

## OFFSHORE PROCEDURE: PRACTICAL ISSUES IN THE OPERATION OF OFFSHORE STRUCTURES;

Clients establish offshore trusts, corporations, LLC's and LLP's relying, quite reasonably, on their advisor's recommendations. But clients often know of 'offshore' only in a general sense, sometimes without having much comfort in what it is they do know. In my experience, many clients initially know little about the day to day operation of the corporate or trust structure put in place and asset placement options, including banking. They can be unsure as to how a trustee operates a structure and deals with assets, and what part, if any, they play in the process of investing them safely and productively.

Advisors owes it to their clients to provide not only information, but a real understanding of the offshore process, particularly when this is quite likely different from what a client has been used too, domestically. Underlying what otherwise might simply be an advisor's good intentions, is a professional duty to fully inform, competently advise, and make independent recommendations to, a client. As well, the advisor is in a position to add value to a client's choices. An advisor thus needs to be in a position to explain the intricacies, nuances, and mechanics of offshore trust and banking operations.

The positive side of this educational process is that a fully informed client is more confident and likely to not only accept an advisor's recommendations, but less in the way of 'control' a sensitive issue post the Anderson decision.

While personal relationships between advisors and service providers underlies much existing offshore business, there are a number of industry realities, and due diligence inquires anyone seeking a new provider should be aware of. (The term 'service provider' incidentally, covers trust companies, legal, and financial advisors in offshore jurisdictions. For convenience I use the term 'trust company' in this paper to cover all categories of service provider.) I propose to deal with the essentials of operating an offshore corporation, an offshore trust and an offshore bank account. Many of the features are common to all offshore structures.

### 1. CORPORATIONS

Corporations, companies, IBC's, by whatever name, are still sold and used in large numbers, far more so, for example, than trusts. They may be used for a single transaction and are commonly not renewed after the first year's registration. They

have a short shelf life. Compare trusts, which are commonly maintained for many years. The purposes of the entity and nature of relationship between client and trust company is usually quite different.

#### PRICE

Despite the best marketing efforts to distinguish finely wrought legal advantages in one type or in one jurisdiction, as opposed to another, corporations are or are on the way to becoming, commodities. With some exceptions at both the bottom (Panama?) and the top (Bermuda?) of the price scale, they are, like all commodities, sold essentially on the basis of price as opposed to content, quality.

Their price is determined on a large scale where the particular jurisdiction or features of the corporation are not particularly important to the purchaser. As with other commodities, like wheat or money, profitability is determined by price, volume and convenience; one reason why successful 'corporation' jurisdictions like the BVI have upgraded their registry facilities to provide for electronic everything.

Trust companies often provide nominee shareholders, director, secretary, and registered office for an all-inclusive annual fee. Some trust companies offer the bare company incorporation and add services and fees as required. It is often confusing to compare quotations for services from one provider to another, unless one is aware of the two bases for quotation. The apparently low initial fee can sometimes end up quite high once essential aspects are paid. Transactional services are always extra and usually charged by the hour. Rates vary depending on the level of service required. Some providers charge basis point fees based on asset value, although most clients perceive this to be worthwhile only when value is added. An advisor needs to sort out price and convenience aspects before proceeding further.

#### ESTABLISHMENT

Corporations in the offshore world exist by virtue of their registration, requiring the payment of annual fees both to the government and the administrator, usually a trust company. Depending on the underlying system used in a particular jurisdiction they are special corporations available only to non-resident use, or as a special category of domestic corporation exempt local taxes. It is self evident that without payment of the required fees, a client's corporation can be entangled in complications unwanted by the client or the jurisdiction.

## OWNERSHIP

The next thing to deal with is the common conceptual error made by many clients and even by some advisors. Who owns the company? While a trust company can for the company and provide a shareholder and director, it does so only as nominee for the client. A declaration of some sort is made by the trust company to this effect. To go further would involve the trust company as a participant in the client's actual affairs.

Some jurisdictions permit companies to own their own shares and this process can be useful, though while it shields the client from legal or beneficial ownership it also means he may have a perception of having a tenuous link to the whole. He usually wants more. Very convoluted structures with other corporations formed to be shareholders, directors, or advisors, to the first can result.

There are other control or ownership options such as bearer shares, or bearer debentures, (the existence of which suspends the normal control and management functions and rights of the directors) and most rely on related privacy regulation for their appeal to clients, rather than legal efficacy.

## OPERATION

Once established, how is the company operated? Options range from full service administration and operation by the trust company, through to operation entirely by the client and his nominees, with minimum passive administration carried out by the trust company. We distinguish administration and operation. The client can be as close to or as far away from actual operation of the corporation as he wishes.

## COMMUNICATIONS

In each case though, basics require that someone must be nominated with authority to communicate with the trust company to convey instructions and receive communications. The means of communications must also be agreed. A trust company will likely require indemnification from a client if, as will likely be the case, anything other than hard copy original signed instructions are envisaged. The latter are conventional in Hong Kong for example, because of a widespread reluctance to accept faxes which can be faked. These are matters to be worked out with the trust company at inception.

Privacy of communications is another issue to consider. Letters and packages as well as many if not all-electronic communications can be intercepted and monitored

by government agencies or even commercial rivals. The client's reasonable wish for privacy is sometimes erroneously and unfairly equated with mala fides or worse.

Of course, in the real world, e-mail is now widely used, although verification protocols are still being worked out. Encryption is clearly attractive. But already E-mail is so convenient that the fax may soon be a redundant machine; remember telexes?

'Communications' might include travel links. Clients rarely want to turn a physical visit, if they make one, into an ordeal by adventure.

#### INSTRUCTIONS

Assuming a trust company provides a nominee director, the person authorised to communicate with the trust company will issue instructions to that director from time to time in an agreed manner. Leaving aside the potentially complex 'control and management' issues that accompany such instructions, it is clearly in everyone's interest that the instructions be unambiguous and direct. I have seen attempts made to convey instructions in a thinly veiled and often comic code; 'Uncle Max asked if it rained on Saturday night, (identification of the sender) and wants you send him all the travel brochures ( the instruction; transfer all the funds).'

If the 'control' issue is significant in planning, the person authorised to give and receive communications might be appointed as an advisor to the director with particular areas of responsibility. Thus the director's acceptance of the advisor's recommendations may be demonstrated to be in accordance with a corporate plan, and not merely the exercise of the de facto controller's whim.

#### RESPONSES

Proper maintenance of transaction records is what the trust company must do. A director's decision to have the company enter into a binding contract requires evidencing in the form of a resolution authorising him, (or it, if a corporate nominee director is used) to do so. The contract is then executed. Copies are kept on the file. The client may require notarised, or otherwise verified copies.

#### SAFEKEEPING RECORDS

The trust company will usually keep records safe as part of the annual administration contract.

## AUDITS

Whether or not the client wants an audit completed from the standpoint of commercial prudence, the legal requirement to audit corporations varies from jurisdiction to jurisdiction. Most do not require it if the shareholders agree. There is clearly a cost associated with the process. Some jurisdictions, Vanuatu being one, have a thriving CPA service industry based in part on the annual audit requirement for corporations.

Most corporations that hold banking or insurance licenses are required to undertake an audit annually.

## BILLINGS

One item to be agreed in advance is where bills go to be paid and what funds are used to pay them. Some clients authorise payment from funds held by the trust company in advance for particular transactions. More often clients authorise deduction from funds held on approval of a particular billing. Billings tend to be at least equal to those for equivalent domestic services because of the nature of the service and the cost structure of offshore operations in smaller countries. Mail, courier, and utility charges for example are usually higher

## TERMINATION

Sometimes, clients simply abandon corporations, and fail to respond to the trust company's communications. Most good corporate legislation contemplates this, and include provisions that permit these corporations to be struck off the register without fuss, but at the same time permits their being reinstated if creditors, assets, or transactions, hitherto unknown to the trust company belatedly appear. Liquidation is the proper and best way of ending a corporation's existence without comeback. A client should contemplate termination at the outset, and set aside funds to have this completed.

## 2. TRUSTS

By their nature, trusts are conceptually different from corporations and require similar, but subtly different operating procedures. The most difficult thing for most clients to appreciate and accept is that fundamental of a trust, that while they may have an equitable interest as a beneficiary, the trustee is the legal owner of the assets and cannot and should not be 'instructed' to do anything. It is quite proper for a settlor/beneficiary to make requests or recommendations but he cannot make

them mandatory without running into well-established principles regarding so-called 'sham trusts.'<sup>i</sup>

#### ESTABLISHMENT

The settlor is conventionally also a beneficiary, along with family members. There may or may not be co-trustees and a protector (who may be the settlor, although a separate entity is usually now recommended<sup>ii</sup>). The settlor gives up legal ownership of the assets conditional upon acquiring a beneficial interest subject to the terms of the trust agreement.<sup>iii</sup> Conventionally, original documentation is prepared by the client's legal advisor, checked by the trustee, executed by the parties, and registered. Watch out though for the advent of on-line trust formation which could both significantly speed up the process, and challenge the role of the legal advisor, in much the same manner that cut-price brokers challenged the securities industry.

Fee and other administrative issues are similar to those described above for corporations.

#### 'SHAM' TRUSTS

This topic warrants expanded treatment because of the significance a collection of operational indicators can have to the success or failure of a trust. This success or failure may come to light only in the course of later discovery as part of litigation, so it pays to get it right from the outset.

The question revolves around the existence and degree of 'control' exercised over the trustee by the settlor or any beneficiary. Given the uncertainty that exists at common-law regarding this issue, some offshore jurisdictions have resolved the issue in legislation, providing that there shall be no adverse assumption made against a trust merely because the settlor retains control or has an interest as a beneficiary.<sup>iv</sup>

#### COMMUNICATIONS AND DEALINGS

In practise, the real issue is not the fact of a control or other interest existing but the manner and degree of its exercise. A beneficiary might have an unobjectionable right to replace the trustee, but should that beneficiary misunderstand the nature of the right, and seek to instruct the trustee in the manner in which the trustee exercises its functions, the instruction could, if accepted, constitute an infringement of the trustee's duty and weight an implication that the trust was a mere sham.

Thus communications to and from the trustee, and dealings with trust assets are more significant with trusts than with corporations.

Fortunately, there several leading cases to provide examples of what not to do. In *Rahman* <sup>v</sup> the court found that the relationship between the parties was one of principal and agent rather than trustee and beneficiary. Communications and dealings between the parties illustrate the point;

1. the settlor's consent to the trustee's investment decisions was required, but in practise, the settlor appointed new advisors and entered into the investment mandate personally and then gave instructions concerning investments directly. The trustee asked the settlor for 'instructions' in regard to investments.
2. the settlor assigned contractual rights to the trustee, but in practice diverted principal and interest arising under those rights to his own purposes.
3. The trustee paid out trust funds without distinguishing whether they were loans or distributions.
4. On the settlor's instructions, the trustee paid out funds as loans to beneficiaries repayable on the settlor's demand.
5. The trustee disposed of trust assets on the settlor's instructions without regard to the terms of their disposal.

In *Brown* <sup>vi</sup> :

1. the trustee never signed anything other than the trust documentation .
2. communications with the investment advisor all originated from the settlor not the trustee.
3. Investment funds supposedly owned by the trust, originated from the settlor not the trustee.
4. The trust investment fund was controlled not by the trustee, but by the settlor, who was also a beneficiary.

In *Grupo Torras* <sup>vii</sup> similar activities took place. The court held that it could look beyond the documentation to the actual workings of the trust;

'No one ....said that the [trust] is not a trust in the normal sense of that word; what is being sought .....is a lifting of the veil of that trust.....so that the court can determine if, and to what extent, the corpus of the trust , is traceable to part of the funds allegedly misappropriated,,.....,and if so, to what extent that corpus is to be considered as [the settlor's] property and therefore subject to the tracing order.' <sup>viii</sup>

These cases indicate guidelines as to how a trust should be established and operated to avoid the 'sham' argument. It is also interesting to note how guidelines coincide in any case with conventional good business practise;

1. the trustee should be prepared to carry out fiduciary duties properly and establish adequate records.
2. the trustee should take steps to obtain title to trust assets.
3. any appointment of an investment advisor should be defined and documented. The trustee should require proper consents and reporting.
4. The settlor and beneficiaries may request and recommend actions to the trustee, not instruct them.
5. The trustee should not blindly follow a settlor's instructions.
6. A settlor or beneficiary should not be in a position to deal with trust assets without reference to the trustee.

Clearly these matters should be discussed with the trustee so that procedures are adopted that meet reasonable client expectations and needs without jeopardizing the integrity of the structure.

### 3. BANK ACCOUNTS – ASSET PLACEMENT ACCESS AND DUE DILIGENCE

Any one can open an account with a domestic bank, usually on production of conventional identification like a driving licence. Not so in the offshore world. The

very accessing of a bank willing to handle an account is a valuable service. Offshore service providers conventionally make their banking relationships available to clients. They are the ones with the relationships that make conduct of a client's offshore business possible. While they certainly earn fees for this, they are not going to use up, rather than add to, their own credibility in these relationships unless they know the clients and understand their business, and that the bank will accept the client. All banks today practise forms of due diligence that were thought unnecessary in past years. Banking scandals in the 1980's led to new codes of conduct being adopted by most international organisations such as the OECD. Thus a trust company asked to open a bank account will make inquiries to satisfy themselves as to the client's bona fides, knowing that more than likely they in turn will be asked to provide this information to the bank where the account is to be opened.

#### WHAT DOCUMENTATION IS REQUIRED?

Evidence of identity is required, usually in the form of a copy of the beneficial owner's passport. References may be required. Generally, the less well the trust company knows the client, the more they will want in the way of verification as to the identity, bona fides, business, source and ownership of the funds in question, and the purpose the account is to be used for. Advisors should be prepared to provide this material. Where the advisor has a relationship with the bank in question, the due diligence and documentation process is usually simplified.

#### WHO OWNS THE ACCOUNT?

Whatever the beneficial relationship between say trustee and client, the trust company will be owner of the account in the case of an account for a particular trust. A corporation may have an account in its own name. In each case, there will likely be underlying beneficial relationships. In most cases these underlying relationships will need to be disclosed to the bank holding the account.

#### WHO WILL BE THE SIGNATORY?

Where it is the legal owner of an account, the trust company will provide a signatory. There may be other signatories, depending on the level of comfort the client has in the process, and the level of involvement required. Some account mandates require that multiple signatories be obtained before acceptance. This can be an effective safeguard against fraud.

With investment accounts, a client may be appointed as an investment advisor to the trust company with certain defined powers to direct investments.

#### WHAT RECORDS ARE KEPT

Obviously account opening documentation and normal transactional records are maintained, both by the trust company and the bank.

#### PRIVACY

Many if not most (but not all) offshore finance centers have laws intended to keep records private as between the client, trust company and bank concerned. It is usually difficult to access records through the local regulatory process. In some jurisdictions, even litigation is carried out *in camera*<sup>ix</sup> so as to maintain privacy. This aspect of the business has been the subject of considerable criticism by organisations representing economically powerful domestic jurisdictions, <sup>x</sup>fearing at least publicly, that privacy laws in offshore jurisdictions necessarily facilitates the conduct of illegal activities there by citizens of those domestic jurisdictions.

But any reasonable comparison of privacy laws in representative offshore and domestic jurisdictions reveals that, if anything, privacy laws are more not less, highly developed in the domestic rather than in the offshore jurisdictions. One suspects that the domestic jurisdictions are frustrated on two counts; that their status as nations does not afford them greater rights in regard to accessing information than individuals in generally small offshore jurisdictions, and that the arguments put to persuade small offshore nations to 'harmonise' their tax regimes with those of the bigger nations have thus far met with little success.

#### CORRESPONDENTS - CURRENCIES DON'T LEAVE HOME

A simple but fascinating aspect of banking between different countries is that currencies do not leave home. This means that a USD deposit accepted from a trustee by bank A in a country other than the US is not held in that country. Rather, it is held by bank A's correspondent in the US. In other words bank A has an account at the US bank where its USD deposits are held. There are separate independent contractual relationships between client and trust company, between trust company and bank A, and between bank A and its US correspondent. Neither client nor trust company has access too or legal rights in relation to the correspondent account. The same holds true of all currencies.

### DELAYS – WIRE TRANSFERS

Wire transfers generally take between three and five business days to take effect, the latter usually caused by the intervention of a weekend. Remember that even in a simple case, the trust company must give instructions to its bank which then instructs its correspondent, which transfers funds to the intended destination bank. A trust company will require written instructions to move money.

Given the room for human error, advisors are cautioned to check routing, and account numbers very carefully. A receiving bank will not place funds with an account unless both number and name details match. They will then either return them to the sending bank, or await a further correct instruction.

Where significant amounts are being transferred, the trust company will monitor progress – from the time the first bank in the chain deducts the amount from the trust company's account, until it is received at the destination account, no interest is earned. An undue delay might then be the subject of a so-called value claim for lost interest.

### TRAILS

With the possible exception of actual bank notes, transfers of funds whether by wire, money order, or personal or cashier's check leave an obvious trail in the form of bank records somewhere. Quite apart from the alarm their appearance in quantity causes, bank notes are troublesome in this paperless electronic age. Banks must pay for transport, insurance, security, and storage of large sums and these are real costs. Thus wire represents the only practical manner of transferring funds. Advisors are aware of course of the dangers presented by clients who demand privacy for anything other than what might be called ideological reasons. A graphic description of how banking actually works usually deters such prospective clients from a second visit.

### ETHICAL CONSIDERATIONS

'Money makes the world go round' That simple, if sometimes cynical proposition is not often dealt with in discussions of offshore dealings. Banks and other financial institutions frequently pay referral fees in the normal course of business and disclosure is made to clients.

Clients are of course entitled to know whether referral fees are paid to or by their advisors, and institutions where funds are being placed. Some advisors groups are

prohibited from demanding or accepted referral fees even with disclosure. But generally, such fees are conventional and their disclosure at least then puts a client in the position of being able to make a fully informed decision whether or not to accept a recommendation in regard to a particular service.

## CONCLUSION

We note in concluding that despite the best-intended efforts of greater nations, the offshore finance center industry continues to prosper in smaller offshore jurisdictions. As more advisors become familiar with the means of doing business there, so too does the level of client confidence increase. There is a right way and a wrong way in every business transaction and hopefully this outline of procedures I am familiar with constitutes more right than wrong and is therefore of use to you.

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<sup>i</sup> See: In Re Brown; Case A95-00200-DND, US BKRCY, Dist. of Alaska; Grupo Torras; SC of the Bahamas, 1994, No. 72; , Rahman v Chase Bank (CI) Company Limited , J.L.R. 103, Royal Court of Jersey; and David McNair; 'Sham'Issues in Trust Administration, Offshore Finance USA, V1. No. 4, September/October 1999.

<sup>ii</sup> See: Anderson Case;

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<sup>iii</sup> Note: In English common law usage, the governing agreement is called a 'Trust Deed.' In the US, this term describes a document evidencing a mortgage over real estate. To avoid confusion, a better term for the offshore industry is 'Trust Agreement.'

<sup>iv</sup> See; The International Trusts Act 1984, Cook Islands, s.13C.

<sup>v</sup> Ibid, p. 83

<sup>vi</sup> Ibid

<sup>vii</sup> Ibid

<sup>viii</sup> Ibid p. 18

<sup>ix</sup> e.g. the Cook Islands

<sup>x</sup> e.g. see the reports of the Financial Action Task Force, a division of the OECD.