N.Y., 1996) **5** Above, note 4. **6** F.3d 1228 (9th Cir. Nov. 1999) **7** *In re Lawrence*, 279 F.3d 1294 (11th Cir. Fla. Jan 23, 2002) **8** An impossibility defence is a criminal defence occasionally used when a defendant is accused of a criminal attempt that failed only because the crime was factually or legally impossible to commit. **9** Jay Adkisson on *In re Marriage of Harncak*: 'Ex-Spouse Sentenced to Jail in Connection with Belize Offshore Trust', *LISI Asset Protection Planning Newsletter*, Iss425 (20 July 2022) at www.leimbergservices.com **10** *In re Marriage of Harnack*, 2022 Ill. App. 210143 **11** Above, note 9. **12** *FTC* v *Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. Nov. 1999) **13** Flee clauses in offshore trust deeds trigger a change in jurisdiction and trustee when the trust assets are under threat, such as political instability or attempted access by a creditor. **14** Examples of 'successful' offshore self-settled asset protection trusts include *In re Rensin*, 600 B.R. 870 (S.D. Fla. 2019); and *Campbell* v *Commissioner*, T.C. Memo, 2019.