

# Barriers To Litigation In The Cook Islands

Below are three extracts from Cook Islands Trust Corporation's quarterly client newsletter, Pacific Times. These extracts provide an introduction to the practical application of Cook Islands law in court proceedings in the Cook Islands.

## Commencing Proceedings in the Cook Islands

Many of our clients ask what happens if a creditor decides to take court proceedings in the Cook Islands. Perhaps the most important aspect is that while many creditors might look at this possibility, most decide not to once they find out what they are up against.

Most creditors begin by getting a decision in a US court against the settlor of the trust. They attempt to enforce it against the settlor and at that point discover that the settlor's assets have been transferred to a Cook Islands trust. At this point the creditor's contingency fee attorney looks seriously at what is ahead of him. If he proceeds and gets a judgment from a US court setting aside the transfers of the assets to the trust, this is of little benefit to him. That judgment will not be recognized in the Cook Islands as it is based on US law and not Cook Islands law (US courts take the same position when confronted with decisions from other countries without special treaties). The contingency fee lawyer has to instead commence new proceedings in the Cook Islands under Cook Islands law. What does this involve?

- (a) He has to contact and instruct a Cook Islands lawyer to represent his client.
- (b) He has to pay for the Cook Islands lawyer in advance as Cook Islands lawyers are not permitted to act on a contingency fee basis.
- (c) The first step the Cook Islands lawyer will take is to examine the facts of the case to see if the action falls within the time limits set out in Cook Islands law. The most important of these prevents any action challenging a transfer to a trust outside of two years from the date of transfer. So if the assets were transferred in August

1999, the action must be filed in the Cook Islands before the end of August 2001. In most cases this test cannot be met and the Cook Islands lawyer then advises the creditor's lawyer accordingly. That inevitably leads to an early settlement of the claim.

- (d) If on the other hand the action is within the time limits, then the creditor's lawyer can file his proceedings. However, at this time a crucial and unique requirement of Cook Islands law comes into play.

In most countries litigation lawyers commence a case by filing a very broad ranging statement of claim. They do this because they normally do not know whether they have a good case or not until after they have obtained discovery of the other party's documents. So they initially embark on what lawyers call a "fishing expedition". Once they get discovery of documents, if they find they have a case they then amend their original statement of claim to fit the facts they now have.

In the Cook Islands, the creditor's lawyer cannot get discovery until after he has committed to the exact facts on which his case relies. The creditor's lawyer must file an affidavit setting out these facts in considerable detail, as well as refer to the same facts in the statement of claim. If the case proceeds and discovery of documents is ordered, and the documents show a different picture to that originally claimed, the creditor's lawyer is not permitted to simply amend his claim. Instead he must file a completely new statement of claim, and by this time the time periods for him to do so have often expired. What this means is that the creditor's lawyer must get the facts supporting his case right at the outset, and not rely on fishing expeditions to ascertain whether he has a good case or not.

The procedures outlined above are deliberately designed to protect transfers made to trusts from frivolous claims by contingency fee lawyers, and to provide trust settlors with some long term certainty in their financial affairs.

## All About Time Limits

All legal systems have a principle where a plaintiff loses rights if he doesn't use them. In English law, this principle is expressed in the Latin phrase, "laches", or "neglect of rights". Under the doctrine of laches, delay in taking court action prevents a plaintiff from proceeding, but the courts could decide whether that delay was reasonable having regard to all the circumstances. The courts consideration created uncertainty, therefore in the late 1800's the English Parliament passed the first Statute of Limitations.

A statute of limitations introduces arbitrary but finite time limits within which a plaintiff can bring an action. For example, under English law, an action for breach of a contract must be brought within 2 years and an action on a tort within 7 years. The time limits run from the date of the "cause of action", or the event giving rise to the claim. Over the years the courts extended the starting date to the time when the plaintiff had knowledge of the damage suffered. While there is some logic in this, the problem is that it may be 10, 20 or 30 years after the cause of action before the plaintiff is aware of the damage.

The asset protection law passed in the Cook Islands is quite clear in its objective to create certainty, if necessary at the expense of depriving a Plaintiff of his rights. The reason for this is that the law relates to family trusts, a traditional structure used for preserving assets against financial calamity, and one which therefore demands certainty.

The International Trusts Act 1984 ("ITA") introduced two types of time limits. The first is a pure time limit found in Section 13K(2). This section prevents a plaintiff issuing proceedings in a Cook Islands court against assets held by a trust, if those assets were transferred more than 2 years prior to the date the proceedings are filed. So if a sum of \$1M was transferred into the trust in March 2000, the last day for court proceedings to be commenced in the Cook Islands is March 2002. Note however, that if a further \$1M was transferred in March 2003, then that asset is treated separately and must also run the 2-year period before it is protected.

The second category of time limits does not prevent proceedings being issued, but instead deems certain transfers not to be fraudulent. As the plaintiff must establish fraud to succeed against the trust, the result is the same. There are 3 such

deeming provisions:

1. Section 13B(4) provides that a transfer of assets before the cause of action arises cannot be fraudulent.
2. Section 13B(3) provides that a transfer of assets more than 2 years after the cause of action arose cannot be fraudulent. These tests run from the "date of the cause of action" or the DCA. This term is defined in Section 13B(8) to mean the date of the act giving rise to the liability, and it excludes knowledge. Where there are successive acts, then the earliest act is the relevant one.
3. Section 13B(3) further provides that a transfer of assets will not be fraudulent unless the plaintiff has brought proceedings based on his cause of action (in any court) within 1 year of the date of transfer of the assets.

The tests in Section 13B do not apply where the plaintiff has already issued proceedings in relation to the cause of action prior to the assets being transferred to the trust.

The limitation tests can be quite difficult to apply. For example, a doctor makes an error in March 2000, and transfers assets to a trust in April 2002. The error is "discovered" in March 2003. The plaintiff will be within the 2-year period in Section 13K(2) if he commences an action in a Cook Islands court before April 2004. However, he still has to deal with Section 13B and to do that he must establish the DCA. If he claims the DCA is March 2003, when he discovered the error, Section 13B(4) will prevent him establishing fraud. If he accepts the DCA is March 2000, (which is the effect of Section 13B(8)), then a period of more than 2 years has passed since the DCA and the test in Section 13B(3) prevents any finding that there was a fraudulent transfer.

The consequence of the above time limits is that if a plaintiff is to succeed in an action against a Cook Islands trust, he must act on his rights promptly. Any delay is likely to result in him being unable to proceed against the trust in a Cook Islands court.

## The Solvency Test

The time limits are not the only tests a creditor must meet before he can proceed in a Cook Islands court against a Cook Islands trust. If the creditor gets past the time limits, there is still a further branch of the test establishing the settlor had intent to defraud. This test requires the creditor to prove the settlor was "rendered insolvent" as a result of a transfer of property to the trust. There are several parts of this insolvency test.

1. The burden of establishing solvency is on the creditor - so the creditor will be required to have access to the settlor's financial information before he can proceed.
2. The test is not whether the settler is insolvent under principles of general bankruptcy law, as the Cook Islands does not have bankruptcy law. The fact that the settlor may be insolvent when all his creditors are taken into account (the usual meaning of bankruptcy) is irrelevant. Under the Cook Islands test, solvency is measured by assessing whether, immediately after a transfer to the trust, the settlor had retained sufficient assets to pay the specific creditor who is bringing the action, and no other.

*Example: Settlor (Y) has assets of \$5M, held in a brokerage account. He owes \$5.5M total to a pool of creditors, and is insolvent under normal insolvency tests. One of those creditors, X, is owed \$1M. Y transfers \$4M to his trust, retaining \$1M in his personal account. X's account is recent and he is able to satisfy the time limits and bring an action in the Cook Islands High Court alleging fraudulent transfer. To continue this action, X must be able to establish that at the time Y transferred the \$4M to his trust, Y had insufficient assets left to settle X's account of \$1M. On the above facts, Y retained \$1M in his personal assets, and therefore did not render himself insolvent as a result of the transfer of \$4M. X cannot continue his action against Y in a Cook Islands Court. If Y had transferred \$4.2 M, then the balance held by Y (\$800,000) is less than the debt owed to X, the insolvency test is satisfied, and X may continue his proceedings.*

3. The solvency of the settlor is measured by the fair market value of the settlor's property at the time immediately after the transfer to the trust. The intention behind this part of the test is to provide certainty. There are two aspects to this:
  - (a) If the settlor has some doubt as to the fair market value of his property then before making the transfer he should seek expert advice, and perhaps a formal valuation, prior to transferring assets to the trust. If the valuation supports his solvency then it will also help to rebut any allegation of fraudulent intent.
  - (b) It is irrelevant if the value of the settlors remaining property subsequently increases or decreases.

*Using the above example, if the value of the assets remaining in Y's investment account falls dramatically 6 weeks after the transfer, triggered perhaps by an unexpected and uncontrollable event such as 9/11, it*

	Date of Transfer	Value of Assets Transferred	Balance of Assets Held by Y	Value of X's Claim
1	1 Jan 00	\$1M	\$4M	\$1M
2	1 Sep 00	\$1M	\$2.5M	\$1.2M
3	1 Dec 00	\$1M	\$1.5M	\$1.3M
4	1 Mar 01	no transfer	\$1M	\$1.3M
5	1 May 01	\$0.5M	\$0.5M	\$1.4M

*will not affect the solvency test. Similarly if Y was insolvent, having retained only \$800,000, this will not be remedied by the fact the remaining assets grew to \$2M over the next 6 months.*

4. The above tests must also be applied when there have been several transfers of assets over a long period of time. In this case the creditor will have to establish insolvency at each point in time that a transfer is made. The creditor needs to establish a "balance sheet" showing the settlor's assets and their values at each relevant date, as well as the impact on the solvency of each transfer. It is also not sufficient to merely start off with a valuation and work through mathematically as the settlor's financial position will change with the markets. Example (see chart 01):  
*At points 1,2, and 3 Y remains solvent after each transfer. At point 4 the value of Y's assets are less than the amount of X's claim, however this is caused by market movements and not by any transfer, therefore Y again remains solvent under the Cook Islands test. At point 5 Y made a further transfer to the trust and became insolvent. The transfers prior to this date are not affected and will not be available to satisfy X's claim.*
5. If the value of the creditors claim is uncertain at the date of transfer then the court may take into account the value of a subsequent judgment, but is required to examine the settlors intent. In the above examples if Y took advice and believed he had retained sufficient assets to cover X's claim, then irrespective of X establishing insolvency, X will be unable to establish an intent to defraud. Under Cook Islands law the burden of proof lies on the creditor to establish intent to defraud.

In closing I want to give you an example from real life although the numbers are changed. It raises real issues about the uncertainties of the legal system you live in.

*Y owns a business with an established value of \$20M. He also has personal investment portfolios of approximately \$30M. He has debts of \$8M. He decides to settle part of his assets on an asset protection trust and transfers \$20M of the liquid assets to the trust. He has a balance of \$10M of investments and a business with a value of \$20M. Six months after he has completed the transfers the economy slumps. This has a devastating effect on his business which suddenly collapses. His investments are likewise impacted by the reversal of the financial markets. He cannot now service his debt and the creditor commences proceedings. Twelve months after the transfers he is insolvent, his assets having fallen to less than the \$8M debt. Meanwhile the assets in the trust have*

*survived the market falls under foreign management and remain at their \$20M valuation. The US court's approach to this problem is simplistic - you have a debt of \$8M here, and \$20M over there, therefore you must have had fraudulent intent when you settled the trust. Cook Islands law looks quite differently at the issues. It ignores the changes in valuation occurring after the transfers, and asks whether Y was solvent or not when each transfer took place. The answer in the Cook Islands was that he was solvent, therefore he could not have a fraudulent intent. ■*

---

For further information on any of the matters discussed above, or for any other queries, please contact  
Cook Islands Trust Corporation Ltd at [info@ctrust.org.ck](mailto:info@ctrust.org.ck) or telephone +682 24538