

Asset Protection Trusts

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1. Introduction

Trusts are typically established for estate planning, tax planning, or asset protection objectives. Persons living in politically unstable countries with nationalization or expropriation risk, as well as entrepreneurs and professionals living in litigious countries with litigation exposure, may consider the use of so-called asset protection trusts, which are designed to shield trust assets from creditors' claims. In addition, settlors may consider the use of asset protection trusts to protect assets against matrimonial claims of spouses in divorce proceedings as well as forced heirship claims arising in civil law or shari'a jurisdictions.

2. Principal Attributes of Asset Protection Jurisdictions

Jurisdictions holding themselves out as asset protection jurisdictions will have *reserved powers* legislation, *firewall* legislation and *fraudulent transfer* legislation. *Reserved powers* legislation allows the settlor to retain control and benefit over the trust without invalidating the trust, for example retaining an economic interest in the trust, holding powers of revocation, powers of appointment, powers of amendment, powers to appoint and remove beneficiaries, trustees, etc. *Firewall* legislation typically requires the governing law of the trust to be applied to all matters concerning the trust, and is designed to shield trust assets from foreign law claims arising from a *personal relationship* (matrimonial or community property rights) with the settlor and claims arising from *heirship*, and prohibits the recognition or enforcement of foreign judgments recognizing such rights. Debtor friendly *fraudulent transfer* legislation in asset protection jurisdictions is designed to provide greater protection from creditors' claims, requires the creditor to prove fraudulent intent, and provides short limitations periods for creditor claims. The old common law rule, established by the *Statute of Elizabeth*, the Fraudulent Gifts Act (1570), provides that transfers made with the intention to defraud creditors are voidable at the instance of the creditor, with no limitations period. Asset protection jurisdictions do not apply the *Statute of Elizabeth*.

3. Choosing an Asset Protection Jurisdiction

There are many jurisdictions with asset protection legislation. This article reviews the principal features of asset protection legislation in the Bahamas, the Cayman Islands, the Cook Islands, and South Dakota in the United States. The choice of a suitable asset protection jurisdiction should include not only consideration of the *reserved powers* legislation, the *firewall* legislation, and the *fraudulent transfer* legislation, but also the reputation of the

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jurisdiction, as well as the political stability of the jurisdiction, the court system, the availability of qualified professionals, etc. Since the desire of most settlors is to hold the financial assets of the trust with leading financial institutions, the reputation of the trust jurisdiction should be an important factor in the selection process.

The Cook Islands introduced asset protection legislation in 1989 in the *International Trusts Act*, Cayman in 1989 in the *Fraudulent Dispositions Law*, Bahamas in 1991 in the *Fraudulent Dispositions Act*, modeled closely on the Cayman legislation. South Dakota adopted its asset protection laws in 2005 with the statute on *Qualified Dispositions in Trust*.

a. The Bahamas

The Bahamas trust law is codified in the Bahamas Trustee Act,² and provides for broad *reserved powers* in favor of the settlor without invalidating the trust or causing a trust created *inter vivos* to be treated as a testamentary trust.³ *Reserved powers* are defined to include powers to revoke the trust, powers of appointment, powers to amend the trust, powers to appoint or remove any trustees, protectors or beneficiaries, powers to give directions to the trustees, provisions requiring the consent of the settlor, the appointment of the settlor as protector, retention by the settlor of a beneficial interest in the trust, etc.

The *firewall* legislation of the Bahamas contains a governing law provision that requires all matters regarding trusts governed under the laws of the Bahamas, including the capacity of the settlor, the validity of the trust, the administration of the trust, etc., to be determined exclusively by Bahamas law.⁴ However, the governing law provision does not affect the recognition of foreign law in determining whether the settlor owns the property transferred,⁵ the disposition of immovable property located outside Bahamas which is invalid under foreign laws,⁶ and the recognition of foreign law on the legal formalities for transfer.⁷ The *firewall* legislation also contains a foreign law exclusion clause that precludes foreign law from invalidating trusts governed under Bahamas law where foreign law does not recognize trusts, or the trust defeats rights conferred by foreign law because of a *personal relationship* with the settlor or any beneficiary or by way of *heirship*, or contravenes foreign law or foreign judicial orders recognizing such rights.⁸ *Heirship* rights are expressly excluded from affecting immovable property in the Bahamas or moveable property wherever situated, and *heirship* rights do not constitute an obligation for purposes of the Fraudulent Dispositions Act.⁹ Finally, foreign judgments are not recognized or enforced where they contravene the foreign law exclusion provisions.¹⁰

The *fraudulent transfer legislation* of the Bahamas is set-forth in the Fraudulent Dispositions Act,¹¹ and provides that dispositions of property made with an intent to defraud the creditor

² Bahamas Trustee Act (1998) as amended (2011)

³ Bahamas Trustee Act, Section 3(2).

⁴ The Trust (Choice of Governing Law) Act (1989) as amended (2016)

⁵ *Id.*, Section 7(2)(b)

⁶ *Id.*, Section 7(2)(a)(ii)

⁷ *Id.*, Section 7(2)(e)

⁸ *Id.*, Section 8

⁹ *Id.*, Section 9.

¹⁰ *Id.*, Section 10.

¹¹ The Fraudulent Dispositions Act (1991).

and at an undervalue is voidable at the instance of the creditor.¹² The creditor has the burden of proof to establish intent to defraud,¹³ the standard of proof in civil cases in the Bahamas is “on the balance of the probabilities,” and the creditor must bring the claim within 2 years from the date of the disposition.¹⁴ The obligation must have existed on or prior to the date of the disposition and the transferor must have had notice.¹⁵ Thus, claims not existing at the time of the transfer or disposition are barred. The Act recognizes that foreign law may be applied to determine whether the transferor owns the property or holds powers to transfer the property.¹⁶ If the creditor’s claim succeeds, the disposition is set-aside only to the extent necessary to satisfy the obligation owed to the creditor.¹⁷

b. The Cayman Islands

The Cayman Islands Trusts Law¹⁸ provides for extensive settlor *reserved powers*,¹⁹ which are deemed not to invalidate the trust or cause the trust to be treated as a testamentary trust. These powers include the power to revoke, vary or amend the trust, powers of appointment, power to give investment directions to the trustee, power to add or remove trustees, protectors or beneficiaries, power to change the governing law, power to consent to trustee actions, etc.

The Cayman Islands *firewall* legislation contains a governing law provision that requires all questions regarding trusts governed under Cayman law, including the *capacity* of the settlor, the validity of the trust, the administration of the trust, and the existence and extent of powers, to be determined in accordance with Cayman law without reference to the laws of any other jurisdiction.²⁰ However, the governing law provision does not affect the recognition of foreign laws in determining whether the settlor owns the property,²¹ or the recognition of foreign law prescribing the *formalities* required for transfers,²² and does not validate dispositions of real property situated in a foreign jurisdiction which would be invalid according to the laws of such jurisdiction.²³ The *firewall* legislation also contains a foreign law exclusion clause that precludes foreign law from invalidating trusts governed under Cayman law where foreign law does not recognize trusts, or the trust defeats rights conferred by foreign law by reason of a *personal relationship* to the settlor or by way of *heirship*, or contravenes foreign law or foreign judicial orders recognizing such rights.²⁴ In addition, *heirship* rights are expressly excluded from affecting the ownership of immovable property in Cayman or moveable property wherever situated, and do not constitute an obligation for purposes of the Fraudulent Dispositions Law.²⁵ Finally, foreign judgments are not recognized where they contravene the foreign law exclusion provisions.²⁶

¹² Id., Section 4(1)

¹³ Id., Section 4(2).

¹⁴ Id., Section 4(3).

¹⁵ Id., Section 2

¹⁶ Id., Section 7

¹⁷ Id., Section 6

¹⁸ The Cayman Islands Trusts Law (2020 Revision).

¹⁹ Id., Section 14

²⁰ Id., Section 90

²¹ Id., Section 90(i)

²² Id., Section 90(iv)

²³ Id., Section 90(v)

²⁴ Id., Section 91

²⁵ Id., Section 92

²⁶ Id., Section 93

The Cayman Fraudulent Dispositions Law²⁷ provides that dispositions of property made with an intent to defraud the creditor and at an undervalue is voidable at the instance of the creditor.²⁸ The creditor has the burden of proof to establish intent to defraud,²⁹ the standard of proof in civil cases in Cayman is “on the balance of the probabilities,” and the creditor must bring the claim within 6 years from the date of the disposition.³⁰ The obligation must have existed on or prior to the date of the disposition and the transferor must have had notice.³¹ Thus, claims not existing at the time of transfer or disposition are barred. Foreign law may be applied to determine whether the transferor owns the property or holds powers to transfer the property.³² If the claim succeeds, the disposition is set-aside only to the extent necessary to satisfy the obligation owed to the creditor.³³

c. The Cook Islands

The Cook Islands trust law, the International Trust Amendment Act,³⁴ provides for extensive *reserved powers* in favor of the settlor,³⁵ which are deemed not to invalidate the trusts or cause dispositions to be void. Reserved powers include the powers to revoke, powers of appointment, power to amend the trust, right of settlor to benefit from the trust, power to appoint and remove trustees and protectors, power to direct the trustee or protector, power to change governing law, and power to act as trustee or protector, etc.

The *firewall* legislation of the Cook Islands contains a governing law provision that requires all questions regarding a trust governed under the laws of the Cook Islands, including capacity of the settlor, validity of the trust or disposition, administration of the trust, etc., to be determined exclusively under Cook Islands law.³⁶ However, the Cook Islands *firewall* legislation does not validate dispositions of property that are not owned by the settlor,³⁷ nor not affect the recognition of foreign laws regarding the *formalities* for a disposition or transfer,³⁸ nor validate the disposition of real property situated in a foreign jurisdiction which would be void according to the laws of such jurisdiction.³⁹ The *firewall* legislation also contains a broad foreign law exclusion provision that precludes foreign law from invalidating Cook Islands trusts where the trust defeats the rights of a person held by reason of a *personal relationship* to the settlor or by way of *heirship*,⁴⁰ and where the foreign law does not recognize trusts, or the trust defeats rights conferred by foreign law on any person, or contravenes foreign law or any foreign judicial order recognizing such rights, or because the laws of the Cook Islands are inconsistent with any foreign law.⁴¹ Foreign judgments against settlors, beneficiaries, protectors or trustees of Cook Islands trusts that are inconsistent with

²⁷ The Fraudulent Dispositions Law (1989) as revised (1996).

²⁸ *Id.*, Section 4(1)

²⁹ *Id.*, Section 4(2)

³⁰ *Id.*, Section 4(3)

³¹ *Id.* Section 2

³² *Id.*, Section 7.

³³ *Id.*, Section 6

³⁴ The International Trusts Act (1984) as amended.

³⁵ *Id.*, Section 13C.

³⁶ *Id.*, Section 13H(1)

³⁷ *Id.*, Section 13H(2)(a)

³⁸ *Id.*, Section 13H(2)(d)

³⁹ *Id.*, Section 13H(2)(e)

⁴⁰ *Id.*, Section 13E

⁴¹ *Id.*, Section 13I

the Act or relate to a matter governed by Cook Islands law, will not be recognized or enforced in the Cook Islands.⁴² Finally, the Cook Islands legislation confers exclusive jurisdiction to the courts of the Cook Islands in any action against a Cook Islands trust.⁴³

The *fraudulent transfer* legislation of the Cook Islands is set forth in the International Trust Amendment Act, and require the creditor to prove that the trust was settled with the principal intent to defraud the creditor, and the settlement rendered the settlor insolvent or unable to pay the creditor's claim. The standard of proof on the creditor is "beyond a reasonable doubt." The creditor limitation period is 1 year where the transfer is made within 2 years of the accrual of the cause of action.⁴⁴ Transfers are deemed not to have been made with fraudulent intent where made more than 2 years after the cause of action accrued,⁴⁵ or where the transfer is made before the cause of action accrued,⁴⁶ and claims not existing at the time of transfer or disposition are barred. If the creditor's claim prevails, the disposition is not void or voidable, but the trust will be liable to satisfy the creditor's claim.⁴⁷

d. South Dakota

The trust legislation of South Dakota is set-forth in the South Dakota Codified Laws.⁴⁸ South Dakota does not have *reserved powers* as such, but does list criteria that would be insufficient to establish "dominion and control," which would cause the trust to fail,⁴⁹ or allow a settlor to be deemed in control of a trustee or the "alter ego" of a trustee.⁵⁰ These authorized powers include the settlor acting as trustee, holding powers to remove or replace trustees, receipt of loans from the trust without interest or security, making requests for distribution on behalf of beneficiaries, etc. The settlor may also validly hold powers of revocation and powers of appointment. Special rules apply to *reserved powers* for trusts created under the asset protection statute, *Qualified Dispositions in Trust*.⁵¹ Under the statute, the trust must be irrevocable but the settlor may be a discretionary beneficiary, and the settlor may hold powers to veto distributions, limited powers of appointment, testamentary powers of appointment, receive of distributions at the discretion of the trustee, powers to remove and appoint trustees, protectors or investment advisors, powers to serve as an investment advisor, etc.⁵²

The South Dakota *firewall* legislation contains a governing law provision that requires all matters concerning the validity, construction, and administration of trusts governed under South Dakota law to be determined by South Dakota law,⁵³ including the capacity of the settlor, the powers of the trustees, etc. In addition, the *firewall* legislation contains a foreign law exclusion clause that precludes foreign law from invalidating a South Dakota trust where foreign law does not recognize trusts, or the trust defeats rights conferred by foreign law by

⁴² Id., Section 13D

⁴³ Id., Section 13K

⁴⁴ Id., Section 13B(3)(b)

⁴⁵ Id., Section 13B(3)(a)

⁴⁶ Id., Section 13B(4)

⁴⁷ Id., Section 13B(1)

⁴⁸ Title 55, Fiduciaries and Trusts, Chapters 1-19, South Dakota Codified Laws (SDCL)

⁴⁹ Id., 55-1-32 (SDCL)

⁵⁰ Id., 55-1-33 (SDCL)

⁵¹ Id., 55-16 (SDCL)

⁵² Id., 55-16-2(2) (SDCL)

⁵³ Id., 55-3-40 (SDCL)

reason of a *personal relationship* to the settlor or *heirship*, or the trust contravenes any foreign rule of law or judicial order giving effect to such rights.⁵⁴ Moreover, foreign judgments that do not apply South Dakota law in determining the validity, construction or administration of South Dakota trusts are not enforceable in South Dakota.⁵⁵ Under the asset protection statute, claims related to *forced heirship* are expressly excluded.⁵⁶ Foreign judgments are not enforceable in South Dakota where they conflict with South Dakota policy. Indeed, the asset protection laws of South Dakota are considered to be a matter of Public Policy, and “are inseparably interwoven with substantive rights that a deprivation of legal rights would result if another jurisdiction’s laws and regulations to the contrary are applied to a claim or cause of action described therein.”⁵⁷ Judgments by Federal or State courts are entitled to recognition under the Full Faith and Credit Clause of the US Constitution.⁵⁸ However, the Full Faith and Credit Clause notwithstanding, the South Dakota Supreme Court recently ruled in *Cleopatra Cameron*,⁵⁹ that enforcement of a foreign judgment against a South Dakota trust in violation of the trust’s Spendthrift clause will be denied where it violates South Dakota law and policy. Finally, trusts created under the asset protection statute provide South Dakota courts with exclusive jurisdiction.⁶⁰

The relevant *fraudulent transfer* rules of South Dakota apply to trusts created under the asset protection statute, *Qualified Dispositions in Trust*.⁶¹ In order to fall within the statute, the trustee must be a qualifying South Dakota trustee,⁶² the trust must have an express South Dakota governing law clause,⁶³ the trust must be irrevocable, and, the trust must have a *spendthrift* clause.⁶⁴ The creditor that brings a claim against a Qualified Disposition must show that the transfer was made with the intent to defraud a specific creditor,⁶⁵ and the burden of proof is “clear and convincing evidence.”⁶⁶ For pre-existing creditors, the claim must be brought within the later of 2 years after the transfer or 6 months after the transfer is or reasonably could have been discovered.⁶⁷ For creditors whose claims arise after the transfer into trust, the claim must be brought within 2 years after the transfer.⁶⁸ Certain classes of creditors, known as “exception creditors” with pre-existing claims prior to the date of transfer (child support, alimony, division of marital property, etc.), may reach assets held in trusts created under the asset protection statute.⁶⁹ Where a claim against a Qualified Disposition is successful, the disposition may be avoided only to the extent of the debt.⁷⁰

4. Comparison of Jurisdictions

a. Reserved Powers Legislation.

⁵⁴ Id., 55-3-46 (SDCL)

⁵⁵ Id., 55-3-47 (SDCL)

⁵⁶ Id., 55-16-15(5) (SDCL)

⁵⁷ Id., Chapter 55-16-10 (SDCL)

⁵⁸ Id., Chapter 15-16A-1 (SDCL)

⁵⁹ *Cleopatra Cameron Gift Trust*, 2019 SD 35 (2019)

⁶⁰ Chapter 55-16-13 South Dakota Codified Laws (SDCL)

⁶¹ Id., 55-16 (SDCL)

⁶² Id., Chapter 55-16-2 (SDCL)

⁶³ Id., Chapter 55-16-2(1) (SDCL)

⁶⁴ Id., Chapter 55-16-2(3) (SDCL)

⁶⁵ Id., Chapter 55-16-9 (SDCL)

⁶⁶ Id., Chapter 55-16-10(3) (SDCL)

⁶⁷ Id., Chapter 55-16-10(1) (SDCL)

⁶⁸ Id., Chapter 55-16-10(2) (SDCL)

⁶⁹ Id., Chapter 55-16-15(1) (SDCL)

⁷⁰ Id., Chapter 55-16-16 (SDCL)

The *reserved powers* legislation of the Bahamas, Cayman and the Cook Islands are very similar, and authorize the settlor to exercise broad powers over trusts. The Cook Islands and South Dakota even allow the settlor to be a trustee without invalidating the trust. However, trusts created under the South Dakota asset protection statute do not allow the settlor to be a trustee, and restrict the *reserved powers* that the settlor may hold.

b. Firewall Legislation

All four jurisdictions have governing law provisions that operate in a similar manner, and all have foreign law exclusion clauses that preclude foreign law from invalidating trusts where foreign law does not recognize the concept of a trust, or the trust defeats rights conferred by foreign law by reason of a *personal relationship* to the settlor or by way of *heirship*, etc. Thus, these four jurisdictions would all bar claims based on *personal relationships* and *heirship*, and would not enforce foreign judgments giving effect to such rights. However, the Cook Islands legislation goes further, and excludes the application of foreign laws which are inconsistent with Cook Islands law, and bars enforcement of *any* judgments against the settlor, beneficiaries or the trustee that are inconsistent with Cook Islands trust law or relate to a matter governed by Cook Islands law. The South Dakota asset protection statute bars matrimonial claims, save for exception creditors, and claims based on foreign *forced heirship*, and more broadly bars enforcement of foreign judgments that are inconsistent with public policy. Finally, unlike the Bahamas and Cayman, the Cook Islands and South Dakota laws confer exclusive jurisdiction on local courts for claims against dispositions in trust.

c. Fraudulent Transfer Legislation

The fraudulent dispositions laws of the Bahamas and Cayman require the creditor to prove that the transfer was made with fraudulent intent and at an undervalue. In South Dakota, the creditor must prove that the transfer was made with intent to defraud the specific creditor making the claim. The Cook Islands imposes a higher threshold and requires the creditor to prove that the principal intent of the transfer was to defraud the creditor, and the settlement rendered the settlor insolvent or unable to pay the creditor's claim, and if the settlor remains solvent after the transfer, an action for fraudulent transfer will not lie against the debtor. The burden of proof is always on the creditor, but the standard of proof varies depending on the jurisdiction. In the Bahamas and Cayman the standard of proof in civil matters is "on the balance of the probabilities," in South Dakota the standard of proof is "clear and convincing evidence," which is a higher standard typically applied in civil fraud cases, and the Cook Islands applies the far higher criminal law standard of proof "beyond a reasonable doubt." The creditor limitations period is 1 year in the Cook Islands where the cause of action arises with 2 years of the transfer, 2 years in South Dakota and the Bahamas, and 6 years in Cayman. Claims by "future" creditors, whose cause of action arises after the transfer, are barred in the Bahamas, Cayman and the Cook Islands, but are authorized in South Dakota. Finally, successful claims by creditors will result in the avoidance of the transfer in the Bahamas, Cayman and South Dakota, but not in the Cook Islands, where the trust remains liable.

Of the jurisdictions reviewed, the asset protection legislation of the Cook Islands is clearly the most “debtor friendly,” considering the permissive *reserved powers* legislation, the formidable *firewall* protections, and the onerous *fraudulent transfer* legislation.

5. Weaknesses of Asset Protection Trusts

At the outset, it must be stated that however permissive or “debtor friendly” the rules of the asset protection jurisdiction may be, the settlor will be bound by the fraudulent transfer rules of his country of residence, which will undoubtedly be far stricter.

In addition, the transfers of property into trust by the settlor may be subject to the law of the settlor’s country of residence or the law of the place where the transfer is effected, not the governing law of the trust, and if the transfer is invalid, title to the property will not vest in the trustee. In particular, title will not vest in the trustee where the settlor does not own or have capacity to transfer the property due to community property rules or matrimonial claims. Depending on the jurisdiction, community property or matrimonial rights may vest on marriage, in which case a spouse would not own or have capacity to transfer such property without the consent of the other spouse. In other jurisdictions, such property rights vest on divorce. However, forced heirship rights are treated differently because such rights typically have not vested in the forced heir at the time of transfer, and therefore the transferor would have ownership and capacity to transfer the property. In addition, title will not vest in the trustee where foreign legal *formalities* required to transfer property under are not satisfied.

Notwithstanding the permissive nature of *reserved powers* legislation in these jurisdictions, the retention of powers by the settlor will almost certainly weaken the trust from an asset protection perspective and expose the assets of the trust to creditors’ claims. Indeed, in the case of revocable trusts, judgement creditors may succeed in obtaining enforcement orders compelling the exercise of the power of revocation, see e.g. *TMSF vs. Merrill Lynch*.⁷¹ However, a settlor’s discretionary interest in an irrevocable trust will be far more difficult to attack successfully. In addition, where, according to the terms of the trust, the settlor retains too many powers, creditors may seek to invalidate the trust as *illusory*, see e.g. *Mezhprom vs. Pugachev*,⁷² *Webb vs. Webb*.⁷³ Clearly, the *illusory* trust argument will be far harder to prove where the trust is governed under the laws of a jurisdiction with *reserved powers* legislation. There is also the *sham* trust argument, which requires a showing of a common intention between the trustees and the settlor to mislead third parties, see e.g. *Re Esteem Settlement*.⁷⁴ The effect of a successful *illusory* or a *sham* trust argument will that the trust is declared void and the assets are held by the trustee on resulting bare trust for the settlor, and thus available to creditors.

Where a claimant or creditor brings proceedings in the trust jurisdiction to set aside transfers to a trust, the creditor will be faced with the formidable obstacles posed by the *firewall* legislation and/or the *fraudulent transfer* legislation, where applicable. The claimant or creditor may be required to bring proceedings in the jurisdiction of the trust, either because the local courts may lack jurisdiction over the trustee or because of exclusive jurisdiction

⁷¹ *TMSF vs. Merrill Lynch Bank and Trust Company (Cayman)* [2011] UKPC 17

⁷² *Mezhprom vs. Pugachev* [2017] EWHC 2426

⁷³ *Webb vs. Webb*, [2020] UKPC 22

⁷⁴ *Re Esteem Settlement* (2003) JLR 188

clauses. If the obstacles are simply too great in the trust jurisdiction, the claimant or creditor may always circumvent the *firewalls* and asset protection rules of the trust jurisdiction by bringing attachment proceedings in the jurisdiction where the assets are located.

In conclusion, asset protection trusts should be established for legitimate purposes in reputable jurisdictions. To mitigate attacks by creditors, asset protection trusts should be established in jurisdictions with appropriate *reserved powers, firewall* and *fraudulent transfer* legislation, the trust should be properly funded to ensure that title to trust property vests in the trustee, the trust should be irrevocable, and the beneficial interests of the settlor should be discretionary, etc.