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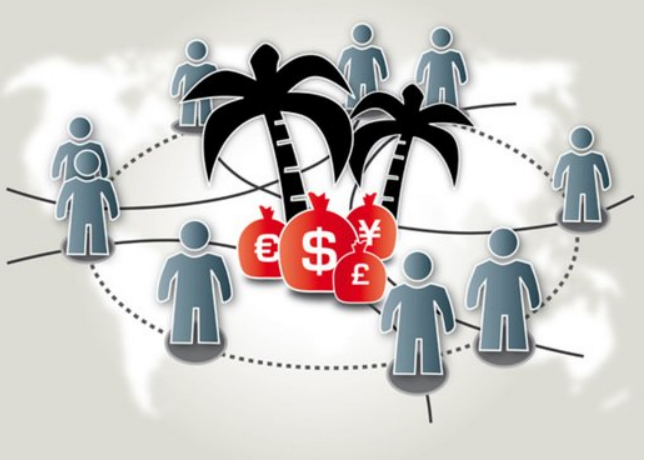
Self-Settled Spendthrifts, Illusions and Shams: When an Asset Protection Trust Affords No Protection

Essential considerations for judgment creditors seeking to attack offshore asset protection trusts.

By **Peter Tyers-Smith and Jonathan D. Cogan** | January 18, 2019



The offshore asset protection trust (OAPT) is typically perceived as a "Grishamesque" invention habitually used to lock away billions of dollars on palm-fringed shores, far away from tax authorities and creditors. The practical reality is far less sensational and trusts established under the laws of leading international financial

centers such as the British Virgin Islands (BVI) and the Cayman Islands are routinely used as sophisticated but entirely legitimate wealth management, estate planning and diversification tools.

As stakeholders vie for market position on the international stage, the question of whether OAPTs are becoming redundant in favor of U.S. domestic asset protection trusts (DAPTs) which provide similar (if not identical) levels of utility in legitimate wealth management and planning strategies, comes to the fore. But how do the OAPT and DAPT compare from a vulnerability perspective when creditors seek to monetize their arbitral awards and judgments from the assets of such trusts?

Settlor-Beneficiaries

In the United States, although as many as 17 states have enacted specific legislation permitting the formation of self-settled DAPTs (DAPT states), these types of trusts are often susceptible to attack where the resident of a non-DAPT state attempts to use the more favorable laws of a DAPT state to create an asset protection trust. In non-DAPT states, subject to a limited number of exceptions, a judgment creditor may reach the trust assets of a self-settled DAPT, whether revocable or irrevocable, in order to satisfy its judgment to the maximum amount that the settlor-beneficiary could receive by way of distribution. It makes no difference whether the settlor-beneficiary's interest arises under a purely discretionary DAPT or a foreign-law governed OAPT, provided the settlor is subject to the jurisdiction of the U.S. court (see for example New York EPTL §§7-3.1 and 10-10.6).

In most offshore jurisdictions, there is no statutory prohibition against self-settled trusts and indeed the settlor of an OAPT may also be a beneficiary without automatically undermining the existence of the trust, and more

specifically, without exposing the assets of the trust to enforcement processes by his or her creditors. To this extent and in the light of the "uneven" playing field amongst DAPT and non-DAPT states, it would appear that the OAPT has more appeal to settlors that wish to maintain an interest in the assets the trust, whilst also shielding that interest from her or his creditors. From a creditor perspective, one can readily appreciate the lack of appetite in seeking to monetize awards and judgments from OAPTs from within the jurisdiction whose laws appear to allow a settlor to transfer her or his assets to a trustee whilst maintaining an interest in those assets.

Indeed, a creditor's lack of interest in seeking to challenge OAPTs in the jurisdiction of creation and administration is likely to be buttressed by the perception that Courts will unhesitatingly uphold any arrangement as a valid OAPT under which a settlor is also a beneficiary and holds reserved powers (including powers of revocation) relating to the administration of the trust. The long-held view is that most offshore jurisdictions have enacted debtor-friendly legislation that will ensure a judgment creditor's ability to satisfy a judgment from purported trust assets fails.

But are OAPTs truly that infallible to creditors' claims?

Illusory Trusts

Like several other leading international financial centers, the BVI and Cayman Islands adopt principles of English common law. Under those principles, where the proper interpretation of the terms of the trust document shows that the fundamental characteristics of a trust are illusory, a creditor will effectively be able to treat the assets of purported trust as those of the settlor. For example, where the terms of the purported trust document permit a settlor-beneficiary to veto the exercise of the trustee's discretion

and to dismiss or replace the trustees without cause, and to ignore the interests of other beneficiaries in doing so, the true effect of the document will preserve the settlor's ownership of beneficial interest in the trust property rather than divest it (*JSC Mezhunarodniy Promyshlenniy Bank v. Pugachev & Ors* [2017] EWHC 2426 (Ch) at 244-5, 278). In these circumstances, the document purporting to create the trust will fail to do so because the settlor-beneficiary will retain effective control over and ownership of the assets.

Although the BVI and Cayman Islands have enacted statutes which create a presumption that a trust is valid even though the settlor is also beneficiary and has reserved powers, it is not conclusive. In the BVI, the fact that a settlor is also a beneficiary with reserved powers is not "*necessarily inconsistent with the existence of a trust*" (Trustee Ordinance 1961 (Cap 303) §2(4)). But where a document purporting to create an OAPT, when properly interpreted, shows that a settlor-beneficiary retains full control over the assets of the purported trust, the document will fail to satisfy the requirements of a valid trust under BVI law. The same is true under Cayman Islands law because the presumption of validity and effect of an OAPT (Trusts Law (2017 Revision) §§13-14) only applies where the settlor-beneficiary retains a "*limited beneficial interest in the trust property*." A settlor-beneficiary that can exercise non-fiduciary powers to fully control the trust effectively retains *complete* ownership of the beneficial interest in the purported trust property and therefore the presumption of validity stands to be rebutted.

Sham Trusts

Although most U.S. states taker a harder, more creditor-friendly line on "self-settled" trusts, they are indisposed to finding that a trust under which a settlor retains powers of control is a "sham" (see Christopher Reimer, "International Trust Domestication: Migrating an Offshore Trust to a U.S. Jurisdiction," 25 Quinnipiac Probate L. J. at 188).

However, in the BVI and the Cayman Islands, where a settlor-beneficiary retains powers that, when properly interpreted, are of a fiduciary nature (i.e., powers which must be exercised for the benefit of all beneficiaries, not just the settlor), but actually exercises those powers selfishly, the document purporting to be a valid OAPT may nonetheless be a "sham."

Provided the creditor can show that, regardless of what the instrument creating the OAPT states, the true intention was the for the settlor-beneficiary to retain control over the assets of the purported OAPT, a judgment creditor can reach those assets to satisfy her or his judgment or award. Although proving intention may be challenging, a carefully-formulated discovery strategy can reveal the all too familiar pattern in which a submissive trustee unhesitatingly follows the orders of the settlor-beneficiary. Such a pattern allows the BVI and Cayman Islands Court to infer that when the OAPT was created, the settlor-beneficiary and trustee always intended that the former would retain control contrary to the appearance created by the trust instrument.

Fraudulent Transfers

Both the BVI and Cayman Islands have modern well-established legislation which enables a creditor to avoid transfers and dispositions of property made with the intent to defraud creditors. Therefore, even if a creditor is unable to undermine the existence of the OAPT through deploying the

illusory or sham arguments, it is still possible to set aside the transfer of the settlor's property to the trustee on the basis that it was made with the intent to defraud.

Conclusions

Whilst settlors and trustees decide whether the time has come to repatriate assets held in a traditional OAPT to a U.S. DAPT, it is important for award and judgment creditors to appreciate the landscape in which they are able to challenge both types of trusts in order to monetize their judgments. The time has come for judgment creditors to realize that there is nothing to fear and all to gain by taking the fight to the offshore jurisdiction in which the OAPT was constituted. In particular:

(1) OAPTs under which the settlor is also a beneficiary can be attacked by creditors *within* the offshore jurisdiction whose laws govern the creation and administration of the OAPT. The courts of these jurisdictions enforce a globally recognized policy that arbitral awards and judgments should be enforced and executed and creditors have recourse to a strong legal armory to achieve that end.

(2) Formulating and deploying an aggressive cross-border discovery strategy to uncover interests held by an award or judgment debtor in OAPTs is key to executing an effective monetization campaign.

(3) Where the terms of the document purporting to create an OAPT give a settlor-beneficiary significant powers that can be exercised selfishly and in a manner that effectively preserves complete beneficial ownership of

the trust property with the settlor, the trust will be ineffective under common law principles applicable in offshore jurisdictions such as BVI and the Cayman Islands.

(4) Where the terms of the document purporting to create an offshore asset protection trust give a settlor-beneficiary significant powers of control that have the characteristics of legitimate fiduciary powers but are exercised only in the interests of the settlor, the trust could be labeled a "sham" under applicable common law principles. In order to do so, it must be shown that the true intention of the settlor and trustee was for the former to retain full control over the assets of the purported trust.

(5) Demonstrating that a purported offshore asset protection trust is illusory or a sham under the governing foreign law presents an alternative route to enforcing judgments against U.S.-based settlors where the only other means by which to compel compliance is through the more draconian contempt jurisdiction of the U.S. court. However, this may not always bring about the desired result of monetization, particularly where the trust instrument contains an anti-duress clause.

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