Drafting Offshore Trusts – Are We Productively Evolving or Just Perpetuating Our Predecessors' Misconceptions?

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Introduction

No one can be sure of the exact time, as perhaps there is none, but let's say 15 years ago offshore asset protection trusts were somewhat of an exotic product, offered by literally a handful of attorneys in the U.S. One Colorado firm well experienced in offshore trusts even offered to partner with other firms and attorneys across the country under a plan where the Colorado firm would prepare and draft all offshore documents for the referring attorney's client, the referring attorney would prepare the usual "local" documents, and the substantial fee would be shared according to a pre-arranged schedule. For many it worked well.

As the field of asset protection planning grew, however, the available educational seminars and extensive materials allowed the "local" attorneys to learn enough to begin preparing all the documents on their own. With extensive available treatises,[1] along with countless other journal and law review articles, today's estate planning practitioner has practically no excuse for not understanding virtually every aspect of offshore asset protection trusts. Despite this, a careful review of the typical documents used today and their treatment of some of the essential issues in drafting offshore asset protection trusts shows that we are still overlooking a lot and unintentionally perpetuating myths and misconceptions in our use of many "standard" provisions.

Using forms – Don't take every rock for granite

Where would we be without our form books? In fact, most of us use form books on a regular basis, since we don't have the time to research and draft for every case. The problem is, if the forms are not correct, it is we who are exposed, not the form books or their authors. Unfortunately, two problems have contributed to this situation. First, as a group we lawyers have a strong tendency to take it for granted that forms promulgated by form books and by other law firms "experienced" in a specialty, such as asset protection planning, are per se adequate, when in fact, that is definitely not always the case. Second, the sub-specialty of offshore asset protection planning as we know it, is actually quite young, at least from a case-law standpoint, so some of the forms in use are actually untested and in many cases the result of best guess work. Therefore, without realizing it, we often find ourselves including provisions that are unlikely to accomplish their intended objectives and omitting others that should be included. This presentation is intended to shed light on some of the myths, mistakes, and oversights that have been perpetuated in the drafting of certain provisions commonly used in asset protection trusts and to offer some suggestions on improving these provisions and the addition of at least one new one. The discussion will include 1) power of appointment provisions; 2) protector provisions; 3) flee (flight) provisions; and 4) the so-called "Jones clause".

Power of appointment provisions

There are two parts to this discussion. The first deals with the tax issues associated with the settlement of an offshore asset protection trust, and the second deals with the exercise of a power, tax issues notwithstanding.

Tax issues

Virtually every offshore asset protection trust is irrevocable, typically providing that the client and her family are the beneficiaries with no right to force a distribution from the trustee. While it is clear for U.S. income tax purposes that such a trust is treated as a grantor trust and is therefore income tax neutral[2], it is not at all clear that the funding of the trust will be gift tax

neutral. For the transfer to the offshore trust to be an incomplete gift for U.S. tax purposes, the trust must include a provision that renders the gift incomplete, and many drafters, much to their dismay as well as that of their malpractice carriers, fail to include such a provision, resulting in a huge taxable gift on funding. Note that a correction of this problem by subsequently adding such a provision through an amendment made (typically) by an independent, non-adverse party (e.g., a protector or trustee) will not necessarily solve the problem, since the gift was already made and the described power to amend will not change that. Instead, an argument would have to be made that it was a "scrivener's error" (three cheers for the person who came up with that expression!), and the provision was inadvertently omitted in the original draft. To avoid this problem at the outset, most attorneys will have the settlor reserve a special testamentary power of appointment.[3] This is a relatively simple solution and does not by itself expose the trust assets to the settlor's creditors even if the power is exercised.[4]

Exercise of a power.

Most offshore asset protection trusts contain one or more powers of appointment. Although such powers are typically special (non-general) powers, whether special or general the terms governing the exercise of the power and the trustee's obligation to investigate whether or not a power has been exercised are often incomplete, unclear, or overlooked altogether. For example, can the power be exercised by an attorney in fact of the powerholder? By a guardian or conservator? Is the exercise of the power only effective upon receipt by the trustee? Must the trustee accept the exercise of a power regardless of its date? Or may the trustee reject it as "stale", or request that the powerholder re-affirm the exercise? May the trustee accept such an exercise after the powerholder's death? In the case of a testamentary power, what duty does the trustee have to investigate whether the powerholder's Will contained an exercise of the power before the trustee continues with the administration of the trust (particularly, the dispositive provisions)? And what if the Will is contested, thereby suspending, at best, a testamentary exercise? If this happens, how does the trustee administer the trust in the meantime?[5] To avoid needless, time-consuming, and expensive court proceedings to clarify such provisions, they should be carefully addressed and complete.

Protector provisions

It is really fascinating to note how quickly we all accepted the "unique" position and role of the trust protector, especially in asset protection trusts. Suddenly we have an "outside" party who can do everything from vetoing trust distributions, to adding and deleting beneficiaries, to amending the trust, all, presumably, in furtherance of the trust purposes. And where we have "irrevocable" trusts holding large chunks of a client's assets managed by strangers in a jurisdiction thousands of miles away, the presence of a protector, viewed as a supervisor or overseer, can provide a significant degree of comfort to the client.

But despite the importance of the position and the special "tailoring" that often accompanies it, we seem to be inclined to blindly follow the conclusions and proposed provisions of those who have gone before us. For instance, until recently, many advisors and even a few commentators maintained that the protector is not a fiduciary, and in any event, they maintain that if there is a question about it, the protector's fiduciary responsibility can simply be drafted away. A practitioner who carefully considers the duties and role of an independent protector has to conclude just the opposite and should draft accordingly to avoid needless questions, delays, and legal expense. Of course, it is possible to give the protector personal (non-fiduciary) powers, but then the role is not really one of trust protector, rather, it is to protect the protector's own interests.[6]

Perhaps one of the riskiest and most vulnerable situations occurs when the protector is given broad powers and is a U.S. person (or organization) subject to jurisdiction of U.S. courts. For asset protection purposes, this could be disastrous, since a U.S. court could treat the protector as the debtor/settlor's agent and order the protector to act, subjecting the protector to contempt proceedings if he refuses to comply with the order.[7] Some advisors argue that under the usual anti-duress provision the offshore trustee would simply refuse to follow the protector's direction pursuant to the court order, and while this may be so, it would at the same time render totally useless the whole purpose of having the protector in the first place. This could be a serious loss, for example, in cases where the protector has the power to change the trust situs or to delete beneficiaries. Other advisors deal with this exposure by restricting the U.S. protector's powers

to negative powers (e.g., the power to veto proposed trust distributions), but once again, this basically emasculates the protector and misses the opportunity to build flexibility into the trust through the protector. All of this points strongly to the conclusion that the protector should not be a U.S. person, and the trust provisions should limit the eligible persons accordingly.

Flee (Re-settlement) clause

The "flee" or "flight" clause commonly found in offshore asset protection trusts is one of those provisions that really impresses just about everyone when they first hear about it. The basic concept suggests that if and when a creditor gets serious and attacks or threatens to attack the trust at its home base, the flee clause can be neatly and quickly exercised (before the creditor's suit hits the fan), and the whole banana thereby moves to a different foreign jurisdiction, thus frustrating the creditor's attack. This has to be one of the biggest myths in the offshore trust world. The fact of the matter is that the typical flee clause is cumbersome and extremely time consuming to effectuate. It should be called the molasses clause. By the time the flee clause gets even close to fruition, the creditor has likely obtained a "Mareva" injunction in the original jurisdiction, freezing the trust's assets and rendering the flee clause a flop. Want some high-profile real life proof? See the Orange Grove case, the Anderson case, and the Weese case.[8]

Let's take a quick walk through the operation of a flee clause to see why what we see is not what we get. First, before the clause can be implemented, a new jurisdiction with appropriate protective laws must be selected, along with a trustee in that jurisdiction. Note that in virtually all asset protection jurisdictions a corporate trustee, meeting all local registration requirements, will be required. Next, the proposed new trustee, before accepting the trust, will want to review the trust and all previous trust accountings. It will want to see the assents to the accounts as well as the existing trustee's due diligence reports. In addition, the new trustee will want to conduct its own due diligence to satisfy all legal and fiduciary duties, as well as clearance of all money laundering issues. And then, because of the oncoming litigation (which must be disclosed to the new trustee), the new trustee may or may not accept the trust.

On the "other side" of the transfer, the existing trustee will want releases from all ascertainable beneficiaries or their representatives and will probably want an indemnification agreement from the key parties, as well as the new trustee, in case the existing (exiting) trustee incurs expenses or legal fees in defending an action against it relating to the trust or to the exercise of the flee clause.

After these numerous and time-consuming tasks are accomplished, the transfer of assets from the existing trustee to the new trustee must then be carried out. Presumably, the trustee of the existing trust holds securities, and if they are to be transferred in kind, additional time is required. Although it would be faster if the securities could be liquidated and the proceeds transferred, the existing trustee may be very reluctant to do so without further indemnification if the liquidation would result either in taxable gains or losses. It may take just as long to draft and approve the necessary additional indemnification agreement between the parties as it would to transfer the securities.

In short, the creditor could just about row to the foreign jurisdiction then walk to the court to ask for his Mareva injunction before the flee clause did its intended job. So is there something else that would work better?

This author proposes what he calls a "Resettlement" clause to replace the flee clause. Typically the flee cause is implemented by the trustee, whose fiduciary duties and exposure to liability severely limit quick movement, as illustrated above. Instead, we can give a third party, which could be the protector, the independent power to appoint any part or all of the trust property to another trust, in one or more other jurisdictions, with substantially the same provisions as the existing trust. Remember, with a flee clause, we must continue to deal with the existing trust until the every last element of the move is completed. Until that occurs, we will be subject to the courts of the jurisdiction from which we are trying to flee. The exercise of a power, on the other hand, when compared to the flee clause, can be virtually instantaneous. This is not to say it would happen overnight, but more like a week or so, instead of several months or more, as with the flee clause.

Furthermore, with the exercise of a power neither the existing nor the new trustee would have to be involved in extensive agreements, obtain releases, etc., etc. They would merely have to satisfy themselves that the power was exercised in accordance with its terms. Finally, both the old and the new trustees would be indemnified and held harmless by the trust on compliance with the exercise.

The Jones clause

What the devil, you might ask, is a "Jones" clause? Although we could find no one who knew where the name comes from nor any meaningful resource on the subject, in the vernacular of the offshore asset protection clan, a Jones clause, sometimes also called a "contingent payment" clause, is a provision in an asset protection trust that allows the trustee to pay certain existing claims against the settlor, despite the protective nature of the trust. While this might at first glance appear to be an oxymoron, in some cases, the offshore trustee may require it, while in other cases, advisors themselves insist on it to avoid exposure to penalties, disciplinary action, or court sanctions for fraudulent transfers.

As noted earlier, there are no resources or studies on "Jones" clauses nor any reported cases we have been able to find. Despite this, there are a variety of very different "model" provisions used and shared by various firms, and a careful examination of these provisions successfully generates serious confusion. The intention of the typical contingent payment (Jones) clause is to permit payment from the trust for money judgments obtained by specified creditors or specified claims in existence at the time of the trust settlement, provided the judgment is final and no further appeals are available. But that does not mean that the judgment creditor merely phones it in to the offshore trustee and gets a check in the mail. The creditor would be required to appear in the foreign jurisdiction with certifiable evidence of his judgments, as well as evidence that it is the result of the claim contemplated in the contingent payment clause. Then he would be paid; I think.

Unfortunately, many, if not most drafters seem to overlook entirely the fact that unless the clause is drafted so that the trustee of the offshore trust has *no* discretion as to payment but rather is

compelled to pay under the terms of the applicable clause, the clause would be useless. This is because a number of the offshore jurisdictions provide by statute that payments may not be made to a creditor of the settlor if the creditor's claim is made outside the offshore limitations period for such claims. Further, most such jurisdictions do not enforce foreign judgments. In addition, most offshore trusts by their terms expressly prohibit payments to creditors of the settlor, which would conflict with the contingent payment clause. Accordingly, from a practical if not a legal standpoint a trustee could virtually never make a payment under a contingent payment clause unless it was absolutely mandatory and superceded any conflicts. In short, the clause should be clear and precise, provide for mandatory payment on satisfaction of the stated requirements, and say absolutely no more than it has to. And even then, we are not really sure of the outcome as there appear to be no precedents on which we can rely.

Conclusion

Drafting offshore asset protection trusts is a constant challenge and a constantly evolving specialty. As we see more cases and legislation on the subject and more creativity from drafters and advisors, our planning and drafting approach will continue to change. And if Delaware-type asset protection trusts are ultimately upheld by the courts, we will undoubtedly see even more special provisions and perhaps even the virtual demise of offshore trusts. Interestingly, if and when that monumental day comes and our courts must face that question, we will probably see hundreds of amicus curiae briefs filed by the offshore trustees in favor of the creditors!

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[1] *See e.g*., *Asset Protection*, *Domestic and International Law and Tactics*, Volumes I, II, III, IV, (Duncan Osborne, ed. Clark Boardman Callaghan 1996); Peter Spero, *Asset Protection: Legal Planning and Strategies,* Volumes I and II (Warren Gorham & Lamont 1994) (which includes sample documents); *Asset Protection Strategies – Planning with Domestic and Offshore Entities,* (Alexander A. Bove, Jr. ed. American Bar Association 2002); *Asset Protection Strategies Volume II,* (Alexander A. Bove, Jr. ed. American Bar Association 2004).

[2] Internal Revenue Code (IRC) § 679.

[3] Treas. Reg. 25.2511-2(b).

[4] *Restatement (Second) Property* § 13.1 (The American Law Institute 1977).

[5] Alexander A. Bove, Jr., *Exercising Powers of Appointment – A Simple Task or Tricky Business?*, Estate Planning, Vol. 28 No. 6 (June 2001); Alexander A. Bove, Jr., *Powers of Appointment: More (Taxwise) Than Meets the Eye*, Estate Planning Vol. 28 No. 10 (October 2001).

[6] See, e.g., *Rawson Trust v. Perlman*, Bahamas Supreme Court 25 April 1990; *see also*, Alexander A. Bove, Jr., "*The Trust Protector: Friend or Fiduciary?"*, Chapter 6 of *Asset Protection Strategies Volume II* (American Bar Association 2004).

[7] *See, e.g*., *FTC v. Affordable Media, LLC*, 179 F.3[d] 1228 (9th cir. 1999).

[8] *See 515 S. Orange Grove Owners Ass'n v. Orange Grove Partners*, Plaint No. 208/94 (High Ct. Rarotonga, Civil Div., Nov. 6, 1995); *FTC vs. Affordable Media, LLC*, 179 F.3d 1228 (9th cir. 1999); *Walker, Trustee v. Weese,* 286 Bankr. 294 (MD 2002).