# LETTER FROM PARADISE: RISKS AND REPUTATIONS IN THE OFFSHORE WORLD

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At 18:00 GMT on Sunday 5 November 2017, I, like many others living in offshore financial centres (OFCs), was poised to review the publication of the "Paradise Papers", which the International Consortium of Investigative Journalists (ICIJ) had promised would include startling revelations about the use of so-called "tax havens" by wealthy individuals and corporations, following a data breach at leading offshore law firm, Appleby.

"Is that it?" was the initial reaction.

There were several examples of famous persons and corporations using offshore trusts and corporations for entirely legal – and well-known - tax mitigation purposes (the morality of which is open to debate), but no evidence of anyone doing anything illegal. Amongst all the voyeurism, it was overlooked that the "Paradise Papers" themselves were stolen property, much of it private and legally privileged material pertaining to individuals. Nor did the press seem to recognise the irony that, whilst castigating OFCs for their supposed "secrecy", they were content to receive and publish stolen materials from a secret source.

The pejorative term "tax haven" - which implies lax regulation and lack of transparency in addition to low or no income or corporation taxes - is not one that is accepted by any of the leading OFCs: Bermuda, the Cayman Islands, the British Virgin Islands, Jersey and Guernsey, the jurisdictions on which this article focusses.

## OFC REGULATION AND PRACTICE

Whilst there are certainly jurisdictions that meet the "tax haven" label, these five OFCs are all tightly regulated with anti-money laundering and anti-terrorist financing (AML/ATF) regulations at least as stringent as in the UK.

Indeed, in many respects these OFCs have been ahead of "onshore" jurisdictions with many offshore financial institutions and professional service providers having instituted voluntary AML/ATF measures long before they - or their onshore counterparts - were required. Regulation beyond AML/ATF is also at an internationally accepted standard. For example, in 2016 Bermuda's regulator, the Bermuda Monetary Authority, was granted "equivalent" status by the EU under "Solvency II" in recognition of its robust scheme of insurance regulation.

Lack of transparency is also a myth. Each of these five OFCs has tax information exchange agreements with leading onshore jurisdictions and all have implemented (or are in the process of implementing) the OECD "Common Reporting Standard" (CRS) whereby persons investing in those jurisdictions will have their financial account information automatically submitted to relevant tax authorities. Bermuda, for example, also has an intergovernmental agreement with the US pursuant to the US Foreign Account Tax Compliance Act (FATCA), ensuring the automatic disclosure of financial details for US tax payers. Only last month, the EU published a "black list" of 17 non-cooperative jurisdictions, based on criteria including transparency and fair taxation, which excluded all the OFCs covered by this article.

But there is no doubt that OFCs, and those working in the offshore finance sector, are feeling the heat: in the current climate, OFCs cannot afford to put a foot wrong, as they seek to demonstrate to the outside world that they are responsible jurisdictions. And, inevitably, some of the media mud has stuck, with individuals and corporations questioning whether it is worth using offshore structures. For example, Thames Water recently announced it would be closing the company's Cayman subsidiaries (used to raise international finance to fund infrastructure improvements in the UK), even though Thames Water claimed there to be no tax advantage accruing to them as a result. As the company's chairman said, "it just looks wrong".

## CLAIMS ACTIVITY

With this in mind, what claims activity has been seen in OFCs or can be expected by financial institutions and professionals operating in OFCs (who, almost exclusively, purchase their errors and omissions insurance from the London Market)?

The need for offshore regulators to demonstrate their effectiveness has obvious implications for all regulated entities. There was a time when regulators in OFCs were regarded as "toothless", anxious to avoid a reputation for excessive regulatory interference in a highly competitive environment with other OFCs. This is no longer the case and indeed many believe that offshore regulators are actively seeking defaulting parties to "throw the book at".

Insurers providing cover for regulatory investigations can expect increased activity, both in terms of the level of costs of responding to an investigation as well as the resulting sanctions (where insurable).

Offshore professionals are also increasingly exposed to the long reach of onshore authorities. In addition to obligations arising under the CRS and FATCA, offshore professionals are subject to statutes such as the UK's Criminal Finances Act 2017, which imposes criminal penalties for the facilitation of tax evasion.

As far as offshore banks are concerned, the increased focus on AML/ATF compliance – both onshore and offshore – has had profound implications. For leading multi-national banks, many rocked by widespread regulatory enforcement actions and huge fines in the US and Europe, the compliance implications of operating in OFCs may not be worth the benefits. HSBC, for example, closed its Cayman operations in 2014 and later divested its trust administration business in Bermuda.

Increased concerns about AML/ATF have also led many onshore banks to question the value of their correspondent banking relationships with independent banks in OFCs, presenting a potential existential threat to some offshore banks. On the customer front, however, offshore banks continue to enjoy a level of protection often not found onshore, with extremely broad exculpation clauses commonplace in customer agreements, presenting severe hurdles for customers wishing bring compensation claims.

Offshore professional trustees have been a distressed risk class for several years. The heavy compliance burden, combined with a move towards more proactive trust management, has increased their operating costs and in turn encouraged consolidation to enhance economies of scale.

Litigation by beneficiaries against trustees has seen a marked increase, in large part as a result of a greater litigation appetite by third or fourth generation beneficiaries. The need to restructure or to collapse older, "dynastic" trusts for high net worth families, perhaps in response to onshore tax considerations, also increases the likelihood of claims against trustees as issues come to light during the restructuring, or trustees get caught in the cross fire of family disputes.

Offshore law firms have not seen any notable change in claims activity since the financial crisis, despite their central role in offshore finance. There is an obvious cyber risk to firms focusing on private client and corporate work, with hackers attracted by the possibility of "Paradise Papers" type revelations. However, it is understood that there have not been any significant client claims against Mossak Fonseca (the firm at the centre of the "Panama Papers") and it remains to be seen whether Appleby will face compensation claims from clients as a result of the disclosure of client information by the ICIJ.

## TAILING OFF

The huge spike in litigation involving hedge funds in the wake of the financial crisis (predominantly in the Cayman Islands) has tailed off substantially in recent years. In a judgment of the Guernsey Court in September, seven former executives of Carlyle Group's mortgage-bond fund, which collapsed in 2008 with over US$1 billion of losses, prevailed on each one of the almost 200 allegations by the plaintiff liquidators, consistent with the trend of failed attempts to hold fund directors liable for investor losses.

Offshore directors continue to be a relatively protected species and, apart from the shock ruling of the Cayman Court in the *Weavering* case [2011], where the directors were found to have acted with willful default in relation to the loss of US$111 million (which judgment was subsequently set aside by the Court of Appeal in 2015), there have been few judgments of concern for insurers.

Notwithstanding this, the practice in many OFCs of professional directors (many of them lawyers) holding multiple directorships – often in the hundreds – has come under sustained criticism and led a move towards such persons holding fewer directorships and taking a more active role in corporate affairs. This may improve corporate governance but it may also increase the exposure of professional, non-executive directors who may no longer be able to claim they lacked knowledge of impugned transactions.

OFCs are used to being caught up in the politics of onshore jurisdictions. If these OFCs are to survive (and I am confident they will), it will be critical that they continue to demonstrate that they are responsible, and cooperative, jurisdictions that play a valuable role in international finance and affairs.

*A version of this article previously appeared in Insurance Day*

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