To Protect And Swerve

Offshore asset protection, which an article speculated would have helped O.J. Simpson, is an industry we can do without.

O.J. Simpson, the Los Angeles Times speculated in a recent article ("A Case of 'Judgment Proofing'" (May 15)), could protect his assets by setting up an offshore trust. The article cites no evidence that Mr. Simpson has set up such a trust but it does illustrate, in a topical way, the issues raised by these trusts. They deserve our attention.

Asset protection trusts have become quite widely used and have been discussed and promoted by respectable lawyers in respectable firms. Although some forms of asset protection are legitimate, the truth is that offshore asset protection trusts are risky in theory and may not work in practice. They can also endanger professional advisers. Nevertheless, the demand for asset protection raises interesting policy questions — not in the Simpson case but because current law forces doctors and other professionals and some business owners to risk their entire net worth in order to engage in their chosen careers.

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First, the basics of asset protection. Federal bankruptcy law and state fraudulent transfer laws allow creditors to invalidate transfers of assets made with intent to defraud, hinder or delay creditors. (Such transfers are not automatically void and an offshore trust remains binding on the trust beneficiaries.) Based on an old English law, the 16th Century Statute of Elizabeth, the law applies both to existing claims and, crucially, claims arising after the transfer occurred.

The Statute of Elizabeth is the law even in offshore locations. However, some, including the Bahamas, Bermuda, the Cayman Islands, the Cook Islands and Gibraltar, have modified it so that only creditors with claims predating the transfer of assets to the trust can seek to invalidate the transfer. This modification is what differentiates a true asset protection trust from other domestic and foreign trust arrangements. No offshore jurisdiction would protect a trust against invalidation at the behest of claimants if the trust was set up after (or in contemplation of) the wrongdoing. (The critical date is the date the claim arose, not, as the Los Angeles Times article implies, the date the resulting lawsuit is filed.)

Even if offshore courts upheld the trust, the transferor could not rest easy. U.S. courts have several weapons to bring a debtor to heel. They can reach trust assets found in the United States. So, a trust could not protect U.S. real estate or a U.S. business nor, for that matter, golf club memberships. The court can also order a debtor to identify and return foreign assets and can use contempt powers, including prolonged imprisonment, to enforce the order. The recent F. Lee Bailey case shows what a determined court can do. And even if a wrongdoer proved that an offshore trustee, and not he, controlled the assets, and that his interest in the trust was entirely in the discretion of the trustee, he would find it difficult to receive trust payments and benefits in the United States. His only option might be to leave the country and never return. This is not a palatable alternative to most U.S.-born individuals.

One neglected source of information about offshore trusts is the IRS. U.S. individuals must report formation of foreign trusts to the IRS and pay taxes on trust income. (There is essentially no income tax benefit for such trusts, although the IRS is convinced that U.S. settlors of foreign trusts under-report income on a massive scale). (Internal Revenue Code Section 679.) Offshore bank accounts similarly must be reported and interest on them is fully taxable.

Although the IRS is bound by strict secrecy laws and cannot disclose tax information to creditors, these laws do not apply to a debtor's bankruptcy trustee. (Internal Revenue Code Section 6103(e)(4) and (5).) Since the trustee's obligation is to collect the debtor's assets and pay his or her debts, the trustee could use tax return information to locate foreign trusts and bank accounts. Recently proposed legislation, which appears certain to pass because it has been estimated to raise billions of dollars, would greatly tighten up reporting of the creation of foreign trusts and receipt of distributions from such trusts and impose a 35 percent penalty for noncompliance. The legislation would increase the information available to the IRS and, therefore, to a bankruptcy trustee.

The Los Angeles Times article suggests that an offshore trust can force creditors to negotiate to avoid the burdens of litigating abroad. This can be true, especially if U.S. courts do not vigorously use their powers to compel debtors to disgorge offshore wealth. But, if that is a major intended benefit of establishing a foreign trust, should lawyers, accountants and bankers get involved in the first place?

We should instead ask what pushes wealthy individuals to set up offshore asset protection trusts. There are, of course, debtors faced with existing debts and tax claims and others trying to evade obligations to children and former spouses. To these individuals, neither sympathy nor assistance should be proffered.

However, many offshore trusts are established to protect assets of reputable professionals, especially doctors, who are required to risk their entire net worth as a condition of pursuing their profession. A medical devices manufacturer conducting business as a corporation risks only shareholders' capital if the device proves defective; a doctor who installs the device must, under California law, risk everything he or she owns.

Bad doctors should compensate a successful plaintiff in a malpractice suit. So should manufacturers of defective medical devices. But why is only the manufacturer allowed to operate with limited liability?

Although shielding business owners from unlimited liability can seem unfair, limited liability benefits our economy. It encourages entrepreneurs and investors to take risks. Risk taking is essential to progress. The threat of unlimited liability in the professions has led to enormous waste. This has been blatantly obvious in health cases, where defensive medicine and excessive testing have been rampant. A similar phenomenon occurs in other professions.

We should consider allowing California professionals and others to shield part of their assets from future creditors, however meritorious, without having to resort to exotic and potentially ineffective offshore trusts. We could require that they carry adequate liability insurance and have conducted a legal audit aimed at improving risk management. We could make an exception for those whose debts are related to criminal activity. We could set limits on the percentage of assets which could be shielded. We could continue to invalidate trusts set up after a claim has already arisen or in contemplation of incurring an obligation. We could define more accurately the responsibilities of professional advisors. We could, in other words, come up with a rational plan which would answer the demand for asset protection while preventing abuse and reducing tax evasion. The offshore asset protection industry is one cottage industry we could do without.