

# Expanding OBOR Using BVI and Cayman Islands Investment Structures

## Expanding the Belt and Road through the Cayman Islands and the BVI

With reportedly over US\$3.87 trillion in projects underway, the footprint of the Belt and Road Initiative ("B&R") not surprisingly includes structuring projects using offshore jurisdictions such as the British Virgin Islands ("BVI"), the Cayman Islands ("Cayman"), Ireland, Luxembourg and Jersey, all of which are leading offshore and midshore jurisdictions, respectively.

The role, in particular, that Cayman and the BVI has played in the B&R is simply an extension of the dominant role that Cayman and BVI structures presently play in the China growth story.

In Asia, at the forefront of B&R activity have been projects in the Greater Bay area - Guangdong-Hong Kong-Macau Bay Area - Hong Kong SAR, the Macau SAR, Guangzhou, Shenzhen, Huizhou, Zhongshan, Dongguan, Zhuhai, Foshan, Jiangmen and Zhaoqing. There have been many projects in the Greater Bay area delivering significant outcomes for policymakers and Chinese society such as:

- (a) focusing on promoting infrastructure connectivity;
- (b) enhancing the level of market integration;
- (c) building technology and expanding innovation;
- (d) generally adding to an enhanced quality lifestyle for residents of the Greater Bay

area including for day-to-day living, working and travelling;

- (e) cultivating international cooperation; and
- (f) supporting the establishment of major cooperation platforms.

Whether through the establishment of investment vehicles such as private equity or hedge funds, holding company structures or downstream investment portfolio companies, structuring through a Cayman, BVI or other offshore or midshore entities is a well-trodden path.

## Why Cayman and the BVI?

Over 91,000 exempted companies; approximately 10,000 funds; 130 trust companies; and 300 active banks are established, registered or, respectively, licensed in Cayman. In the BVI there are over 400,000 business companies; over 900 mutual funds; and more than 1,000 private trust companies.

In order for Cayman and the BVI to assist China and for China to take advantage of the opportunities available in the evolving global economy, it is essential that the Chinese business community understands the beneficial role played by Cayman and the BVI in the global financial services sector.

The many reasons Chinese banks and financial institutions, State-Owned Enterprises ("SOEs"), private companies, government agencies and high net worth

individuals make use of Cayman and the BVI, include:

- (a) the speed and simplicity of establishing entities and relatively low cost which is essential to keep pace with the need of the Chinese business community to set up investment and holding vehicles for new, fast-moving business transactions. In January 2019, both Cayman and the BVI introduced local substance requirements for nine specific business activities (to comply with the recommendations by the OECD's Harmful Tax Practices Group), however, both Cayman and the BVI do not generally impose a high degree of 'local content' on their overseas clients. For example, general speaking, neither exempted Cayman nor BVI companies, need to hold a physical meeting of their directors or shareholders in Cayman or the BVI and they do not need to file audited financial statements in Cayman or the BVI;
- (b) an English-based legal system and established judiciary (with final appeal to the Privy Council in the UK). The legal systems of Cayman and the BVI are ideally suited to undertaking finance and banking transactions due to their business and creditor-friendly legislation;
- (c) low country risk. Cayman and the BVI are politically and economically stable jurisdictions. Cayman has a sovereign debt rating of Aa3 from Moody's;
- (d) appropriate standards of regulation by the Cayman Islands Monetary Authority ("CIMA") and BVI Financial Services Commission ("FSC") which have been assessed by the International Monetary Fund and other international organisations, as being in compliance with international prudential regulatory, transparency, cooperation and anti-money laundering and combatting of terrorist financing ("AML/CFT") standards. CIMA and FSC regulate investment funds, fund management companies, banks and trust companies, insurance business, fund administration and company management in Cayman and BVI, respectively;
- (e) professional infrastructure and reputation. Cayman and the BVI are both well known for their established and experienced financial services sector and their substantial capacity – including in China's case, a substantial Cayman and BVI legal community based in several cities in China including Beijing, Shanghai and Shenzhen;
- (f) recognition of corporate personality and integrity. The ability of Chinese clients to use separate group subsidiaries or, to operate through a segregated portfolio company, to maintain separate businesses and assets, often with their own ring-fenced financing, can be a major contributor to the successful management of business and jurisdictional risks in cross-border transactions;
- (g) Cayman insolvency law is simple and effective, enabling speed and certainty in relation to the enforcement of creditors' and contractual rights both pre and post insolvency;
- (h) tax neutrality means that a Cayman or BVI entity provides a tax-neutral platform so that investors from multiple jurisdictions are not subject to more taxation over and above that payable in each investor's home country. Cayman and the BVI each 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;
- (i) transparency and beyond - Cayman and the BVI meet or exceed all globally-accepted standards for transparency and cross-border cooperation with law enforcement agencies in the world's major economies – including, of course, China. This firm commitment to global

transparency makes Cayman and the BVI an attractive and reliable partner for Chinese regulators and tax authorities. Cayman and the BVI were each an early adopter of automatic exchange of tax information with overseas authorities, including FATCA and the OECD's Common Reporting Standard. The Cayman Islands Tax Information Authority and the BVI International Tax Authority proactively collect tax information from a wide variety of Cayman and BVI entities and shares such information with over 100 other governments providing a level of transparency which assists them in the collection of their own taxes.

### Internationally accepted legal systems

Cayman and BVI structures are well placed to support B&R projects. Just one example of such projects are investment funds investing in venture capital transactions.

China's financial institutions and entrepreneurs are familiar with Cayman and BVI structures, which are based on common law and modelled on English company law principles. Such structures have a simple corporate management system, with internationally recognised shareholders' and creditors' rights such as shareholder limited liability, and creditor priority.

Project entities are able to raise financing in traditional forms of debt instruments including listed or rated notes, warrants or via securitisations – all widely recognised in the international capital markets. Lenders can provide secured or unsecured credit with the comfort of knowing that such concepts as statutory and contractual ring fencing, preferred creditors and shareholders' liquidation preferences, are recognised and well understood by Cayman and BVI courts, which routinely hear complex international disputes. As Cayman

and the BVI are British Overseas Territories, the final court of appeal in both jurisdictions is to the Privy Council in the UK, ensuring international investors' rights will be independently recognised and enforced.

### Investment Funds

Cayman investment funds, and in particular private equity funds structured as exempted limited partnerships or limited liability companies, are likely to be the investment vehicle of choice for raising capital from investors for a B&R project. Cayman is the leading jurisdiction for such structures with a market share of over 40%, enabling investors to structure:

- (a) clear project investment objectives;
- (b) drawdown mechanics for capital contributions;
- (c) provisions for limited partner or limited company member representation on investment committees;
- (d) market practice management fees;
- (e) waterfall distribution;
- (f) orderly winding up of the project through liquidation of the fund;
- (g) a general partner's or project manager's exclusive right to manage the fund project; and
- (h) a recognition of standard concepts such as carried interest or related performance and management fees for fund managers.

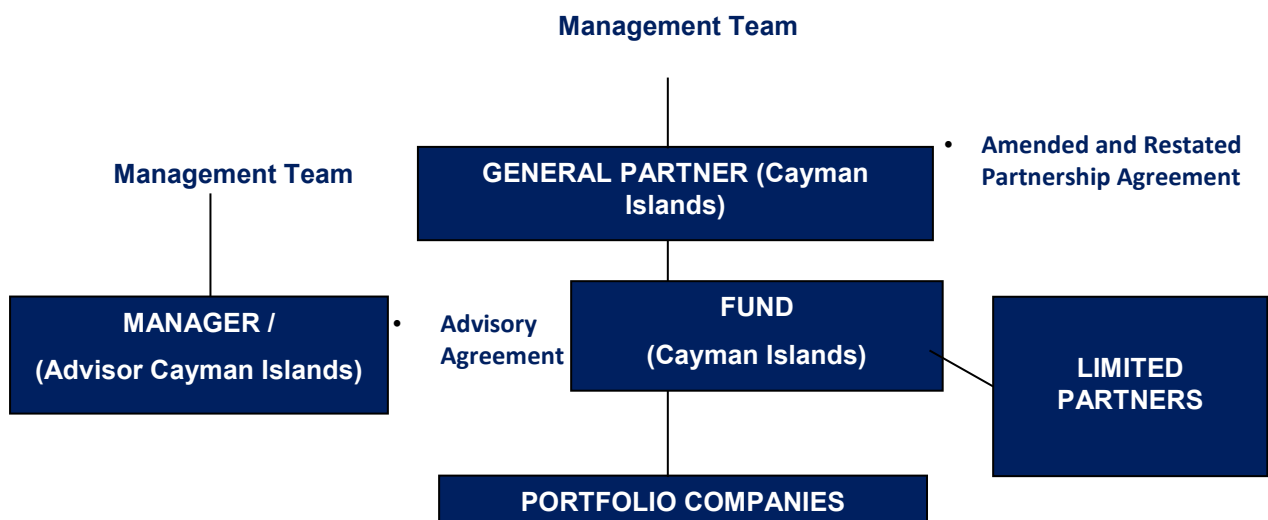
In short, a structure that meets and delivers on the commercial expectations of all participants.

One thing to note about B&R focused funds is the fund size – given the types of likely projects (from infrastructure to innovation) they are typically investing in, it is not surprising that fund sizes are significant – in the RMB billion plus range. Again, given a likely project focus of infrastructure to innovation, such funds would be managed, by, say, the People's Republic of China

("PRC") or related entities including the PRC banks and SOEs, through the ownership by those principals of management shares and day-to-day management of the board of directors at the general partner level of a private equity fund.

**Structure of Cayman Private Equity Fund**

From the Top of the Structure – Establishment:



As noted, Cayman investment funds focused on B&R would typically be structured as an open- or closed-ended exempted limited partnership (ELP). Depending on structuring needs, investment fund managers will often form an ELP to act as a private equity fund, investing in a portfolio or venture company; and / or form an alternative investment vehicle, a parallel fund or co-investment vehicle for international, including the PRC investors.

**Principals**

Project participants may come from different walks of life – bankers, property developers, SOEs or listed companies. Their varying backgrounds, investment profiles and strategies may have to be reflected in a shareholders or investment agreement at the general partner (GP) level which

primarily ensures adequate control and management of the fund.

The shareholders' agreement would document the principle commercial terms of the transaction representing the rights and privileges attaching to the shareholding or ownership stake of the respective principal.

Provisions would include:

- (a) Voting rights
- (b) Return on capital investment including dividends or distributions
- (c) Transfer restrictions
- (d) Protective provisions
- (e) Liquidation or winding up preferences

**Project Terms**

Where the structure is that of a private equity fund, the parties would document the project terms under the principle fund document - where the fund is structured as a limited partnership that would be under a partnership agreement or limited liability company agreement in the case of an exempted limited liability company.

Some of the principal terms of the partnership agreement would be as follows:

Duration – typically the term or duration of the fund would be allied to the investment objectives or project timeline which obviously creates some certainty for investors.

Economics – the project fund may set out an indicative distribution and payment waterfall which may include:

*Return of realised capital and costs: First, 100% to Limited Partners equal to capital contribution*

*Preferred return: Second, 100% as commercially agreed – 6-8% on capital contribution*

*general partner catch up: Third, 100% - as commercially agreed 80/20 split: 80% limited partners and 20% to general partner represented by carried interest.*

Management fee – commercially determined – 1-2% per annum on limited partner's or investor's capital commitment or proposed investment is not untypical.

Expenses – typically paid out of the fund's assets.

Withdrawal – on termination of the fund, with the agreement of the GP or operator of fund.

Special terms – special arrangements may be made with particular investors through side letters setting out terms particular to their investment profile.

There may be no restriction on types of distributable currency including RMB.

## Types of B&R Projects

The ELP may be formed for any lawful purpose to be carried out and undertaken either in or from within the Cayman Islands or elsewhere upon the terms, with the rights and powers, and subject to the conditions, limitations, restrictions and

liabilities mentioned in the Partnership Act (defined below).

The investment objectives of the ELP could be as broad as investing in projects in the Greater Bay Area or as narrow as an investment in a particular portfolio or venture capital company. In short, other than restricted by applicable law, the partnership structure does not seek to constrain the reach of B&R projects and with its imbedded flexibility is well placed to help with structuring project goals.

## Key Factors

1. an ELP must at all times comprise at least; (i) one or more general partners, at least one of which shall: (a) if an individual, be resident in the Cayman Islands; (b) if a company, be incorporated under Cayman Islands law or registered as a foreign company under Part IX of the Cayman Islands Companies Act; or (c) if a partnership, be an exempted limited partnership registered pursuant to the Exempted Limited Partnership Act (the "Partnership Act") or registered as a foreign limited partnership from certain recognised jurisdictions pursuant to section 42 of the Partnership Act; and (ii) at least one limited partner.
2. limited partners shall not be liable for the debts or obligations of the ELP save as provided in the partnership agreement, and as otherwise specified in the Partnership Act, in other words, investors take comfort from the fact that their exposure would be as they so determine under the commercial terms they agree.
3. general and limited partners may be companies or partnerships.
4. general partner or principals may take an interest as a limited partner,

in other words, principals are able to invest in the fund.

### What are some of the advantages of a partnership structure?

The ELP structure is internationally recognised and widely used.

There are no onerous official filing and publication requirements to establish the partnership or as a pre-condition to any effective change in filed information. Formation is by a general partner and at least one limited partner signing a partnership agreement (in simple form or otherwise) and the general partner filing with the registrar of exempted limited partnerships a short form registration statement containing basic details about the partnership. Partnership funds can be set up quickly with relative ease.

On 7 February 2020, the Cayman Government published the Private Funds Act and the Private Funds (Saving and Transitional Provisions) Regulations 2020 (the "PFL") which provides for the registration of closed ended funds (private funds) with CIMA. The Act, reflecting Cayman's commitment as a co-operative jurisdiction, is responsive to EU and other international recommendations and covers similar ground to existing or proposed legislation in a number of other jurisdictions. The PFL will generally apply to private funds set up as an ELP, company, unit trust or a limited liability company unless out of scope on the basis set out in the PFL.

The Partnership Act benefits from the English common law principle that a partnership is not a separate legal person and conducts its business through its general partner. In all practical respects, however, the administrative ease and flexibility of the corporate form is provided, with the result that a limited partner of an ELP stands in most respects in a similar

position to a shareholder in a Cayman exempted company.

The ELP structure, squarely places the management of the fund with the GP or principals behind the fund, i.e. the project manager. Those seeking project investment opportunities, subject to the express provisions of the limited partnership agreement that governs the management of the fund, (i) would not take part in the management of the fund and (ii) and, in their capacity as a limited partner, do not owe any fiduciary duty in performing any of their obligations under the partnership agreement to the partnership or any other limited partner.

The establishment of the Cayman fund does not restrict the establishment of or investment in parallel investment funds to co-invest with the Cayman fund including RMB funds.

### Economic Substance Act

A brief word on Economic Substance. Cayman introduced the International Tax Cooperation (Economic Substance) Act (2021 Revision) and the BVI enacted the Economic Substance (Companies and Limited Partnerships) Act, 2018 (together, the "ES Act"), respectively, which introduces certain reporting and economic substance requirements for 'relevant entities' conducting 'relevant activities'. The ES Act in both Cayman and the BVI are responsive to global OECD Base Erosion and Profit Shifting standards regarding geographically mobile activities. It is worth noting that under the Cayman ES Act an entity that falls within the definition of an investment fund is not a relevant entity for the purposes of the ES Act and thereby falls outside the scope of the ES Act. The ES Act defines an 'investment fund' as an entity whose principal business is the issuing of investment interests to raise funds or pool investor funds with the aim of enabling a

holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management or disposal of investments and includes any entity through which an investment fund directly or indirectly invests or operates. 'Investment fund business' is defined as the business of operating as an investment fund. 'Investment interests' means a share, trust unit, partnership interest or other right that carries an entitlement to participate in the profits or gains of the entity.

The result of this is that entities structured as an investment fund as well as an entity which the fund establishes to deploy capital, for instance, a typical Cayman SPV investing in a portfolio company, would also fall within the definition of an investment fund for the purposes of the ES Act and thereby falls outside the scope of the ES Act.

**Fund Focus**

For the principals and investors, the investment strategy is enabling in that may include one of achieving an absolute or positive return on investment mark to market notwithstanding that, for instance, the underline Greater Bay area project investment may well be subject to some volatility.

The fund focus could be narrower or more specific - for instance, investments in debt securities, including debt instruments, convertible securities, derivatives, listed and private equities and related funds and securities investment.

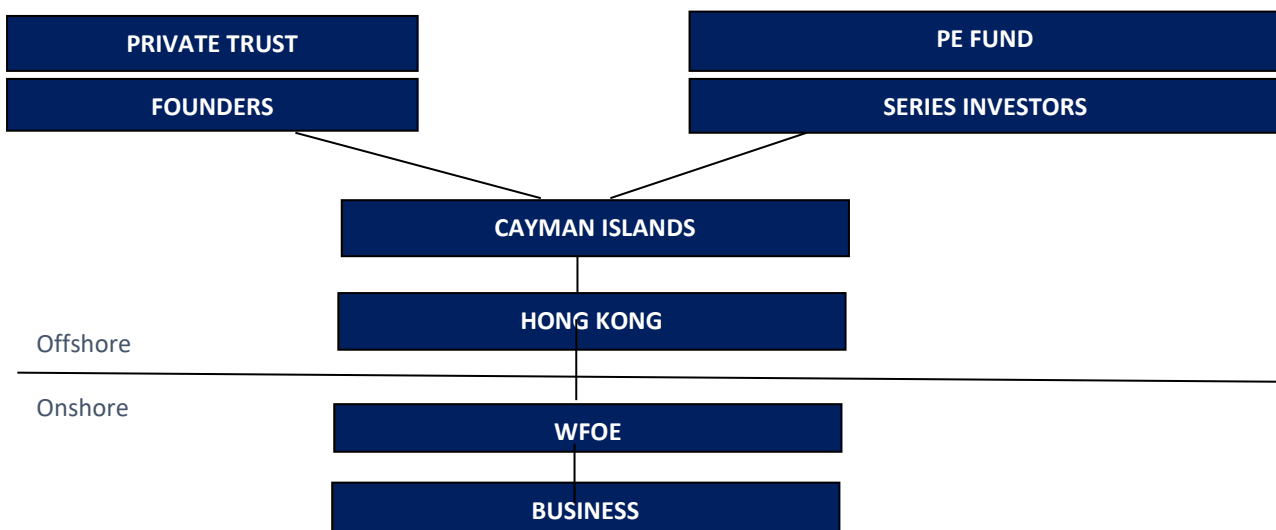
**Project or Investment Company**

As noted, the project range of B&R is extensive – infrastructure, transportation, science, technology, innovation, real estate, healthcare, tourism to name a few – all ventures one would see coming from typical venture capital, small medium enterprises, and other enterprises. Therefore, not surprisingly, the project fund would invest in projects that are commonly structured through a Cayman or BVI portfolio or holding company which indirectly holds the interests in the underlined B&R project.

**Structure of Cayman Private Equity Investment**

The project fund can seek an investment in a variety of ways – heavy or light – ranging from hardware construction projects to software tech companies from AI to blockchain.

Most leading PRC companies started their life as a portfolio company, which would include the BAT companies – Baidu, Alibaba



and Tencent, which prior to being listed Cayman Chinese operating companies, formed part of an investment portfolio of an investment fund. Now B&R project funds are benefiting from the very same Cayman offshore structures to construct their own B&R investment. The benefits are equally as compelling: in short, *a tried and tested structure that secures one's investment pre and post proposed exit.*

### What are the benefits Cayman or BVI portfolio companies provide?

In no particular order and by no means an exhaustive list:

- Voting rights
- Conversion of Shares
- Transfer of Shares / Restrictions on Transfers
- Right of First Refusal
- Right of Pre-emption
- Redemption Rights
- Repurchase Rights
- Variation of Rights Provisions
- Tag Along Provisions
- Drag Along Provisions
- Put Option
- Call Option
- Protective / Restrictive Provisions
- Appointment of Directors
- Dividends and Distributions
- Winding Up

The above shopping list is a list of provisions one would usually see baked into the relevant transaction documents of these transactions. The Cayman model is best in class for delivery of those protections and rights that investors and project principals are seeking with the BVI model also popular.

### Voting Rights

These range from no voting rights or decision-making capability to the more typical one member, one vote to weighted voting where investors, in particular,

significant project parties, would want their voting power to represent their economic investment i.e. a number of votes per share held that enables the exercise of voting power independent of other shareholders that can influence decision making. The point of voting rights is that it represents the right to be heard and counted disproportionately or otherwise.

There are no prescribed Cayman or BVI laws as such that constrain the parties in commercially determining their arrangements for the allocation of voting rights per share or relative to an investment.

### Conversion of Shares

Typically, a project investor would in the first instance want preferred shares or shares that represent an economic interest. Such preferred shares reflect the fact that at the outset the investor's investment is at risk – it is always at risk pre-exit. The investor's rights pre-exit would focus on economic returns or rights in the event that the investor seeks a return on capital prior to, say, an initial public offering ("IPO") of the portfolio company's shares. However, in the event the company does get to IPO then the investor would want IPO shares – at that point it would have the right to convert its preferred shares into IPO or ordinary shares.

In practice, various mechanisms can be deployed under Cayman or BVI law to achieve the result of conversion with little trouble and potentially limited potential tax or other down side risk to the structure.

### Transfer of Shares / Restrictions on Transfers

The focus here is on stability and continuity. If an investor wants out, who will be the new investor or transferee? Existing investors will want a say and therefore would want to place restrictions on an investor's ability to



transfer shares to a third party. Other than as provided for under the company's constitutional documents, Cayman or BVI law does not place additional constraints on the transferor's ability to transfer shares but does afford the parties the flexibility to manage those rights.

## Right of First Refusal

Aligned to restriction on transfer of shares is the right of an investor to have shares the subject of a transfer to be offered to existing investors first. There are no Cayman or BVI laws restricting the right to be offered shares ahead of anyone else.

## Right of Pre-emption

Similarly, subject to the discharge of its fiduciary duties, Cayman and BVI law does not seek to dictate to the parties to whom a company may issue shares to or what investors can be project partners.

## Redemption Rights / Repurchase Rights

Shares may be purchased or redeemed by the company in such manner and upon such terms as may be authorised by or pursuant to the company's articles of association. Accordingly, so long as the company would be able to pay its debts as they fall due following a redemption / repurchase, there is a great deal of flexibility as to the form or manner that purchase or redemption of shares could take.

## Variation of Rights Provisions

The common law right that an investor's agreed position under the company's constitutional documents is not varied or amended unless otherwise agreed to, is well understood. Cayman and BVI law recognises this common law principle but also provides for its trademark common sense flexibility allowing the parties to

determine how far and to what extent the arc of their understanding should extend – that's ultimately a matter for the parties to determine.

## Tag Along Provisions

Where an offer for the purchase of the shares of one shareholder is made, the company may afford the same right to other shareholders to be taken up on similar terms or in the jargon, for those other investors to tag along with that initial deal – there are no impediments to that under BVI and Cayman law.

## Drag Along Provisions

Conversely, where there is the potential for one investor to hold up a buyout or sale, subject to the articles of association of the company, Cayman and BVI law affords the parties the flexibility to *drag* the hold out investor along.

## Put Option

Subject to the lawful constraints on a repurchase or redemption of shares mentioned above, there are no statutory legal constraints on a right for an investor to sell shares back to the company.

## Call Option

Subject to the terms of the allotment and issue of any shares, the company may make calls (or a request) upon shareholders in respect of any monies unpaid on their shares (whether in respect of par value or premium). This right is important, in particular where shares are issued as partly paid and a call is not met, when coupled with a right of forfeiture, such shares may be forfeited by the company.

## **Protective / Restrictive Provisions**

The scope protective or restrictive provisions is often one of the most hotly contested provisions – these will vary in their scope and nature however, the key messaging as a matter of Cayman and BVI law is that the parties are afforded the flexibility to negotiate the scope and range of their commercial terms as one would expect experience investors to be afforded – Cayman and BVI law are light touch in their oversight of commercial terms.

## **Appointment of Directors**

The investors usually want the right to be represented at board level or with respect to the day to day management of the company which board of directors undertake. For holding companies sitting under an investment fund, there is no onerous Cayman or BVI law regulatory oversight at the portfolio company level, or for instance, demands for local or independent directors to be appointed. The make-up and shape of the board of directors is a matter for the parties.

## **Dividends and Distributions**

Under Cayman law, it is expected that dividends should be paid out of profits or assets legally available for distribution, and in any event subject to the company's ability to make such payments. As a matter of BVI law, a BVI company may only pay a dividend if its directors are satisfied on reasonable grounds that the BVI company will satisfy the solvency test immediately after the payment is made.

## **Liquidation Preference / Winding Up**

Both Cayman and BVI law does make clear that there are rules of the road governing the rights of preferred, secured and unsecured creditors ranking ahead of investors or shareholders however, among themselves,

the priority or order of distribution to shareholders where there are different classes of shares is a matter for the shareholders to determine. Therefore, there is somewhat of a free hand given to the shareholders to determine under its articles of association liquidation preference provisions among different classes of shareholders.

## **Belt and Road – Cayman and BVI structures governing the rules of the Road**

In conclusion, what Cayman and BVI structures have to offer is a tried and tested product that is well suited for B&R projects. Whether structuring inbound China as seen through typical VIE structures, where Cayman and the BVI are used as an offshore holding company primed for listing on a Chinese or overseas stock exchange, or for outbound investments as a vehicle used to structure a B&R investment through an investment fund or otherwise to effectively deploy capital, Cayman and the BVI lead the way into and out of China.

## About the Author

Everton Robertson is a partner of Maples and Calder's Finance team in the Maples Group's Hong Kong office. He is a private equity, finance and funds lawyer who has acted for major financial institutions, corporations, private equity firms and UHNWs throughout Asia. His focus includes venture capital and pre-IPO financing, mergers and acquisitions, IPOs and the establishment of open and close ended investment funds.

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