SPVs in structured finance transactions: Cayman Islands

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An article on the establishment of structured finance SPVs in the Cayman Islands.

Scope of this article

This article addresses the establishment of structured finance *SPVs* in the Cayman Islands, including a discussion on the reasons for choosing the Cayman Islands, the types of corporate structures typically used and applicable international standards and local regulations.

Rationale for choosing the Cayman Islands

Cayman Islands entities are used for a broad range of structured finance products with investors worldwide purchasing instruments issued by Cayman Islands entities. The types of structured finance transactions undertaken in the Cayman Islands include:

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- *Securitisations* and *CLOs*.
- *Note repackagings*.
- Credit linked transactions such as *credit derivatives* and *credit linked notes*.
- *Catastrophe bonds* and other alternative risk transfer products.

Often, the challenge for multinational companies, investment banks and fund managers is how to create a business or investment fund structure which is able to accommodate international investors within existing tax and securities laws that apply to the investors, the management team and the business or investment activities, each of which could be based in multiple jurisdictions.

Cayman Islands entities provide a neutral base in which to combine investors from a number of jurisdictions investing in assets located in the same or other jurisdictions. This means that investors are not subject to double taxation by virtue of the SPV adding extra layers of taxation at different levels of the structure in addition to the investors' home country tax. This neutrality is important because it provides a level playing field for all investors. It avoids creating a vehicle in a jurisdiction that may provide more benefits to some investors over others.

The Cayman Islands offer the opportunity to do this without foreign exchange controls and without significant restrictions on the payment of interest or dividends, the repayment of capital or the ability to repurchase shares or redeem or repurchase debt.

Specific practical reasons for the extensive use of Cayman Islands vehicles by institutions, governments and major corporations include:

- Speed and simplicity of establishment.
- Relatively low cost, particularly in the context of typical transaction sizes.
- Flexible and practical business statutes and appropriate levels of regulation.
- Accessibility of share premium (being the funds received on the subscription for shares in excess of a company's nominal or par value) (subject to ongoing solvency) for the payment of dividends and redemption of shares. This can be highly significant for corporate groups who want to ensure that funds are easily distributable between group subsidiaries.
- Appropriate levels of regulation.
- English-based legal system, established judiciary and absence of political or sovereign concerns. The laws of the Cayman Islands are substantially based upon English common law, and a number of "key" English statutes. This gives Cayman Islands law and its legal system a common origin with those of many of its users, including the United States. It also means that SPVs (and the types of securities which Cayman SPVs offer) are well recognised and accepted around the world.
- Recognised Stock Exchange; the Cayman Islands Stock Exchange (CSX) was established in 1997 and in July 1999 was granted approved organisation status by the London Stock Exchange which was the first time that an offshore stock exchange had been added to the list. Further, the UK HM Revenue and Customs has designated the CSX as a "Recognised Stock Exchange" for the purposes of section 1005 Income Tax Act (ITA) 2007. This means that:
  - debt securities listed on the CSX can satisfy the "quoted eurobond exemption" which allows payments by a UK paying agent to be made gross without deduction of UK withholding tax;

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- securities listed on the CSX are recognised as "qualifying investments" for PEP and ISA savings purposes (this relates to closed-ended companies); and
- UK pension schemes can hold securities listed on the CSX.

Corporate structures

In a structured finance context, exempted companies and segregated portfolio companies are commonly used in Cayman Islands structures.

Exempted company

The Companies Act (As Revised) of the Cayman Islands (Companies Act) provides for the establishment of a category of companies which will carry on business outside the Cayman Islands (although an exempted company must have its registered office in the Cayman Islands). These companies are known as “exempted companies” and are the vehicle most commonly used in structured finance transactions. The segregation of assets and liabilities can be achieved by the adoption of a group company structure comprising a number of different exempted companies; an arrangement which will be upheld in law in the absence of fraud (see *Adams v Cape Industries plc [1990] 1 Ch 433*). Furthermore, it is possible to segregate assets and liabilities within an exempted company on a consensual basis relying on limited recourse language in relation to creditors, and asset allocation provisions in the memorandum and articles of association in relation to shareholders.

Segregated portfolio company

An exempted company may be registered as a segregated portfolio company (SPC) under the Companies Act and must include "SPC" or the words "Segregated Portfolio Company" in its name.

An SPC has the power to create one or more segregated portfolios in order to segregate the assets and liabilities of the SPC held for the account of a segregated portfolio from the assets and liabilities of the SPC held for the account of any other segregated portfolio of the SPC, or the assets and liabilities of the SPC which are not held for the account of a segregated portfolio of the SPC (called the general assets of the SPC). It should be noted that it is not necessarily the case that the laws of other jurisdictions will recognise such statutory limitation of recourse. It is therefore prudent to also include standard contractual limited recourse provisions in the relevant documentation.

The SPC is a single legal entity and any segregated portfolios of the SPC are not separate legal entities from the SPC itself and therefore a segregated portfolio of an SPC cannot hold shares issued by the same SPC in relation to another of its segregated portfolios.

As the SPC is a single legal entity there is only one set of registration and annual fees (though these are higher than for an exempted company that is not registered as an SPC). However, for an SPC there is the need to establish and maintain appropriate procedures to ensure that the assets and liabilities of each segregated portfolio are appropriately segregated. The Companies Act allows each segregated portfolio of an SPC to apply certain legal principles usually applied for a separate legal entity, for example, the calculation of profits for dividend purposes. By way of illustration, an SPC may create and issue one or more series or classes of shares, the proceeds of the issue of which will be included in the segregated portfolio assets of, and accounted for in, the segregated portfolio in respect of which the segregated portfolio shares are issued. An SPC may pay a dividend or other distribution in respect of segregated portfolio shares of any class or series. Such segregated portfolio dividends are paid

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by reference only to the accounts of, and out of, the segregated portfolio assets and liabilities in respect of which the segregated portfolio shares were issued and in accordance with the rights of such shares.

Specific advice would be required in each case as to the suitability of an SPC for a particular transaction in all relevant jurisdictions.

Incorporation time and fees

The government fees payable upon registration of an exempted company and at the end of each calendar year are based on the authorised, not the issued, share capital of the exempted company. Standard practice for a structured finance transaction is to have the maximum authorised share capital for the minimum annual return fee, that is an authorised share capital of US $50,000 which incurs an incorporation fee and annual return fee of US$573.17 payable to the Registrar of Companies in the Cayman Islands.

The government fees payable upon registration of an SPC and at the end of each calendar year are based on the authorised, not the issued, share capital of the SPC. As for an exempted company, standard practice for a structured finance transaction is to have the maximum authorised share capital for the minimum annual return fee, that is an authorised share capital of US $50,000 which incurs an incorporation fee and annual return fee of US$573.17 payable to the Registrar of Companies in the Cayman Islands. There is an additional SPC specific annual fee of US$2,439 together with an additional US$366 in respect of each segregated portfolio, up to a maximum of US$1,829 in the aggregate.

There is the option of incorporating the exempted company or SPC on an express basis for an additional fee (which is currently US$487.80 plus a fixed fee of US$250) which means that the Registrar of Companies will usually incorporate the exempted company within 24 hours of receiving the relevant documentation. The turnaround time to incorporate an exempted company on a standard basis is 4-5 days.

Shareholding

Assuming that the Cayman Islands entity is not carrying on banking business, its issued share capital can be entirely nominal. It is often the case that 250 ordinary shares with a par value of US$1.00 each are issued. All of the issued share capital can be held by one shareholder of record.

It is a usual rating agency requirement for a rated structured finance transaction that the Cayman Islands company be bankruptcy remote hence the incorporation of the company as an "orphan". For this to be achieved, the shares of the company are held by a share trustee under a declaration of trust for the benefit of a charitable institution or for charitable purposes.

It is not necessary as a matter of Cayman Islands law that any of the shareholders, directors or officers be resident in the Cayman Islands nor is it necessary for an exempted company or SPC to hold an annual general meeting of its shareholders, although one may be held either within or outside the Cayman Islands.

Directors

The board of directors may be comprised of such number of persons as may be desired, although it is usual for the board to consist of at least two persons. No officers are required by law, although it may be convenient for a company secretary to be appointed. There is no Cayman Islands legal requirement that any meetings of the board of directors be held in the Cayman Islands although it is often important that the meetings of the directors are held offshore from an onshore structuring perspective.

Under Cayman Islands law, a director of a Cayman Islands company is obliged to comply with a number of duties, breach of which may, in certain circumstances, result in personal liability on the part of the director. The duties include: acting bona fide

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in what they consider to be in the best interests of the company, to exercise the powers vested in them for the purposes for which they were conferred and not for collateral purposes, and to not improperly fetter the exercise of future discretion. However, provided a director complies with the fiduciary duties and the requisite duties of care, diligence and skill, the fact that a decision turns out to be wrong, not beneficial, or causes loss, will not of itself necessarily establish personal liability.

It is a duty of the directors of an SPC to establish and maintain procedures to:

- Segregate, and keep segregated, portfolio assets separate and separately identifiable from general assets.
- Segregate, and keep segregated portfolio assets of each segregated portfolio separate and separately identifiable from segregated portfolio assets of any other segregated portfolio.
- Ensure that assets and liabilities are not transferred between segregated portfolios otherwise than at full value.

Particular care should be taken by the directors to ensure that where they have delegated the management or administration of the SPC or any of its segregated portfolios that such delegates are aware of the required procedures and act in compliance with such procedures.

Continuing obligations

The Companies Act contains a number of continuing obligations applicable to both exempted companies and SPCs. It should be noted that banks, trust companies, building societies, money services businesses, credit unions, insurance companies, insurance managers, company managers, mutual fund administrators and regulated mutual funds are subject to additional Cayman Islands regulation, which is beyond the scope of this note.

The following is a summary of the main continuing obligations:

Name strip
The name of the company must be displayed at the registered office.

Minute book
A minute book should be maintained and, although there is no requirement that this be maintained at the registered office, this is generally the case. The minute book should contain the certificate of incorporation, certificates of good standing, if obtained; a certified copy of the memorandum and articles of association, originals, or duplicate originals of minutes of board of directors and shareholders' meetings and any attachments referred to in the minutes and originals, or duplicate originals of written resolutions of the directors and shareholders.

Company registers
The company registers must be maintained, and these include:

- The register of mortgages and charges specifically affecting the property of an exempted company or SPC (referencing the relevant segregated portfolio, if applicable). If any mortgage or other form of security interest is granted, full particulars must be provided immediately, and the register updated. This register can be inspected by any member or creditor of the company. It is a requirement of the Companies Act that this register be maintained at the registered office.

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- The register of members of the exempted company or SPC, which contains the names and addresses of the shareholders of the company, the date on which the name of any person was entered on the register as a shareholder and the date on which any person ceased to be a shareholder. The register also contains the number of shares held, the distinguishing number(s) (if any) of such shares, the amount paid (or considered as paid) on the shares, the date of issue, the date of transfer and the person to whom the shares are transferred. If the company is an exempted company or SPC, the register is not a public document and the register need not be held at the registered office. Since shares are not validly issued or transferred until the appropriate entries are made in the register of members, it is important that such entries are made on a timely basis.
- The register of directors and officers, which gives their names, addresses, date of appointment and date of resignation. The register is required by the Companies Act to be maintained at the registered office but is not a public document. The Registrar may make the list of the names of the current directors, and alternate directors if applicable, available for inspection by any person on payment of a fee.

Filing procedures

The following events should be notified to the registered office in order that the Registrar of Companies may be advised, and the appropriate fee paid. There are statutory time constraints, either 15 or 30 days, for due notification and it is therefore important to provide the information to the registered office promptly to avoid imposition of penalties:

- Change in directors or officers.
- Increase in the authorised capital.
- Change of name.
- Alteration of the memorandum or articles of association.
- Change of location of the registered office.
- Any special resolution passed by the shareholders.

Books of account

All companies must keep proper books of account, although they need not necessarily be kept at the registered office. The books of account must be such as are necessary to give a fair and true view of the state of the company's affairs and explain its transactions. If the company is not a bank, trust company, building society, money services business, credit union, insurance company, corporate manager, mutual fund administrator or regulated mutual fund, its accounts need not be audited as a matter of Cayman Islands law.

Statutory company meetings

There is no requirement for the directors of an exempted company or an SPC to hold a meeting in the Cayman Islands each year.

Segregation of assets and execution of documents by SPC

In addition to the requirement for the segregation of assets as discussed above when dealing with an SPC, any act, matter, deed, agreement, contract, instrument under seal or other instrument or arrangement which is to be binding on or to benefit a segregated portfolio must be executed by the SPC on behalf of the relevant segregated portfolio.

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Annual requirements

An annual return (in the case of exempted companies and SPCs) must be submitted to the Registrar of Companies in the January of the year following incorporation and in each January thereafter, and the appropriate annual fee paid.

Taxation

There is no direct taxation in the Cayman Islands. In addition, an exempted company and an SPC may obtain a 20-year tax exemption undertaking issued by the Governor in Cabinet guaranteeing an exemption from tax for a period of 20 years (although in certain circumstances, this can be extended to 30 years).

It should be noted that some stamp duty may arise if an original document is signed or once signed brought physically into the Cayman Islands, but this is subject to a level of capping with regard to the duty charge.

Although the Cayman Islands are not a party to any double tax treaties, it is often possible to structure transactions to eliminate or reduce the domestic withholding tax rate on payments received on underlying assets to an economic level for example, by establishing a subsidiary in a jurisdiction with favourable double tax treaties such as Ireland.

Contractual requirements

In rated structured finance transactions, rating agencies generally require non-petition provisions to be included in any agreement between the SPV and its creditors. Under these provisions the creditors agree not to petition for the insolvency of the company nor to join any proceedings. Further, the rating agencies require limited recourse language to be included which limits the recourse of creditors to the underlying assets supporting the transaction so in the event that such assets are insufficient to meet creditor's claims in full, the company has no further obligations to those creditors and the claims are extinguished.

Dissolution of the company

Once a structured finance transaction is concluded it is often the case that the SPV is no longer required and can be dissolved. Under Cayman Islands law, provided the SPV is solvent, there are two main ways to do this: voluntary liquidation or striking off.

Voluntary liquidations

Usually triggered by a resolution of the company's shareholders (or a pre-agreed event in the company's constitutional documents), a voluntary liquidation typically involves a solvent company seeking to wind down its affairs and return surplus funds to its shareholders in an orderly fashion. Voluntary liquidation is often a simple and uncontroversial procedure, which does not involve the Court.

Liquidator's role

The principal duty of the liquidator of a Cayman Islands company is his or her statutory obligation to realise the (unsecured) assets of the company so that they can be distributed to creditors and thereafter, if and to the extent there is a surplus, to investors. The liquidator takes steps to identify the company's creditors, wherever they may be located and whatever the governing law of their claim. The liquidator will then impartially adjudicate the validity of their claims against the company. A liquidator's decision is subject to review by the Court, upon application of a dissatisfied creditor.

The liquidator has the power to pursue any claims the company may have against third parties (including, for example, the company's former management). Cayman Islands law also has concepts of fraudulent preferences and fraudulent dispositions.

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Distribution of assets in a Cayman Islands liquidation

The principal goal of a Cayman Islands liquidation is to distribute the Company's assets in accordance with Cayman Islands law and/or any contractual arrangements between the financially interested parties.

Under Cayman Islands law, creditors rank ahead of shareholders in a liquidation. If there are insufficient funds to pay the creditors in full, the *pari passu* principle will apply (subject to any contractual arrangements to the contrary such as, for example, a subordination agreement).

This principle does not affect rights of security, set-off, close-out or netting. As mentioned above, secured creditors stand outside of the liquidation, and can enforce their security in accordance with their contractual rights.

Striking off

An alternative to the voluntary liquidation of a Cayman Islands company is to apply to the Registrar of Companies to have the company struck off from the register. This is a quicker and cheaper process than a voluntary liquidation and involves the directors of the company confirming to the Registrar that the company is no longer carrying on business and has no assets and liabilities as well as passing appropriate written resolutions. However, it should be noted that with a strike off, as opposed to a liquidation, a party having proved to be a creditor can apply to have the company reinstated for a period of 10 years from the date of the striking off.

International standards and Cayman Islands regulation

The Cayman Islands is committed to meeting international standards and global practices. The Cayman Islands cooperates and engages with domestic and international regulators and organisations to promote the integrity and transparency of the finance industry. In response to such ongoing discussions, the Cayman Islands has enacted various legislative and regulatory regimes in order to meet international standards of best practice for transparency and cooperation.

A number of the fundamental legislative changes to enhance tax transparency and cooperation with international authorities which have been enacted in the Cayman Islands include, but are not limited to:

- Regulations to give effect to the Foreign Account Tax Compliance Act (FATCA), which is the mechanism for reporting information on financial accounts held by US persons to the US Internal Revenue Service. The Cayman Islands has entered into an inter-governmental agreement to improve international tax compliance and the exchange of financial account information with the United States (US IGA), to implement the automatic tax information exchange regime.
- Enabling legislation to bring into effect the OECD Standard for Automatic Exchange of Financial Account Information – Common Reporting Standard.
- Regulations with respect to Country-by-Country Reporting (CbCR), which is part of Action 13 of the OECD/G20 Action Plan on Base Erosion and Profit Shifting (BEPS).
- Legislation on economic substance, which was enacted in response to the work of the OECD and the European Union on fair taxation.
- Legislation governing the collection, maintenance and sharing of information regarding the ultimate beneficial ownership or control of Cayman Islands companies and Cayman Islands limited liability companies.

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The Tax Information Authority (TIA) in the Cayman Islands collects information on certain tax matters and exchanges information with other competent authorities in other jurisdictions pursuant to various international agreements. The TIA is the sole dedicated channel in the Cayman Islands for international co-operation on matters involving the provision of tax related information. The TIA is a function of the Department for International Tax Cooperation within the Cayman Islands Government's Ministry of Financial Services and Home Affairs.

The classification, notification and reporting obligation of a Cayman Islands SPV under any of the above regimes would be determined on a case-by-case basis, depending on the nature of the SPV and the particular structure.

Conclusion

The Cayman Islands continue to be a favoured jurisdiction for structured finance transactions given its cost efficient and timely company incorporation processes, its depth of professional expertise and experience and its appropriate regulatory framework.

Further reading

For an overview of the use of, and choice of jurisdiction for, special purpose vehicles in structured finance transactions, see *Practice note: overview, Structured finance SPVs and choice of jurisdiction*.

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