

Private equity funds in the Cayman Islands

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Introduction

This guide explains the attractions for international managers, sponsors and investors of the Cayman Islands as the jurisdiction in which to domicile a private equity fund.

The term 'private equity fund' commonly denotes a non-retail fund investing in illiquid assets and, whilst used most frequently in the context of a typical buyout fund, covers a range of funds including real estate funds, venture capital funds, infrastructure funds, credit opportunity and other debt funds, secondary funds and funds of funds.

Private equity/closed-ended funds established in the Cayman Islands normally take the form of limited partnerships (which will be the focus of this guide) although sometimes are formed as companies.

Mourant Ozannes' Cayman funds advisory team advises managers, sponsors and investors globally on all aspects of law and regulation pertaining to the structuring and operation of investment funds in the Cayman Islands.

Regulatory overview

Regulation of investment funds in the Cayman Islands is governed by the Mutual Funds Law of the Cayman Islands although this only applies to open-ended funds. Consequently, closed-ended funds such as private equity funds are not subject to regulatory oversight by the Cayman Islands Monetary Authority. In addition, the fund's general partner does not require any form of approval or licensing in the Cayman Islands.

Exempted limited partnerships

An exempted limited partnership (ELP), the typical vehicle of choice for a private equity fund domiciled in the Cayman Islands, is formed under, and subject to, the Exempted Limited Partnership Law of the Cayman Islands (the **ELP Law**). The ELP Law adopts principles similar to those enshrined in the Delaware Revised Uniform Limited Partnership Act, and this similarity with the Delaware model makes the ELP particularly attractive to managers and investors in the US. The key provisions of the ELP Law are summarised below.

There are no capital gains, income, withholding, estate or inheritance taxes in the Cayman Islands. The ELP will apply for (and can expect to obtain) an undertaking from the Cayman Islands government that no form of taxation that may be introduced in the Cayman Islands will apply to the ELP for a period of 50 years from the undertaking being given (hence the ELP's 'exempted' status).

Key features

An ELP does not have a legal personality of its own (notwithstanding its registration in the Cayman Islands) and is, to this extent, a combination of contractual rights and equitable interests in the assets of the ELP, which are held on trust for the partnership by the general partner (and, if there is more than one, by the general partners jointly) and in accordance with the terms of the limited partnership agreement (the **LPA**).

The general partner (the **GP**) is the operative legal entity, responsible for managing the business of the ELP and is ultimately liable for all debts and obligations of the ELP to the extent that the ELP has insufficient assets. The GP will sign all contracts on behalf of and in the name of the ELP. The GP must be a Cayman resident individual, a Cayman registered company, a foreign company or foreign partnership registered in Cayman or another ELP. No additional licences or approvals will be required for the GP, and the GP may have any number of directors who will not be required to be resident in Cayman or to meet in Cayman.

Not having its own legal personality, the ELP is generally regarded from an onshore tax perspective as being tax transparent (or as having 'see-through', 'look-through' or 'flow-through' status, which signify the same thing) with the effect that the ELP itself will not be liable to any onshore taxes, and value distributed by it will 'flow-through' to the investors (and may be subject to local taxes in their hands).

There are no restrictions on the number of investors that may be admitted to an ELP.

Registration of an ELP and GP can take place on a same-day basis, with the certificates of registration following within three to five working days (a fast track process delivering the certificate in around 48 hours is also available).

The ELP Law

The ELP is essentially a creature of contract, and is formed by the signing of an LPA by the GP and by at least one limited partner. At this point, the LPA will often be a short-form document and will be accompanied by a 'Section 9 Statement' made by the GP confirming certain basic details about the ELP and lodged with the Registrar of Exempted Limited Partnerships in the Cayman Islands. A short-form LPA can be restated into the full-blown agreement, in accordance with the terms of which investors will be admitted into the partnership.

The GP and the limited partners may agree between themselves the terms governing the partnership, subject to a relatively light overlay of statutory provisions contained in the ELP Law. Some of the provisions of the ELP Law are mandatory, and some can be varied or waived in the LPA.

The following provisions of the ELP Law are mandatory:

- The ELP's name must include the letters 'LP' or the words 'Limited Partnership'.
- The ELP must have a registered office in the Cayman Islands, for service of process and forwarding of notices and communications.
- The ELP cannot undertake business with the public in the Cayman Islands (other than as may be necessary for the carrying on of its business outside the Islands); this is the basis on which the ELP obtains its 'exempted' status.
- The GP must act at all times in good faith and, subject to any express provisions of the LPA to the contrary, in the interests of the ELP.
- The GP is liable for any debts and obligations of the ELP if the ELP's assets are insufficient to discharge them. Any debt or obligation incurred by the GP in the conduct of the ELP's business shall be treated as a debt or obligation of the ELP. Any property of the ELP conveyed to the ELP or to its GP will be deemed to be held by the GP on trust for the ELP as an asset of the ELP.
- A limited partner may not participate in the conduct of the ELP's business, and all contractual documents and papers must be executed by the GP as the contracting party acting on behalf of the ELP. Any limited partner participating in this way, as though it were a general partner, will be liable for the debts and obligations of the ELP, if it goes insolvent, to any person transacting business with the ELP through the limited partner and who had actual knowledge of such limited partner's participation and who reasonably believed that limited partner to be a general partner.
- The ELP Law set outs certain non-exhaustive 'safe harbours' of activities in which a limited partner may engage without risk of losing its limited liability status; a limited partner's participation on an advisory board or investment committee will typically be within the safe harbours. The LPA may nonetheless provide for any amount of limited partner participation in the conduct of the ELP's business (subject as noted above).
- If a limited partner receives a return of any part of his contribution or is released from any outstanding obligation in respect of his commitment to the partnership at a time when the ELP is insolvent (including where the payment or release causes the insolvency) and the limited partner has actual knowledge of the insolvency of the ELP, that limited partner shall be liable to the ELP for six months

from the date of payment or release for the amount of the payment or the due performance of the released obligation.

- A limited partner may transfer all or any part of its partnership interest in the manner provided by the LPA, but such transfer shall not absolve the transferor of any liability previously incurred in respect of (i) its taking part in the conduct of the ELP's business, or (ii) amounts of capital received and required to be returned (both as described above).
- An ELP shall continue until wound up and dissolved by resolution of the general partners and a two thirds majority of limited partners, unless the LPA provides otherwise; and the provisions of the Companies Law and the Companies Winding Up Rules shall apply to govern the winding up and dissolution of an ELP (except to the extent that such provisions are inconsistent with the ELP Law).
- If, following the ELP's registration, any change is made to its name, the general nature of its business, its registered office address, its duration or the name and address of its GP (or one of them), the GP must file with the Registrar of Exempted Limited Partnerships a statement of the change within 60 days of its occurrence.
- The GP must maintain or cause to be maintained (i) a register of limited partners, (ii) a record of the amount and date of the contribution or contributions of each limited partner and the amount and date of any payment representing a return of the whole or any part of the contribution of any limited partner (both of which must be updated within 21 days of any change) and (iii) a register of security interests in respect of partnership interests in the ELP. The register of limited partners is open to inspection by any partner subject as may be provided in the LPA and by non-partners with the consent of the GP. The record of contributions is open to inspection by any person, with the consent of the GP and the register of security interests is open to inspection by any person.

Certain other key provisions of the ELP Law are non-mandatory or non-prescriptive in effect, and may be adopted or varied in the LPA as may be agreed between the partners, for example:

- The limited partners will not be liable for any debts and obligations of the ELP if the ELP's assets are insufficient to discharge them.
- The ELP Law provides that a limited partner may demand and receive from the GP information about the ELP's business and financial condition, but the LPA may waive or vary this provision (subject to the obligation of an open-ended partnership registered with CIMA to prepare accounts and have them audited).
- A GP or limited partner may contract with, or lend money to, the ELP *qua* partner or otherwise, subject to the inviolable duty of the GP to act in good faith in the interests of the ELP and to any debt owed by the ELP to a GP transacting in such manner ranking behind the ELP's other creditors (secured or unsecured).
- No capital commitment is required of the GP or of a limited partner (although the LPA will typically provide for such); contributions may be made in cash, property or other assets (but not by way of loan by a partner to the ELP).
- The GP may take an interest in the ELP as a limited partner in addition to its interest as GP.
- The ELP Law provides, subject to any provision of the LPA to the contrary, that the ELP shall be automatically dissolved on the expiration of 90 days following the service, by or on behalf of, the sole or last remaining GP, of notice of the GP's death, bankruptcy, dissolution, winding up, withdrawal or removal, unless a majority of partners (or other majority specified in the LPA) elects within that 90 day period to appoint one or more new general partners.

Save as mentioned above, the LPA may contain such terms as may be agreed between the general partner and the limited partners.

Side letters

The GP of an ELP may enter into side letters with individual investors to provide for contractual arrangements additional to those contained in the LPA. It is common for investors entering into side letters to demand most favoured nation (MFN) clauses guaranteeing them the same rights extended to other recipients of side letters. These arrangements are unobjectionable under Cayman Islands law, but the normal steps must be taken to ensure that the terms of a side letter (and any MFN arrangements) are not in contravention of, or inconsistent with, the terms of the LPA. Nothing in the side arrangements can be

allowed to prevent the GP from discharging its obligation under Cayman Islands law to act at all times in the good faith and (subject to any express provisions of the LPA to the contrary) in the interests of the ELP.

Consideration should be given to making specific provision in the LPA for the GP to enter into side arrangements with individual investors within specified parameters. In all cases, Cayman Islands legal advice should be sought.

Legal opinions

A legal opinion will typically be required from the fund's onshore and offshore legal advisors. The offshore opinion will be addressed to the investors and will speak to the valid formation and good standing in the Cayman Islands of the ELP and its GP, the ability of the ELP (acting by the GP) to enter into the LPA and other documentation, the enforceability of the LPA and other documentation and the enforceability of the obligations thereunder of the GP.

Exempted limited companies

The contractual flexibility of the LPA and the relatively light statutory overlay of the ELP Law combine to ensure that the ELP is the vehicle of choice for managers choosing Cayman as the domicile for their private equity fund. It is possible, however, to use a Cayman Islands exempted limited company as the fund vehicle and to largely (if not entirely) replicate the mechanics of an LPA in the company's articles of association, often in tandem with an LPA-style shareholders' agreement.

The articles will require careful drafting to replicate limited partnership mechanisms, and the following is illustrative of the issues requiring consideration:

- Capital calls can be effected in one of two ways: (i) partly paid shares are issued in respect of the first closing, with provision for additional sums to be paid on those shares on each subsequent closing or capital call; or (ii) fully paid shares equal to the amount of capital called at first closing are issued, with additional fully paid shares being issued for each subsequent closing or capital call. The difficulty with approach (i) is that partly-paid shares cannot be repurchased by the company as a matter of Cayman Islands law, which causes difficulties (for example) when enforcing forfeiture provisions against a defaulting limited partner. Additionally, partly-paid shares must be allocated a distinguishing number in the company's books, which places an administrative burden on the company's directors or administrator.
- Capital accounting can be replicated by including in the articles a mechanism for tracking additions and subtractions from each investor's capital account, but this is generally more difficult than using the contractual flexibility of an LPA. The directors of a corporate fund will be under an obligation to treat all shares in a class identically, and this complicates the scenario in which an investor has to be treated differently (for example when it becomes a defaulting partner, or when its participation in distributions differs contractually from that of other investors). Whilst it is conceptually possible to make provision in the articles for the variation of economic entitlements attaching to a share of any class without prior sanction by class consent or other corporate action, the mechanics will be more cumbersome than those customarily found in an LPA.
- Interest payments made by additional partners being admitted in subsequent closings can be implemented by the establishment in the company's books of a separate class account for each investor, in order to enable interest payments by incoming investors to be allocated amongst existing investors.
- Claw-back provisions are possible, but more difficult, to draft in articles of association.

The tax transparency of a Cayman Islands company can be achieved for US managers and US non-taxable investors by means of the 'check the box' procedure, the broad effect of which will be that the company (whether a standalone fund, master fund or feeder fund) will be treated as a partnership for US tax purposes. That said, the same managers and investors may well be more familiar with an ELP and it may be more acceptable (not to mention cost effective) to use an ELP as the pooling vehicle, with corporate 'blocker' vehicles being established to cater for investors with specific regulatory and tax considerations.

Conclusion

The tax exempt, tax transparent, non-regulated and highly flexible nature of the ELP and the absence of regulatory or licensing requirements touching the general partner, together with the flexibility of the Cayman Islands exempted limited company, combine to make the Cayman Islands the pre-eminent jurisdiction for offshore private equity funds. From its offices in the Cayman Islands, Mourant Ozannes' Cayman funds advisory team is well placed to assist managers, sponsors and investors with all aspects of Cayman law and regulation pertaining to investment funds.

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