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Trusts and Estates Forum

Special Drafting Considerations For Asset Protection Trusts -

The Offspring of Offshore Trusts

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[Published in Massachusetts Lawyers Weekly, September 6, 2004]

Language is the currency of the law. And perhaps no more so than in the challenging task of drafting an asset protection trust to be administered in a foreign jurisdiction (a "foreign asset protection trust" or "FAPT"). There are a number of issues involved not usually seen in the typical estate plan, including protection of the settlor's beneficial interest in a fully discretionary trust administered in a far away land, navigation around the domestic and foreign fraudulent transfer rules, and protection of the trust fund from creditors. The unique offspring of these issues have provided new trust provisions and considerations unfamiliar to many lawyers.

This article will explore four such trust provisions often used in an FAPT – three unique to the asset protection trust, and one already familiar to the trust bar. With each, the authors will first

outline the problems the provision seeks to address, then turn to a consideration of the factors a lawyer must consider when drafting the provision.[*]

The Protector

For any lawyer who practices asset protection law, a common concern of clients who contemplate the settlement of an offshore trust is one, well, of trust: "How will I know the trustee will manage the trust fund wisely and exercise its considerable discretion in the best interest of the beneficiaries?" Of course, simple due diligence regarding the choice of a proper jurisdiction and the selection of a competent, bonded, trustee will provide a client some peace of mind. Nonetheless, if there was someone else to oversee the trust, someone whose sole purpose was to monitor the trustee and insure the trust's proper administration, then the client may feel better about sending her hard earned assets overseas. That someone is a trust protector.

A provision for a trust protector will often meet the client's concerns for "control" when, in fact, lack of settlor control is the name of the game for asset protection purposes. Protectors are not new. Almost twenty years ago the Cook Islands enacted a statutory definition of protector, and other offshore jurisdictions followed suit. For example, Nevis law defines the protector as following:

> " 'protector' in relation to an international trust means a person who is the holder of a power which when invoked is capable of directing a trustee in matters relating to the trust and in respect of which matters the trustee has a discretion and includes a person who is the holder of a power of appointment or dismissal of trustees;"

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

[*] Attorneys who would like to see related sample forms prepared by the authors may request them by emailing levin@bovelaw.com.

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. *See, e.g., FTC v. Affordable Media, LLC,* 179 F.3d 1228 (9th Cir. 1999). 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 or entities accordingly.

With this in mind, the issues for a drafter to consider in the development of protector provisions in an offshore trust include:

- Should certain persons or categories of persons be disqualified from holding the position of protector?
- Is the protector a fiduciary? Can you negate that status by definition within the trust?
- Who appoints the protector and successors?
- Can a protector be removed? By whom? And how?
- Will there be a successor protector or is the position personal to original protector?
- What functions of the trustee, if any, do you want the protector to oversee?
- Regarding oversight, should the protector be required to consent to trustee action, or object? What about inaction of the protector?
- What powers will be held solely by the protector? For example, will the protector alone have the power to change the situs of the trust?
- Will the protector be paid?

- Can the protector employ advisors?

For more on protectors, see *The Trust Protector: Trust(y) Watchdog or Expensive Exotic Pet*?, Estate Planning Magazine August 2003.

The Resettlement Clause

As stated above, the selection of the appropriate jurisdiction for the asset protection trust is a vital component of the overall plan. However, many factors may subsequently render the carefully selected jurisdiction unfavorable: new legislation may change the legal landscape or political unrest may occur, or legal action by a creditor or potential creditor may in of itself dictate a change of situs and the law which governs the administration of the trust. The FAPT must anticipate and address all of these concerns.

The provision of a jurisdictional clause, sometimes called a "flee," or "flight" clause or the equivalent within the FAPT mandates the consideration, within certain circumstances, of the change of the trust's situs, its trustee, and the law governing the trust's construction and administration. The clause may require a change, or may leave the decision in the discretion of the trustee.

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. (Originating in English courts, the Mareva injunction is designed to prevent a defendant from transferring assets

which, in the court's opinion, the defendant is likely to move outside the court's jurisdiction. *Mareva Compania Naviera SA v. International Bulkcarriers SA.*, [1975] 2 Lloyd's Rep. 509.

The authors propose instead what they call a "resettlement" clause to replace the flee clause. The flee cause is typically 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, who 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 every last element of the move is completed. Until that occurs, we will be subject to the courts of the jurisdiction from which the trust is 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 terms of the trust on compliance with the exercise of the clause.

Considerations in drafting the clause include:

- Whether the exercise of the power's change of situs should be mandatory or in the discretion of the protector?
- Whether a mandatory change of situs will encourage a court to impose a Mareva injunction against the trust?
- What situations will suggest a change of situs?
- Will the trigger event change both the situs and the governing law?
- Should the clause provide for funds to be left in the "old" trust to be used to defend any attacks?

Powers Of Appointment

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 (Internal Revenue Code § 679), 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. *See* Treas. Reg. 25.2511-2(b). 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. *Restatement (Second) Property* § 13.1 The American Law Institute 1977.

It should also be noted that an alternative to the retained special power of appointment might be a retained limited power of amendment. The retained power of amendment by the settlor would also cause the transfer into trust to be incomplete for gift tax purposes, and would confer grantor trust status for income tax purposes. The advantage to the retained power to amend would be the

elimination of the need to transfer assets out of the FAPT should the settlor exercise the power to amend in her Will. On the other hand, the exercise of the power to appoint typically entails the appointment into a new trust, and thus the often cumbersome process of transferring title, asset by asset, to the new trustee.

Considerations in drafting a special power of appointment include:

- Will the power be a lifetime power? A testamentary power? Or both?
- Will the power be exercisable by the settlor alone, or with the consent of a third party? If the latter, who will be that third party? Will there be a successor? Does the third party have to be "non-adverse"?
- Can the power be exercised by an attorney-in-fact of the powerholder? By a guardian or conservator?
- Will the special power of appointment be a broad special power or will the objects of the power be limited to certain class, such as the issue of the settlor?
- How will the trustee know if the power has been exercised?
- 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? *See* Alexander A. Bove, Jr., *Exercising Powers of Appointment – A Simple Task or Tricky Business?* Estate Planning Magazine, June 2001.

Contingent Payment Clause

Since the Statute of Elizabeth of 1571 there has been a prohibition against the transfer of property with the intent to hinder, delay, or defraud a creditor. In the modern era, the Uniform Fraudulent Conveyance Act (1918) and, more recently, the Uniform Fraudulent Transfer Act (1984) have codified this prohibition and together with general common law principals and federal bankruptcy law. 11 U.S.C. §548(a)(1)(the federal equivalent of the Uniform Fraudulent Transfer Act) and 11 U.S.C. §727(a)(2) (denial of discharge sanction where there has been a fraudulent transfer) operate to permit a creditor under certain circumstances to undo a prior transfer by a debtor, for example, a transfer into a FAPT. Note that fraudulent transfer rules apply not only to known creditors – those who have asserted a claim, filed a lawsuit, and obtained a judgment – but also, importantly, "reasonably anticipated" creditors. If the scalpel has already slipped, the doctor who sits in your office contemplating the funding of an asset protection trust "just in case" a problem arises already has a fraudulent transfer problem. And, once the problem is explained to the client she may hesitate to proceed with the asset protection trust due to her desire not to participate in a "fraud". You, too, as the lawyer may hesitate to assist the client since creditors have been known to sue (usually unsuccessfully) the lawyer who assisted in a fraudulent transfer. Furthermore, in egregious cases the offshore trustee may be reluctant or may refuse to accept the trust in the face of a large claim or potential claim.

To give the client and the lawyer, and often the trustee, peace of mind, a "contingent payment clause" – sometimes cryptically referred to within the asset protection bar as a "Jones clause" – should be included within the FAPT. Simply stated, the clause tells the trustee "If this creditor obtains a judgment and comes knocking, pay him." The transfer into the trust will not be fraudulent as to a creditor who is specifically to be paid out of the trust fund. But nothing, of course, is that simple. Many considerations come into play here, however, as set forth below. What may be the most challenging aspect for the drafter is how to walk the fine line between authorizing the foreign trustee to pay a certain creditor (permissible), and requiring the foreign trustee to pay a "foreign judgment" where such judgments are not enforceable in the foreign jurisdiction. (An issue outside the parameters of this article is whether or not the trustee in a fully discretionary trust may pay a beneficiary's creditors as a benefit to the beneficiary, even in

the absence of a contingent payment clause. See the recent article on the Grupo Torras litigation in Vol. 7 Trusts & Trustees Issue 4 (March 2001).

The intention of the typical contingent payment 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; we 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, and 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 superseded 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.

In light of the above, the drafting considerations for a contingent payment clause include:

- Should the trust name the specific creditor the client reasonably anticipates and/or list known lawsuits already filed? Will this be seen as an admission of liability?
- Should you set forth the intention of the settlor not to engage in a fraudulent transfer or violate the bankruptcy laws?

- Is the trustee authorized to pay the creditor directly, or rather to remit the judgment amount to the settlor?
- When is payment actually made?
- How will the foreign statute of limitations come into play, if at all?
- Should the trustee distribute the amount of the judgment with interest from the date of settlement of the trust? Are certain portions of the trust fund exempt from payment?
- When is the judgment finally determined for the purpose of payment?
- What must the creditor submit to the trustee to receive payment?
- Must the creditor prove that no other assets of the debtor exist to pay the judgment?
- Does the general exculpation clause and right to hire advisors clause protect the trustee for its exercise of discretion in the method of payment of the claim?

Conclusion

Drafting 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. In the meantime, we must constantly review our provisions in the light of developing law and exchange of ideas.