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In this article, Stewart observes that while foreign asset protection trusts have gained in popularity, they have fared poorly in court when challenged.

Foreign asset protection trusts (FAPTs) are often sold to potential clients as solid asset protection structures that can withstand most legal attacks. These prospective customers are being deceived, however. Most reported cases in which a creditor attacked a FAPT have resulted in settlor losses. The cases exhibit several theories to thwart these structures, but they all have in common a judge who wants to prevent debtors from accumulating large debts while also making creditors whole through the judicial system.

Before delving into the case law, let's define a few terms. A settlor or grantor creates a trust by contributing some type of property. The settlor or grantor designates one of more beneficiaries who receive some type of benefit from the trust — usually a stream of income or income and capital payments. The trust may include a spendthrift position, which prevents the beneficiary from alienating his trust interest.[1] For example, if beneficiary John Smith owes $50,000 to a third party, Smith may be tempted to assign his trust interest to the party to satisfy the debt. A spendthrift provision prevents this transaction.

A FAPT is another name for a "self-settled spendthrift trust," in which the settlor creates a spendthrift trust and makes himself a beneficiary. For example, Ed Jones contributes $500,000 to a spendthrift trust and makes himself the primary beneficiary. If Jones owes $100,000 to a creditor who then seeks repayment, Jones theoretically can say, "I can't assign my beneficial interest to pay this because it's subject to a spendthrift provision."

The Uniform Trust Code (UTC) does not sanction self-settled spendthrift trusts. The comments to section 505 state that "a settlor who is also a beneficiary may not use the trust as a shield against the settlor's creditors. The drafters of the UTC concluded that traditional doctrine reflects sound policy."[2] The underlying reason is based on public policy: grantors should not be allowed to transfer assets to a potentially creditor-invulnerable vehicle, run up large debts, and then plead poverty when sued, only to still benefit from the assets squirreled away in the trust.

Despite the UTC's spendthrift prohibition, numerous offshore locations have amended their statutes to allow self-settled spendthrift trusts, hoping to attract high-net-worth individuals. Some went further by amending their fraudulent transfer rules in debtor-friendly ways, while

[1] Uniform Trust Code section 502(c) ("A beneficiary may not transfer an interest in trust in violation of a valid spendthrift provision and, except as otherwise provided in this article, a creditor or assignee of the beneficiary may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.").

[2] UTC section 505, comments.

others simply did not recognize foreign judgments, forcing creditors to retry cases in potentially hostile venues.

In addition to funding trusts in debtor-friendly locations, practitioners add specific terms and conditions to bolster the trust's protective capabilities. A "choice of law" clause specifically identifies which jurisdiction's laws a court should use to interpret the trust's terms. The settlor almost always chooses a debtor-friendly jurisdiction. Another common drafting technique is including a "duress clause," which allows a trustee to deny a beneficiary's disbursement request if it is made while under duress — which usually means being forced by a court. As explained later, courts have struck down these techniques.

Choice of Law

Some jurisdictions have amended their statutes in a debtor-friendly manner. To capitalize on this development, planners add a clause to trust documents identifying a specific jurisdiction's laws to govern the trust's implementation and interpretation. This designation, however, is not the last word on choice of arbiter; a court can redesignate under the Restatement of the Conflict of Laws. In several FAPT cases, this analysis has gone against the settlor. *In re Portnoy*[3] is a prime example.

Portnoy involves several areas of law: asset protection, bankruptcy, conflict of laws, and trusts. Here are the relevant events in chronological order:

- March 1987: Larry Portnoy guarantees all loans and debt of his company Mary Drawers.
- March 1988: Mary Drawers receives a $1 million loan.
- February 1989: Portnoy becomes aware that Mary Drawers will not be able to repay the loan.
- August 1989: Portnoy forms an offshore Jersey Trust. Portnoy is the primary beneficiary. Jersey is known as an asset protection haven. The trust document specifically states that Jersey law will govern the trust's interpretation.
- 1990 and 1992: Portnoy transfers his salary and real estate to his wife and daughter.
- February 1990: A lawsuit is filed against Mary Drawers for defaulted loan proceeds.
- September 1991: Judgment is made against Mary Drawers for approximately $183,000.
- October 1995: Portnoy files for bankruptcy. As part of his bankruptcy filings, he discloses the existence of the offshore Jersey trust. This is the first time his creditors have been informed of the trust's existence.

The decision — which went against Portnoy — employs several lines of reasoning. The first focused on the choice of law analysis, which required the court to determine whether Jersey or New York law would govern. The court noted that settlors are allowed to specify which laws govern their trusts and that this designation should not be defeated "unless this is required by the policy of a state which has such an interest in defeating his intention . . . that its local law should be applied."[4] Later in the case, the court explains that "it is against [New York] 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] This reasoning strongly implies that a planner's attempts to invoke the laws of a debtor-favorable jurisdiction will be defeated if the jurisdiction hearing the case, like most, has a public policy preventing a debtor from enjoying his assets at the expense of his creditors.[6]

The second line of reasoning — which is tangential to the first — is used to determine "the state whose interests are more deeply affected." The court noted that Portnoy settled the trust in

[3] *In re Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

[4] *Id.* at 698.

[5] *See also In Re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998) ("The attempt of a man to place his property in trust for his own benefit under limitations similar to those which characterize a spendthrift trust is a departure from the underlying basis for the creation of such trusts. That aside, the public policy which sustains such trusts when created for the benefit of another is, where the settlor is himself the beneficiary, overborne by other considerations. . . . To admit the validity of such trusts would open too wide an opportunity for a man to evade his just debts to be permissible unless sanctioned by statutory enactment. This is the reason why the overwhelming weight of authority holds ineffective attempts to establish them.").

[6] *Id.* at 101.

Jersey, and had a Jersey firm administer it. Portnoy's trust planners hoped that these two factors would prevent the U.S. court from exercising its jurisdiction. They did not. All parties were U.S. residents, the creditors had no contact with Jersey, and Portnoy had extensive U.S contact when he established the trust. The court ruled the large number of U.S. contacts meant the United States had the "weightier concern," allowing it to use U.S. law. Although the trust resided in a foreign jurisdiction, the nexus with the United States was determinative. This analysis strongly implies that if the settlor lives in the United States when litigation begins, a court will rule that sufficient U.S. contact exists to apply U.S. law.

Duress Clauses

Drafters of FAPTs realized that courts might hold grantors in contempt because they would not repatriate assets from a foreign jurisdiction. To prevent this, drafters included a duress clause stating that if a court places a grantor in duress (usually by threatening contempt), the grantor will not only be stripped of any power to control the trust, but will also lose all trust benefits. Theoretically, this should allow the U.S. grantor to argue that compliance with the repatriation order is impossible. *Lawrence v. Goldberg*[7] contains reasoning that thwarts duress clauses.[8]

In January 1991 Stephan Jay Lawrence funded a Mauritius trust with $7 million. He had the sole power to appoint or remove a trustee. He added a spendthrift clause one month after forming the trust. In March 1991 Lawrence lost a $20.4 million arbitration award. He later added a duress clause as well as a provision that terminated his beneficial interest if he declared bankruptcy — which he did two years later. The bankruptcy court eventually ordered Lawrence to turn over the trust assets. Lawrence told the court this was impossible, citing the duress clause. The court disagreed, held him in contempt of court, and placed him in jail pending compliance with its order.

These facts exemplify the scenario that a duress clause is designed to thwart. After being ordered to turn over all trust assets, Lawrence sent a request to the trustee, only to have him cite the duress clause as the reason for noncompliance. Lawrence dutifully went back to the court and said, "I tried." The court rejected his charade. They first noted that a duress clause violated Florida public policy preventing a trust grantor from forming a self-settled spendthrift trust if the grantor is also a beneficiary.[9]

The court then delivered a potential knockout blow to all duress clauses, ruling that "Lawrence's claimed defense is invalid because the asserted impossibility was self-created."[10] This is the most damning statement from the decision. The court will see through clever draftsmanship when it is designed to subvert public policy. No other interpretation of the court's reasoning is possible.

The impossibility defense should be left to truly impossible situations. For example, suppose a grantor funded a trust in a country where a military coup occurs, followed by a nationalization of all offshore assets. In this case, compliance with a repatriation order is truly impossible. However, no court should allow clever draftsmanship to either circumvent judicial power or thwart public policy, which duress clauses are clearly designed to do. For practical purposes, *Lawrence* made duress clauses moot.

Family Member as Beneficiary

Some attorneys who draft FAPTs recognize that a court could eventually force their clients to disgorge assets. One method to prevent this is to place assets in a trust with a family member as the trustee, beneficiary, or both. This tactic was used in *Solow*.[11] The court ruled against the taxpayer.

The following transactions are at the heart of this case:

- The Solows formed a Cook Island trust.
- Mrs. Solow was the sole beneficiary.
- Mr. and Mrs. Solow mortgaged the couple's $5.2 million residence and transferred the funds to the Cook Island trust.

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[7] *Lawrence v. Goldberg*, 279 F.3d 1294 (11th Cir. 2002).

[8] *See also S.E.C. v. Solow*, 682 F. Supp.2d 1312 (S.D. Fla. 2010) and *S.E.C. v. Bilzerian*, 112 F. Supp.2d 12 (D.D.C. 2000).

[9] *See* discussion above on section 505 of the UTC.

[10] *Lawrence*, 279 F.3d 1294.

[11] *Solow*, 682 F. Supp.2d 1312.

- Mrs. Solow was the sole owner of a second property valued at $1.2 million. She mortgaged this asset and transferred the funds to the Cook Island trust.

The SEC sued Mr. Solow, alleging he engaged in a fraudulent trading scheme. After losing, Mr. Solow faced $5.2 million in damages. He asserted the impossibility defense, arguing that he owned no assets and was entirely dependent on his wife.

The court first noted that Mrs. Solow — in whose name all the assets were held — received no inheritance, did not bring any assets to the marriage, and did not work while married. Yet she somehow came to own millions of dollars in real estate and paid all her husband's bills — including his legal defense. As for the couple's financial accounts, she merely acted as a conduit in accordance with her husband's instructions. The intent behind Mr. Solow's actions were clear: he "transferred assets to his wife after the verdict and before the disgorgement order to avoid the forthcoming disgorgement order."[12] The court then applied the now-standard principle that it will not recognize an impossibility defense when the defendant creates the "impossible" situation.

Should You Still Use FAPTs?

First, offshore trust proponents cite the unsavory character of the grantors in the case law to discredit the adverse decisions. This observation is entirely accurate; the cases involve people convicted of fraud, securities laws violations, and other crimes. The implication is that a client using a FAPT who is not a criminal would stand a better chance of surviving a creditor's attack. This argument is unconvincing, however. As documented here, courts based their decisions on public policy, regardless of the parties involved.

Second, offshore trust promoters argue that these cases largely involve "super-creditors" (primarily government agencies) that used their statutory powers to achieve a result unavailable to nongovernmental actors. This is also unconvincing, largely for the reason given: courts ruled against debtors based on public policy. Judges did not want to let debtors have their cake and eat it, too. This conclusion could just as easily be reached for a private actor.

Third, offshore trust proponents note that these decisions occurred long past the point when most other creditors would have given up or settled. This is a good argument. The FAPT failures (as I call them) occurred at the end of seven-, eight-, and 10-year cases, largely undertaken by government agencies with the goal of making victims whole. This explains why they were more than willing to engage in protracted and complex litigation. It is distinctly possible that private creditors would have settled these cases long before the government actors.

But whether to use a FAPT is a different matter. Most practitioners charge hefty fees to establish these vehicles. This is followed by annual fees associated with having an offshore trust. And all this is for an entity that will fold when attacked. While the losses have occurred at the end of long and expensive trials, it is possible that, because of creditor-friendly decisions, more creditors will challenge these structures, knowing that *stare decisis* is on their side.

Previously I have argued that FAPTs should only be used as the final component of an asset protection plan. However, the pro-creditor reasoning I have outlined is too strong to ignore. Considering the number of adverse decisions, the judicial reasoning voiding FAPTs, and the cost of setting them up and maintaining them, they're simply not worth it. ■

[12] *Id.* at 1329.