

Repackaging Transactions – Key Advantages to Cayman Islands Orphan Trust SPVs

GUIDE

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Introduction

The establishment of repackaging vehicles in Asia is on the rise with regional and international banks and financial institutions expressing interest in, or pursuing, the establishment of repackaging programmes or standalone issuer vehicles to service their, or their client's, specific needs.

Under a standard repackaging transaction, investors (the **Noteholders**) will purchase secured, limited recourse notes (the **Notes**) which are issued by an 'orphan' special purpose vehicle (the **Orphan SPV**) to enable the Noteholders to take a position in, or obtain exposure to, specific underlying assets (the **Underlying Assets**) which back such Notes and without the risks or balance sheet consequences of directly holding such assets. This is achieved by funding the payments required on such Notes (and in effect, repackaging the Underlying Assets into the Notes issued by the Orphan SPV). The proceeds of the issuance of the Notes will typically be used by the Orphan SPV to acquire the Underlying Assets. In consideration the Orphan SPV will immediately grant security over the Underlying Assets in favour of the trustee of the Notes (the **Trustee**) who will hold the security for the benefit of the investors or Noteholders.

Repacks are used for many reasons but typically they are used to meet the specific requirements of the investors or Noteholders which in turn are driven by various investment parameters or restrictions, investor return profile and appetite for risk.

This guide examines the key features of a repack vehicle and the advantages of incorporating an Orphan SPV in the Cayman Islands through the use of Cayman Islands exempted companies and segregated portfolio companies.

Orphan SPV – Key Features and Advantages

Accounting treatment

One of the primary features of a repackaging transaction, and a key driver (from an arranger's perspective), in establishing a repackaging vehicle, be it under a programme or a standalone issuance, is the off-balance sheet advantages such a structure provides in respect of the Underlying Assets. An arranger will want to ensure that the SPV is not regarded, for legal and accounting purposes, as a subsidiary or even an affiliate of the arranger or the arranger group, but rather that it is incorporated as an independent company to achieve an 'orphan SPV' status.

Off-balance sheet advantages

The off-balance sheet advantages are attractive to an arranger and include, amongst other benefits:

- the arranger can take comfort that the Underlying Assets involved in an issuance or trade will not be 'sheeted back' or consolidated with the arranger or the arranger group, providing benefits to the arranger from a legal, accounting and regulatory perspective, and
- the sale of the Underlying Assets by the arranger (if originated by the arranger) to the Orphan SPV and subsequent removal of them from its balance sheet frees up capital reserves it may be required to hold

against such assets to improve capital adequacy ratios in addition to providing cash-receipts on the sale of such assets.

Setting up an Orphan SPV through trusts

Establishing an SPV as an 'orphan' is permitted in the Cayman Islands and can be incorporated by a corporate services provider such as Mourant Governance Services (Cayman) Limited (**MGS**). An Orphan SPV can typically be established by setting up one of the following trusts:

Charitable trust

Shares in the Orphan SPV will be issued to a licensed trustee which:

- is established in the Cayman Islands and which is completely independent from the arranger;
- will hold the legal title to the shares in the Orphan SPV; and
- will establish a charitable trust structure by declaring a trust over the shares issued by the Orphan SPV such that the beneficiary will be a charitable organisation in the Cayman Islands.

This arrangement will make the SPV 'orphan' in nature given that the shares of the Orphan SPV form part of the trust assets of the charitable trust and are not owned by the arranger or other originator of the Underlying Assets. The charitable trust structure is the most commonly utilised in Asia when establishing an Orphan SPV for repackaging transactions.

STAR trust (purpose trust)

Similar to a charitable trust, the shares in the Orphan SPV will be issued to a licensed corporate trustee, however the purpose trust (known as a STAR trust in the Cayman Islands) is created for a specific purpose and will be held on behalf of a residuary beneficiary (which is usually a Cayman Islands charity). The purposes of the STAR trust will be set out in a trust deed and will typically be to subscribe for the shares in the Orphan SPV and to carry out the obligations of the Orphan SPV under the trust documents and related transaction documents.

One of the key differences between a STAR trust and a charitable trust is that an 'enforcer' can be appointed pursuant to the trust deed of a STAR trust whose role is to ensure the trustee of the STAR trust carries out its obligations. The enforcer does not need to be resident in the Cayman Islands and the arranger can act in this role, making it an attractive option particularly if there are any concerns as to the execution of the trustee's powers by the arranger or the Noteholders.

Independence of an Orphan SPV

Repackaging vehicles are structured as Orphan SPVs in the Cayman Islands to ensure that the issuer is independent and to give best possible assurance that the arranger or other originator cannot exert improper influence over the issuer.

Key actions and steps to ensure independence

In order to avoid accounting and/or legal consolidation between the Orphan SPV and the arranger, there are actions and steps that are typically taken to reflect the independent nature of the Orphan SPV, which include the following:

- appointing independent directors based in the Cayman Islands who have no link or nexus to the arranger, are not employees of the arranger and receive no fee or payment from the arranger;
- requiring the independent directors of the Orphan SPV to consider and pass a board resolution in respect of any transactions it proposes to enter into;
- preventing any of the Orphan SPV's assets to co-mingle or be pooled with the assets of any other company;
- appointing separate legal counsel to advise the Orphan SPV in all of its dealings with any third party, including those parties to any repackaging programme;
- restrictions on security for the obligations of another company;
- producing separate accounts which are not consolidated with any other entity;

- holding itself out as having a distinct and independent existence, being able to acquire and hold assets and carry on business in its own name in a manner separate from any other party; and
- maintaining arms-length relationships with other parties to the repackaging transaction or programme whereby any dealings with such other parties are documented on an arms-length basis for proper consideration and in respect of which the directors of the Orphan SPV consider the terms of each transaction and pass resolutions on the basis that they are satisfied (i) there is genuine corporate benefit to the Orphan SPV and (ii) it is in the best and commercial interests for the Orphan SPV to proceed with such transaction.

Key Considerations of an Orphan SPV Structure

Bankruptcy remoteness

One of the key criteria for an Orphan SPV issuer in a repackaging transaction is to ensure that it is a bankruptcy remote vehicle, particularly in (albeit unique) circumstances where the obligations of the Orphan SPV are not secured against the Underlying Assets.

Main purposes of bankruptcy remoteness

The purpose of bankruptcy remoteness is to ensure that the Orphan SPV will not be affected by the insolvency of any of the other transaction parties, most notably any entity from the arranger group. This is partly achieved through the off-balance sheet treatment discussed under 'Orphan SPV – Key Features and Advantages – Accounting treatment' above, however, there are two other key critical elements which would need to be addressed in the transaction documents, namely:

- limited recourse provisions; and
- non-petition provisions.

These provisions (which are discussed further below) operate to ensure that, where an Orphan SPV is a multi-issuer of Notes (which are supported by security over the Underlying Assets relating to that series of Notes), each series of issued Notes and the relevant Underlying Assets acquired by the proceeds of those Notes are effectively ring-fenced from the other series of Notes issued by the Orphan SPV and the associated Underlying Assets of that issuance. Accordingly, any claim by a secured creditor of the Notes can only be made against the specific Underlying Assets for that series of Notes. This is a critical aspect of a repackaging programme to ensure that the creditors of one series of Notes are not able to bring a claim on the Underlying Assets of another separate series of Notes issued by the same Orphan SPV, avoiding cross-collateralisation of different series of Notes and safeguarding the credit worthiness of the Orphan SPV.

Limited recourse

The terms of each transaction document executed by an Orphan SPV issuer should be drafted to make it clear that the Orphan SPV issuer enters into such document (and the transaction generally) on the basis that its liability is limited to the proceeds received on specific Underlying Assets which are held by the Orphan SPV in relation to the series of Notes issued by the Orphan SPV issuer (namely, the specific Underlying Assets which were acquired with the proceeds of the Notes).

Typically, these limited recourse provisions will be drafted such that the other transaction parties to the repackaging transaction will agree that upon realisation of the Underlying Assets relating to the series of Notes issued, to the extent there is any shortfall to meet any claim or obligation, then any such claim will be extinguished and no other assets of the Orphan SPV shall be available to meet any resulting shortfall. This means that any such shortfall will be borne by the other transaction parties and ensures the integrity of the Orphan SPV, particularly in relation to any issuer which is a multi-issuance entity and which may hold other assets which have been secured in favour of other series of Notes. Following enforcement of the relevant security over the Underlying Assets, the transaction parties will agree that no further action may be taken against the Orphan SPV and that no winding up proceedings may be commenced.

While there is no direct judicial authority in the Cayman Islands with respect to such provisions:

- a contractual provision which provided for the extinguishment of a secured debt after exhaustion of the assets on which that debt was secured will be valid, binding and enforceable as a matter of

Cayman Islands law (assuming that the provision was valid, binding and enforceable under the law governing the contract in which it was contained); and

- after the extinguishment of the secured debt, the secured creditor would not have standing to make a claim in respect of the debt, whether for its repayment, the winding up of the Orphan SPV or otherwise.

A court of the Cayman Islands would be unlikely to seek to expand the liabilities of the Orphan SPV beyond those assumed by it under each transaction document to which it is party as properly interpreted in accordance with the governing law of that transaction document. If all of those liabilities had been extinguished it is then highly unlikely that a basis would exist for filing a petition to wind up the Orphan SPV with a court of the Cayman Islands.

Upholding non-petition

Similar to the limited recourse provisions, the transaction parties of the repackaging transaction should also be required to all agree under the terms of the relevant transaction documents entered into by the Orphan SPV that they will not take any steps or present any petition against the Orphan SPV for its liquidation.

The advantages of utilising a Cayman Islands incorporated SPV are again highlighted as this contractually agreed position is expressly recognised by statute in the Cayman Islands pursuant to section 95(2) of the Companies Act of the Cayman Islands (as amended) (the **Companies Act**) which states that the '*Court shall dismiss a winding up petition or adjourn the hearing of a winding up petition on the ground that the petitioner is contractually bound not to present a petition against the company*'.

As such, the courts of the Cayman Islands must dismiss a winding up petition against an Orphan SPV, or adjourn any hearing of a winding up petition against such Orphan SPV, if the petitioner has contractually agreed not to present a winding up petition against that company. Accordingly, it is imperative from the position of the Orphan SPV that all other transaction parties (typically, each a secured creditor) agree to the terms of the non-petition provision and that the provision is expressed to capture, and binds, all other transaction parties to the repackaging transaction.

Other steps to ensure bankruptcy remoteness

Other steps which should be taken to ensure the Orphan SPV is a bankruptcy remote vehicle are as follows:

- establishing a new entity with no previous operating history and with a limited number of creditors;
- appointing a director or directors which are independent of the arranger or originator of the Underlying Assets relating to the Notes issued by the Orphan SPV;
- restricting the purpose and activities of the Orphan SPV in the constitutional documents and the repackaging transaction documents; and
- ensuring that the Underlying Assets are transferred from the originator to the Orphan SPV pursuant to a 'true sale' (which depends on the *situs* of the Underlying Assets).

The Use of Segregated Portfolio Companies in Repackaging

As discussed above, for stand-alone issuances or multi-issuance repackaging note programmes, repackaging transactions will be structured to ensure the documentation includes ring-fencing provisions to protect and preserve the Underlying Assets for the benefit of the secured creditors. This approach is market-standard across a wide-range of jurisdictions and is widely accepted by regulatory authorities, listing exchanges and rating agencies.

Where there is a concern that the contractual ring-fencing may break down, or may otherwise not be legally recognised, a Cayman Islands segregated portfolio company (an **SPC**) can be used as a repackaging vehicle to help to mitigate such concerns. The Companies Act provides that a Cayman Islands exempted company can be registered as an SPC.

Key features of an SPC

The attractiveness of using an SPC for a repackaging vehicle becomes evident upon examination of the legislative principles underpinning the creation of the SPC (which can be, and regularly is, incorporated as an Orphan SPV). The Companies Act provides that an SPC is a single legal entity within which may be

established various segregated portfolios. In practice, an SPC issuer can establish a new segregated portfolio for the issuance of each new series of Notes that it issues.

The assets and liabilities of each segregated portfolio are, pursuant to the Companies Act, legally separate from the assets and liabilities of:

- the other segregated portfolios established by the relevant SPC; and
- the general assets and liabilities of the SPC which are not attributable to a specific segregated portfolio.

For more information on the Cayman Islands SPC, please see our guide on [Cayman Islands segregated portfolio companies](#).

Why SPCs are used in repackaging: ring-fencing

The effect of this regime in a repackaging context is to codify the ring-fencing concepts similar to those described above, such that the assets and liabilities of the SPC issuer which relate to a specific series of Notes issued by the SPC acting for the account of a specific segregated portfolio would be attributable only to that specific segregated portfolio.

Recourse of creditors

Creditors of the SPC acting for the account of a specific segregated portfolio would only have recourse to

- the assets attributable to that specific segregated portfolio, and
- (unless specifically prohibited by the articles of association of the SPC) the SPC's general assets, to the extent the assets of the specific segregated portfolio are insufficient to satisfy the liability to meet any claim against the SPC acting for the account of that specific segregated portfolio (in our experience, the articles of association typically expressly prohibits this).

Accordingly, where there is a shortfall, creditors of a specific segregated portfolio would not be permitted to make a claim against the assets of another segregated portfolio (which would typically relate to a separate series of Notes).

The benefits of using an SPC as an issuer are that the ring-fencing requirements are entrenched in statute rather than merely in contract (although in practice both levels of ring-fencing are relied upon). While it is possible there could be uncertainties relating to the recognition and application of the Cayman Islands statutory segregation regime in a foreign court, given it is embedded in statute, the statutory regime would bind non-consensual third parties who are not captured by the contractual ring-fencing (which only binds the parties to the repackaging transaction documents).

Administration of the Orphan SPV

An Orphan SPV needs to appoint a number of service providers in administering the trust structure and to ensure its independence and to enable its effective operation, including:

- share trustee;
- independent director(s); and
- registered office provider.

There are a range of corporate service providers based in the jurisdiction which provide these services, including MGS which delivers a comprehensive range of fiduciary, administration, accounting and governance services through a dedicated team of experienced professionals in Hong Kong and the Cayman Islands. MGS has comprehensive industry knowledge and experience with repackaging structures and other complex structured finance transactions, working on structured finance and asset finance transactions alongside of the world's leading financial institutions.

In addition to providing independent directors, share trustee and foundation services and registered office services, MGS is able to offer a full range of fiduciary services which support the ongoing maintenance of an Orphan SPV, such as AML officer services, FATCA and CRS reporting services and listing agent services ensuring the Orphan SPV is appropriately managed on a daily basis.

This is indicative of the widely recognised and well established financial and professional services centre that has developed in the Cayman Islands.

Contacts

A full list of contacts specialising in Cayman Islands law can be found [here](#).

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