$1.50 VOL. 25 NO. 12 www.ocbj.com March 25-31, 2002

ORANGE COUNTY BUSINESS JOURNAL

THE BOARDROOM POST-ENRON

Operating Offshore: A Tale of Two Companies

by James B. O'Neal and James S. Weisz

If you travel to George Town, Grand Cayman these days, you will note that one of the buildings downtown has a partially completed top floor. The building houses the law firm of Hunter & Hunter, which originally began construction to add a floor to house the staff needed to manage the myriad number of legal entities affiliated with Enron. When Enron's woes became public, construction stopped. Please don't worry, though, about the appearance of downtown George Town. The landlord is completing the construction, but Hunter & Hunter will not likely be taking the extra space.

Between daily revelations about the offshore activities of now bankrupt companies and increasing pressure from the major industrial countries to eliminate secrecy in tax-haven countries, you may be left wondering whether there is a legitimate reason for international companies to operate offshore. Does the revelation that a company has an affiliate in the Cayman Islands, a subsidiary in Bermuda or a joint venture partner located in Luxembourg automatically mean that the executives running the company are one notch away from money launderers? In some people's minds, even the mention of a Cayman Island subsidiary conjures up the images of financial improprieties such as suitcases of cash being whisked away to some tropical isle.

A tale of two companies

There are instances where these images are justified. But more frequently, as the law firm of Hunter & Hunter knows all too well, the distinction between legitimate and illegitimate uses of offshore jurisdictions is much more subtle. These subtleties can be illustrated by the story of two companies. One we will call Acme, and the other we will call Rex. Both companies are in the computer software development and distribution business. Both companies have international sales, maintain multiple offices in various geographic regions throughout the world, including the United States, and both companies are profitable. Both companies are publicly owned, having stock that has been traded for years on major stock exchanges.

The similarities of the two companies end with the nature of their management. Acme is managed by individuals who look for every loophole, both in financial reporting and in paying taxes. The head of Acme, John Smith, never met an idea that he didn't like. Rex, on the other hand, is managed by individuals who understand the need for careful planning to mitigate the tax burden that their international operations would otherwise need to bear, but appreciate the need for a cautious approach to any proposed transaction that is submitted to them for their consideration. More about Rex and its CEO, Bill Jones, a little later.

Looking for loopholes

But first, we will look in more detail at an idea that was presented to Acme that ultimately proved to be worse than useless. After Acme went public, its competition became more fierce, resulting in downward pressure on the prices it could charge for its products. Accordingly, its gross margin on sales was under pressure. After doing as much as he thought possible to cut production and distribution costs, John Smith decided to look at reducing the cost of borrowing. As Acme's margins became thinner, the strength of its balance sheet became less attractive, and the ratio of its debt to shareholders' equity began to grow. At the same time, John Smith was under tremendous pressure to open additional branches to expand Acme's consulting operations to meet analysts' expectations for growth. This meant more office space, which in turn meant more debt. Because the strength of Acme's balance sheet was eroding, the debt was incurred at increasingly greater cost.

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One day, consultants came to Mr. Smith and suggested a way for Acme to improve its balance sheet while at the same time continuing to grow at the rate the analysts expected. The transaction worked like this—instead of Acme borrowing from its working capital loan to put a down payment on a building and then borrowing additional funds to finance the rest of the purchase price, a special entity could be set up to do the same. This special entity would buy the building, obtain the financing and rent the building to Acme. The consultants promised that this could keep the debt off Acme's balance sheet. The nature of the rent could be characterized as short term, thereby enabling Acme not to disclose the lease as a long-term lease for financial accounting purposes, also beneficial to its balance sheet.

In order for the lender to be satisfied that the property used to secured the loan could not be tied up in bankruptcy in the event Acme's financial affairs deteriorated, the lender insisted that the owner of the real estate be a company established in the Cayman Islands. The lender insisted that this company be owned by a trust, which included terms preventing the company from declaring bankruptcy. John Smith recognized this as a legitimate request by the lender because he had once learned that such an arrangement in the Cayman Islands could offer the lender greater protection against bankruptcy than could a similar arrangement in one of the states. Although some states also offer lenders similar comfort, setting up the arrangement in the Cayman Islands seemed to offer the lender additional protection without any corresponding consequence to Acme.

This all seemed reasonable to Mr. Smith, and he gave the go ahead to use this structure to purchase a new regional headquarters facility in Houston, Texas. Acme's board also approved the transaction. As the transaction proceeded, the lender explained that it was not quite satisfied with accepting only the property as security for its loan and asked for a guaranty from Acme. Acme's accountants advised that such a guaranty might require the disclosure on Acme's financial statements of the debt. Mr. Smith turned to the consultants for a solution. They suggested that if the bank were to get a personal guaranty from two directors of Acme (both with high net worth), as well as the managing director of the investment bank that took Acme public, then the loan could be made without any guaranty from Acme. Naturally the two directors and the investment banker wanted to be indemnified by Acme. Acme indemnified the directors and investment banker and placed some of its stock into an escrow account to secure the guaranty. Mr. Smith was concerned that payments might be required on the indemnity if things did not work out, so he asked Acme's chief financial officer to run the Cayman Islands company. As originally structured, most would agree that the loan would properly be excluded from Acme's balance sheet. But with the additional "features" added after board approval, the transaction is not appropriate as Acme plans to report it.

The transaction was consummated and the financial statements were issued *not* reflecting any of the debt in the special purpose company. Mr.Smith liked the transaction so much that he used it many other times to purchase other facilities around the globe. Hundreds of millions of dollars worth of debt was not reported on Acme's financial statements.

The harsh reality

Unfortunately, Acme's financial condition continued to deteriorate until the time when it needed to file for bankruptcy protection. Naturally, its stock price plummeted when it filed for bankruptcy protection. As part of the bankruptcy process, the public became aware of the so-called "off balance sheet financing" transactions in which Acme had been engaging. Now, in addition to accusing Mr. Smith of running an otherwise successful company into the ground, headlines were being published like "Smith Moves Acme Money to Cayman Islands" and "Acme Has Dozens of Offshore Accounts."

Mr. Smith then became aware of the harsh reality that while the use of a special purpose company domiciled in the Cayman Islands was not much different than using a special purpose company domiciled in Delaware or Nevada, the impression that it gave was far different. Mr. Smith learned that the advice the consultants gave him concerning the accounting treatment for the

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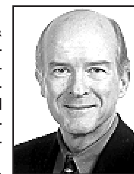
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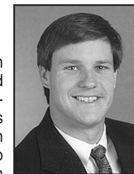
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debt owed by the special purpose entities was the subject of heated debate in the accounting and financial communities and not as clear as they suggested. Mr. Smith now finds himself in trouble with the Securities and Exchange Commission for his failure to appreciate the inappropriateness of the accounting for the transactions. Of course, the accounting treatment would have been equally inappropriate if the special purpose companies had been formed in Delaware instead of the Cayman Islands, but the headlines were just too tempting and the focus shifted to the offshore nature of the transactions.

Even more tragically, the independent members of the board of directors of Acme were questioned for their willingness to involve Acme in " risky offshore transactions." Again, the mistake that was made was the failure to keep track of an evolving transaction and to appreciate the inappropriateness of the accounting treatment, but the headlines focused only on the offshore aspect of Acme's transactions.

Creative but cautious

Unlike Acme, Rex is headed by Bill Jones, who is creative but cautious. Recently, Rex has been experiencing pressure on its margins from competitors outside the United States who have the advantage of operating from low or no tax jurisdictions.

To be able to reduce its product costs without sacrificing the bottom line, Rex decides to sell certain of its intellectual property ("IP") to be used by Rex outside the U.S. to a Cayman Islands company it owns pursuant to a qualified cost sharing arrangement. Rex also decides to license certain IP and technology related to another of its popular products to its Bermuda subsidiary. The purpose of both these transactions is to legitimately reduce the effective worldwide income tax rate, to *defer* U.S. taxation on its non U.S. source income (the deferral to be used to further expand the overseas business activities) and to respond to competitive pressures within the industry. Both of these actions enable Rex to maintain overall after tax profitability.

Qualified cost sharing

In the Cayman Islands structure, Rex licenses to its Cayman entity its rights to its IP related to its "X-7 Accounting Software" to be used outside the United States. The license permits future improvements and enhancements to the X-7 IP to be developed by the foreign operating affiliate licensees of Rex. The Cayman entity will buy the IP from Rex (in cash or by a term note) for the fair market value of the existing IP. The fair market value is determined by an independent third party transfer pricing study and appraisal. This structure is a qualified cost sharing plan recognized as appropriate tax planning by the Internal Revenue Service. Such IP can then be licensed by the Cayman Islands affiliate to Rex's other foreign affiliates for an arm's length royalty charge.

Active royalty

The second transaction is an active royalty structure whereby Rex's Bermuda subsidiary acquires certain rights from Rex related to Rex's popular "G-10 Inventory Control Software." The license agreement between Rex and its Bermuda subsidiary allows the subsidiary to copy the G-10 software, to localize the G-10 software for foreign markets, to continuously update the software, and to distribute it throughout the world. The Bermuda subsidiary then distributes the software to unrelated customers throughout the world. The distribution is via the Internet from an E-commerce exchange owned and operated by the Bermuda subsidiary. Alternatively, Rex might wish to employ a variation of this structure with a licensing arrangement using a Dutch subsidiary. In that case, Rex might seek a Dutch tax ruling permitting a reduced Dutch tax rate. Such a ruling, along with the income tax treaty between the U.S. and Holland, would then provide Rex with the competitive advantages it seeks.

Appropriate uses of offshore entities

One lesson is clear: there are many complex income tax issues inherent in these structures. Many U.S. companies do engage in legitimate outbound U.S. tax planning strategies in many forms similar to the above transactions. Many structures are, as noted, motivated in large part—if not entirely—by competitive business pressures. Accordingly, as with any type of tax planning, there are many appropriate and legitimate uses of offshore entities. The challenge for professionals advising John Smith and Bill Jones is always to know where to draw the line between appropriate and inappropriate uses of these offshore planning structures.

Similarly, board members, executive officers and their advisors must consider the other implications of both a proposed action and a passed opportunity. One frequently overlooked area is that of liability coverage. Acme's board is now scrambling to determine whether Acme's Director & Officer liability policy covers the costs of defense of the shareholder lawsuit. It may turn out that it does not because two of the directors were actually parties to the transactions (as guarantors), rather than just acting in their capacities as Directors.

The members of the boards of directors of companies like Acme and Rex must not cross the line to the inappropriate side, but should not reject any proposed structure just because it involves offshore entities. The cost of engaging in an inappropriate transaction is high, as it was for Acme, but the cost of not doing the planning that Rex did can be substantial if the failure to utilize legitimate planning tools erodes Rex's competitive advantage.

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