registered office of the company to provide nominee subscribers to the memorandum.[27] The memorandum must specify the number of shares pledged by each subscriber.[28] There must be at least one subscriber who must subscribe for at least one share.[29]

1.010 The memorandum will also set out the objects of the company.[30] If no objects are specified or if the objects are specified, but the business of the company is not restricted to the furtherance of those objects, then the company will have the power and authority to carry out any object not prohibited by the Companies Law or any other Cayman legislation.[31]

1.011 No act of a company will be invalidated by reason only of the fact that the company lacks capacity; that is, the ultra vires rule does not apply.[32] A lack of capacity or power can however be asserted in proceedings by a member or a director to prevent the company from taking a particular action by the company against its directors for loss or damage for an unauthorised act.[33]

1.012 The Companies Law permits an exempted company to issue bearer shares but such the issue of such shares is restricted to any person other than a custodian.[34] The Companies Law also expressly prohibits a shareholder from transferring bearer shares to a person other than a custodian and where shares are so transferred; a transferee is required to transfer such shares to a custodian within 60 days.[35] If the shares are not transferred within the prescribed time limit, the shares will be considered null and void for all purposes under the Companies Law.[36]

1.013 Articles provide for the regulation of a company's affairs and are generally registered along with the memorandum upon incorporation.[37] Each memorandum and the articles, if any, must be numbered and filed consecutively and endorsed with the date of the month and year of such filing.[38] The Companies Law contains a table (Table A) setting out standard regulations that may be adopted by reference.[39] However, the general practice has been to exclude Table A in favour of other articles prepared by the Cayman Islands service provider or law firm.

1.014 Where articles have been registered, a copy of every special resolution in force must be annexed to or embodied in every copy of the articles issued after such

[27] Although it is possible for the subscriber to the memorandum to be some other person such as the original shareholder.
[28] Companies Law, section 7(3).
[29] Companies Law, sections 5 and 7(2).
[30] *Ibid*, section 7(4).
[31] *Ibid*, section 7(4).
[32] *Ibid*, section 28(1).
[33] Companies Law, section 28(1).
[34] Companies Law, section 229(1). A custodian is defined under the Companies Law as "an authorised custodian" who is a person licensed under the Companies Management Law (2003 Revision) to act as a custodian of bearer shares or a bank or trust company licensed under the Banks and Trust Companies Law (2003 Revision) or a "recognised custodian" which is an investment exchange or a clearing organisation operating a securities clearance or settlement system and carried on in a country specified in the Money Laundering Regulations (2003 Revision) and which has been approved by The Cayman Islands Monetary Authority to act as custodian of bearer shares. *Ibid*, section 2(1).
[35] Companies Law, sections 229(2) and 229(6).
[36] Companies Law, section 229(6).
[37] *Ibid*, section 26(1).
[38] *Ibid*, section 26(2).
[39] *Ibid*, section 22(1) and Schedule 1.

resolution is passed.[40] The articles must also be divided into paragraphs numbered consecutively, bear the same stamp as if they were contained in a deed and be signed by each subscriber to the memorandum in the presence of and attested by at least one witness.[41] If articles are not registered with the memorandum the company may, subject to the conditions of the memorandum, adopt articles which must be signed by each existing shareholder of the company in the presence of and attested by at least one witness or by passing a special resolution.[42]

1.015 In the case of an unlimited company the articles must state the number of members with which the company proposes to be registered and, if the company has a share capital, the amount of share capital with which the company proposes to be registered. In the case of a company limited by guarantee, the articles must state the number of members with which the company proposes to be registered.

1.016 The memorandum, together with the articles, forms the constitution of a Cayman company. When the memorandum and articles of the company are registered, they bind the company and the members thereof to the same extent as if each member has subscribed affixed his or her seal thereto.[43]

1.017 A copy of the memorandum and the articles must be forwarded to every shareholder if requested on payment of a reasonable sum, not exceeding CI$1.00 for each copy and where provision is not made for payment, the copy must be provided gratuitously.[44] A sample of all the required documents are attached in Annexure A herewith.

1.018 Every company must have a registered office in the Cayman Islands to which all communications may be sent.[45] Notice of the situation of the registered office must be provided to the Registrar of Companies and published by Public Notice.[46] The location of the registered office is a matter of public record.[47] Although the registered office of a Cayman company is set out in its memorandum, the directors of the company may, by resolution, change the location of the registered office provided that within 30 days of the resolution being passed the company must deliver to the Registrar a certified copy of the resolution.[48] The resolution of directors does not physically amend the memorandum and it is therefore possible for a company to have the name of one registered office in its memorandum while maintaining another.

1.019 The minimum number of directors of a Cayman company is one.[49] There is no requirement that any of the directors should be a resident in the Cayman Islands.

[40] Companies Law, section 63(1).
[41] *Ibid*, section 23.
[42] *Ibid*, section 25(2).
[43] *Ibid*, sections 12 and 25(3).
[44] *Ibid*, section 29.
[45] *Ibid*, section 50.
[46] *Ibid*, section 51(1). Public Notice is defined under the Cayman Companies Law as a public notice affixed by the Cayman Registrar on the public notice board in George Town, Grand Cayman or such other place as may be fixed, from time to time, by the Governor in Council.
[47] Companies Law, section 51(2).
[48] *Ibid*, section 11(1).
[49] Although this is not expressly stated in the Cayman Companies Law, the position is inferred by section 57 of this Cayman Companies Law which confirms that a meeting of directors may be validly convened and business conducted where only one director is present.

5. A declaration signed by a director of the company stating that the operations of the company will be conducted mainly outside the Cayman Islands;

6. A voluntary declaration or affidavit signed by a director of the company stating that after having made due enquiry, the director is of the opinion that:

   (a) no petition or similar proceeding has been filed and remains outstanding or order made or resolution adopted to wind-up or liquidate the company in any jurisdiction;

   (b) no receiver, trustee or administrator or other similar person has been appointed in any jurisdiction and is acting in respect of the company, its affairs or its property or any part thereof;

   (c) no scheme, order, compromise or other similar arrangement has been entered into or made in any jurisdiction whereby the rights of creditors of the company are and continue to be suspended or restricted;

   (d) the company is able to pay its debts as they fall due;

   (e) the application for registration is bona fide and not intended to defraud existing creditors of the company;

   (f) any consent or approval of the transfer required by any contract or undertaking entered into or given by the company has been obtained, released or waived, as the case may be;

   (g) the transfer is permitted by and has been approved in accordance with the charter documents of the company;

   (h) the laws of the jurisdiction of incorporation of the company permit the transfer by the company and have been complied with; and

   (i) the company will upon registration under the Companies Law cease to be incorporated, registered or exist under the laws of the place of its incorporation;[79]

   The declaration or affidavit must also include a statement of the assets and liabilities of the company made up to the latest practicable date before making the declaration or affidavit.[80]

   A director making a declaration or affidavit as required without reasonable grounds is guilty of an offence and liable on summary conviction to a fine of CI$15,000 and to imprisonment for five years;[81]

7. An undertaking by a director of the company that notice of the transfer of the company to the Cayman Islands has or will be given within 21 days to the secured creditors of the company; and[82]

[79] Companies Law, section 201(3).
[80] *Ibid*, section 201(3).
[81] *Ibid*, section 201(4).
[82] *Ibid*, section 201(2).

8. Payment of the government fee which will be equivalent to the government fee for incorporation of a Cayman company.[83]

1.047 The name of the company must be approved by the Cayman Registrar prior to the application being filed.[84] The Registrar of Companies will register the company as a Cayman company by way of continuation provided that:

1. the company is constituted in a form or substantially a form which could have been incorporated as an exempted company limited by shares under the Companies Law;

2. that the company, if it is or would be prohibited from carrying on its business in or from within the Cayman Islands unless licensed under any law, has applied for and obtained the requisite licences; and

3. the Registrar is not aware of any other reason why it would be against the public interest to register the company.

1.048 Certificate to the effect that the company is registered by way of continuation as an exempted company and specifying the date of the registration.[85] From the date of registration the company continues as a body corporate for all purposes as if incorporated and registered as an exempted company under the Cayman Law.[86]

1.049 The Companies Law requires amendments to the charter documents to the extent that they do not comply with the requirements of the Companies Law as they relate to an exempted company to be made within 90 days of registration by special resolution passed in accordance with the Companies Law.[87]

1.050 There is also a procedure for provisional registration by way of continuation which requires certain continuation application documents[88] to be provided upon provisional registration with a fee of CI$1,500. The balance of the documents in support[89] is then provided at the time of continuation.

[83] Companies Law, section 201(2).
[84] Companies Law, section 201(2). There is however provision for a company to undertake to change its name to an acceptable name within 60 days of registration.
[85] Companies Law, section 202(1).
[86] Companies Law, section 202(3).
[87] *Ibid*, section 203(1).
[88] *Ibid*, section 201(6). The company's charter documents; a notice of registered office of the company; a declaration that the business of the company will be conducted mainly outside of the Cayman Islands and a director's affidavit confirming no petition or similar proceeding has been filed and remains outstanding or order made or resolution adopted to wind-up or liquidate the company in any jurisdiction; no receiver, trustee or administrator or other similar person has been appointed in any jurisdiction and is acting in respect of the company, its affairs or its property or any part thereof; no scheme, order, compromise or other similar arrangement has been entered into or made in any jurisdiction whereby the rights of creditors of the company are and continue to be suspended or restricted; and the company is able to pay its debts as they fall due.
[89] Namely, the government fee for registration; the director's undertaking that secured creditors have been notified or will be notified and a further affidavit in support confirming the application for registration is bona fide and not intended to defraud existing creditors of the company; that any consent or approval of the transfer required by any contract or undertaking entered into or given by the company has been obtained, released or waived, as the case may be; that the transfer is permitted by and has been approved in accordance with the charter documents of the company; that the laws of the jurisdiction of incorporation of the company permit the transfer by the company and have been complied with; and that the company will upon registration under the Companies Law cease to be

2.004 It should be noted that rights to be included in the memorandum of association and articles must relate to the rights of the shareholders in their capacity as shareholders of the company and not as personal rights. On the other hand, including identical provisions in a shareholders agreement (which is likely to be governed by the law of the jurisdiction from where the investors originate) and a company's constitutional documents (which will be governed by the law of the jurisdiction in which the company is incorporated) may result in a conflict when determining the obligations of the parties as the governing laws may treat a particular obligation differently.

2.005 Once a decision has been made to contain provisions in the memorandum of association and articles, there will also be a need for a decision on how such provisions are to be included and whether the agreement can be incorporated by reference. The preference should always be that the constitutional documents be drafted on a stand alone basis without referring to external agreements. In the event of a conflict between the provisions in the shareholders agreement and the memorandum of association and articles, as between the company and the shareholders of the company, the provisions in the memorandum of association and articles should as a matter of Companies Law prevail over the shareholders agreement.

2.006 Private equity and joint venture transactions often include provisions for preference shares. Preference shares are a useful tool providing parties with a mechanism to give an incoming investor priority on the distribution of any dividend or liquidation proceeds. Additionally, the introduction of a convertibility feature provides an investor with comfort that in the event of any further share issuances by the company, the investor's economic interest will not be diluted, even if the price of the shares to be issued is lower than the price of the shares acquired by the investor. The terms of the preference shares are extremely important as they can determine how the management of the company governs its affairs through the life of the investment and what return on the investment the investors expect to see. The rights attaching to preference shares are likely to address voting, dividend, redemptions, convertibility and return of capital in the event of liquidation as well as the appointment of directors and other corporate governance issues.

2.007 An increasing number of Cayman Islands companies are being listed on the major stock exchanges. The Companies Law contains flexible provisions in relation to corporate governance, leaving it almost entirely to the memorandum and articles of association of the company to determine the regulation of the company. In addition, the constitutional documents of a Cayman Islands company are not a matter of public record.

2. Veto Rights and Super Majorities

2.008 Voting would on the face of it appear straightforward but it should be noted that the Cayman Islands follow English common law principles and it may not be possible to provide holders of preference shares with express veto rights over certain corporate actions taken pursuant to powers granted by statute to the company.[4] Articles will need

[4] *Russell v Northern Bank Development* [1992] BCC 578, [1992] 1 WLR 588. This would apply whether or not the veto rights are contained in the articles or a separate shareholders agreement.

to be carefully worded to allow for those shareholders who wish to have these rights to achieve an effective veto in certain matters. This is commonly done by providing that the resolution to effect the relevant corporate action requires the approval of the specified majority of holders of preference shares.

2.009 It should however be noted that this restriction only relates to covenants by or restrictions on the company. Any obligation of a shareholder under a shareholders agreement (eg not to vote to approve such actions) would normally be enforceable *vis-à-vis* other shareholders.[5] However, specific performance may not be available and damages may not be an appropriate remedy.

3. Dividends

2.010 Care should be taken when drafting preference share terms to consider whether a dividend is cumulative and whether payment is to be made purely from profits (and if so, how those profits are to be calculated) or from other accounts that may be applied towards payment of dividends. It should be noted that any payment of dividends will require a board resolution[6] approving its payment to record that the company has sufficient funds to satisfy the requirements of the Cayman Law.

2.011 In addition, where dividends are cumulative and payable upon redemption, care should be taken over the manner in which the redemption amount is calculated. If accrued and unpaid dividends themselves become payable, they may not be paid by the company if there are not sufficient distributable reserves to do so. However, provided the company satisfies the statutory tests for redemption, there is nothing preventing an amount equal to the amount of dividends accrued being added to and forming part of the redemption amount. Careful drafting of the terms may thus permit a shareholder to redeem his shares with an amount equal to his accrued dividend even where the company is unable to pay the accrued dividend to the shareholder.[7]

2.012 The Companies Law does not regulate the source of funds which may be used by a company to declare and pay a dividend. At common law, the position follows the United Kingdom position that dividends may be declared and paid out of profits.[8] There is no statutory definition of the term "profits" under the Companies Law so that the amount of profits will normally be determined by reference to the applicable accounting principles. In addition, under the Companies Law, the share premium

[5] *Ibid*, see also *Welton v Saffery* [1897] AC 299.

[6] But not necessarily shareholders approval, depending on the memorandum of association/articles of the company.

[7] The position perhaps is different from a winding-up. Under English law authorities, it appears that where preference shareholders "rank both as regards dividend and capital in priority to all other shares..." this includes a right to accumulated but unpaid dividend on a winding-up, whether or not the payment originated from profits. *Re EW Savory Ltd* [1951] 2 All ER 1036 and *Re Springbok Agricultural Estates Ltd* [1920] 1 Ch 563.

[8] The Cayman Islands courts have expressly approved *dicta* of Buckley J in *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] Ch 353 that surplus arising from a revaluation of an asset may be distributed as profit where (a) the valuation could not be open to criticism and (b) the company has fluid assets available for the payment of dividend, leaving it with assets of sufficient value to meet commitments shown on the liabilities side of its balance sheet. *Pacific Properties Limited (in liquidation) v McNeill and JM Bodden II* (1990–91) CILR 171.

2.021 The Companies Law contains provisions regulating the redemption and purchase of shares. A Cayman Islands company may, if authorised to do so by its articles of association, issue shares that are to be redeemed or are liable to be redeemed at the option of the company or the shareholder.[15]

2.022 No shares may be redeemed or purchased unless they are fully paid[16] or if to do so would result in there no longer being any issued shares of the company other than treasury shares.[17] Redemptions and purchases may be effected in such manner as the articles of association of the company may determine.[18] Where the articles are silent, the manner of purchase must be authorised by a resolution of the company.[19]

2.023 The Companies Law however provides for the avoidance of doubt that a company's articles of association or a resolution of the company may authorise the company's directors to determine the manner or any of the terms of a redemption or purchase provided the determination is not inconsistent with the company's articles of association.

2.024 Shares may be redeemed out of profits of the company, out of the share premium account or out of the proceeds of a fresh issue of shares made for the purposes of the redemption[20] or if authorised by its articles, out of capital, subject to the company being able to pay its debts as they fall due in the ordinary course of business.[21] The premium in excess of the amount of the *par* value to be redeemed may be funded out of profits or the company's share premium account;[22] or if authorised by its articles, out of capital, subject to the company being able to pay its debts as they fall due in the ordinary course of business.[23] The Companies Law does not require the company to exhaust any one account before using another.[24] The case of *RMF Market Neutral Strategies (Master) Limited v DD Growth Premium 2X Fund (in Official Liquidation)* discussed above should be noted on the inapplicability of the solvency test for payment of redemption monies out of share premium.

2.025 In the event that the amount of capital paid on a redemption or purchase is less than the par value of the shares to be redeemed or purchased, the credit that arises is required to be transferred to the company's capital redemption reserve. The capital redemption reserve is subject to the same restrictions as share capital, except that it may be used to fund a bonus issue of shares.[25] It would also appear that the reserve can be used to fund a purchase or redemption where there is no sufficient capital to do so.[26]

15 Companies Law, section 37(1).
16 *Ibid*, section 37(3)(a).
17 *Ibid*, section 37(3)(b).
18 *Ibid*, section 37(3)(c).
19 *Ibid*, section 37(3)(d) does not expressly say that a resolution of shareholders is required; however this is the common interpretation of this provision.
20 *Ibid*, section 37(3)(f).
21 *Ibid*, section 37(6)(a).
22 *Ibid*, section 37(3)(e).
23 *Ibid*, sections 37(5) and 37(6); the position is different from that under other common law jurisdictions such as Hong Kong and the United Kingdom in that capital may be used for the payment of premium on a redemption of shares.
24 Companies Law, sections 37(5) and 37(6).
25 *Ibid*, section 37(4)(d).
26 *Ibid*, section 37(5)(d).

2.026 The Companies Law expressly permits the issue of shares which are to be redeemed or liable to be redeemed. Previously, the Companies Law only provided for the issue of shares that could be liable to be redeemed and, there was some concern whether shares may retain a redemption feature in any other way such as through a variation of share rights. A recent amendment to the Companies Law now expressly provides that it shall be lawful for the rights attaching to any shares to be varied, subject to the provisions of the company's articles of association, so as to provide that such shares are to be or are liable to be so redeemed.[27]

2.027 The Companies Law now also authorizes a company, subject to any express provision of the company's memorandum and articles of association to the contrary, to accept the surrender for no consideration of any fully paid share (including a redeemable share) unless, as a result of the surrender, there would no longer be any issued shares of the company other than shares held as treasury shares.[28]

2.028 In addition, where shares are purchased, redeemed or surrendered, a company has the option for the shares not to be cancelled but instead be classified as treasury shares. To hold shares as treasury shares, the memorandum and articles of association of the company must not prohibit the company from holding treasury shares, the relevant provision of the memorandum and articles of association must be complied with and there must be either an authorisation in the company's articles of association or by a resolution of directors to hold such shares in the name of the company as treasury shares prior to the purchase, redemption or surrender of such shares.[29]

2.029 A company that holds treasury shares may at any time cancel the shares in accordance with the provisions of the company's articles of association or (in the absence of any applicable provisions) by a resolution of the directors. If cancelled, the amount of the company's issued share capital will be diminished by the nominal or par value of the shares cancelled but the company's authorized share capital will not be reduced.[30] Alternatively, the company may transfer the shares to any person, whether or not for valuable consideration (including at a discount to the nominal or par value of such shares).[31]

2.030 An amount equal to the lesser of the amount of payment out of capital and the transfer consideration (if any) received by the company on a transfer of a treasury share must be applied to the extent that any payment out of capital was made in relation to the initial purchase or redemption of the share, to the company's share capital. If the consideration received for the transfer where any payment out of share premium was initially made as the purchase or redemption, the share premium account will be credited by an amount equal to the lesser of the initial payment out of share premium and the balance of any amount not credited to capital.[32]

2.031 For so long as a Cayman Islands company holds treasury shares, the company must be entered in the register of members as holding the shares but the company will not be treated as a member for any purpose and may not exercise any rights attaching to such

27 Companies Law, section 37(1).
28 *Ibid*, section 37B(1).
29 *Ibid*, section 37A(1).
30 *Ibid*, section 37A(3).
31 *Ibid*, section 37A(3).
32 *Ibid*, section 37A(4).

(c) fixed and/or floating charges over bank accounts (See Section 8 below); and

(d) assignment of rights, claims and receivables by way of security (see Section 9 below).

2. Guarantees

3.005 Guarantees by a Cayman Islands company of the debts and other obligations of companies within the same group are a common feature of finance transactions involving Cayman Islands companies. A company may also guarantee the obligations of non-affiliated third parties although, for the reasons discussed below, care should be taken by the directors to ensure there is a corporate benefit in doing so.

3.006 Guarantees are typically (although not necessarily) documented under the same governing laws as the finance documents to which they relate and are usually granted by the direct parent, if any, and by each material subsidiary of the borrower.

3.007 The directors of the company providing any up-stream, down-stream or cross-stream guarantees should always consider the corporate benefit to the guarantor of providing the guarantee and whether, in all the circumstances, the provision of a guarantee and/or security will be in the best interest of such guarantor. It is not generally difficult to show there is corporate benefit to a company in providing a down-stream guarantee for the obligations of a wholly owned subsidiary. Likewise, in the context of a financing transaction that is of benefit to the whole group irrespective of which shareholder of the group is the borrower, there is generally little difficulty in directors of a company providing cross-stream or up-stream guarantees satisfying themselves that an indirect commercial benefit will accrue to the company.[10] In contrast, where a company guarantees the obligations of a non-affiliated third party, the directors should take additional care in identifying what consideration or other benefit will accrue to the company in return for entering into the guarantee. If a guarantor receives little or no discernible direct or indirect commercial benefit from the transaction as a whole, there is a risk that a Cayman Islands court may set aside the guarantee or related security as being in breach by the directors of their fiduciary duties to act in the best interests of the company.[11]

3.008 To avoid risk of the validity of a guarantee being challenged by a shareholder it is common for secured parties to require that the guarantor obtains the approval of its shareholders to "whitewash" the transaction before it is consummated, although this step may not remove the risk of challenge by other parties, including liquidators.

3.009 There are no restrictions imposed under Cayman Islands law on the amount of any guarantee that a company may provide although the directors when considering the corporate benefit to the company should be cautious of guaranteeing obligations that clearly exceed the net worth of the company.

[10] Although it is still generally advisable for the guarantor's shareholder(s) to approve or ratify such action by the directors.

[11] On an action brought by a shareholder, creditor or liquidator.

3. Mortgages and Charges

3.010 The two most common types of security granted by or over a Cayman Islands company are mortgages and charges. Although they are conceptually different, the practical distinction between mortgages and charges is not significant.[12] In each case the security is effective without any necessity for the secured party to be in possession of the secured asset and both give the secured party a proprietary interest in the secured asset[13] which is effective on the insolvency of the mortgagor or chargor.

3.011 A legal mortgage requires the transfer to the secured party of legal title to an asset whereas, under an equitable mortgage only the beneficial title to an asset is transferred to the secured party (with legal title remaining with the mortgagor). The fact that a mortgage is by way of security means that the secured asset has been transferred only to secure an obligation and that, once that obligation is discharged, the mortgagor is entitled to have the legal or beneficial interest (as the case may be, depending on whether the mortgage is legal or equitable) in the asset transferred back to it. This right, which is itself a proprietary interest, is usually referred to as the "equity of redemption" and cannot be extinguished without express order of a court (for example, an order for foreclosure).

3.012 A charge is rather more difficult to define than an equitable mortgage, but has been judicially described as a proprietary interest granted by way of security without a transfer of title or possession.[14] A charge creates a security interest which attaches to a particular asset and generally travels with it into the hands of a third party.[15] In reality, although there are technical differences between an equitable mortgage and a charge, there are few practical differences between them. Both may be granted over current and future-owned assets and in each case there are fewer formalities to their creation than in in relation to a legal mortgage.

3.013 Whilst a legal mortgage is often taken pursuant to the special statutory regimes (governing, for example, real estate, ships and aircraft), equitable mortgages and charges[16] are by far the most common type of security interest encountered in the Cayman Islands in relation to commercial lending.

4. Perfection of Security

3.014 Perfection of security generally refers to the steps a holder of a security interest (i.e. the lender(s) or the security agent appointed on its or their behalf) must take to protect its interest in the secured assets. In certain jurisdictions, failure to perfect a security interest renders it void against other creditors. Typically, perfection requires further acts other than simple execution of the document creating the security interest.

[12] A full analysis of the technical distinctions between a mortgage and a charge is beyond the scope of this chapter and the discussion in this chapter is intended to be a summary only.

[13] Although the nature of the proprietary interest varies depending on whether the security is a legal mortgage, equitable mortgage or a charge.

[14] *Re Bank of Credit and Commerce International (No. 8)* [1998] AC 214 at 226, which would be persuasive in the Cayman Islands courts.

[15] The exception to this rule is where the charged asset is transferred to a *bona fide* purchaser of full legal title for value and without notice of the existence of the charge, who will acquire the asset free of the charge.

[16] Both fixed and floating.

3.026 An equitable mortgage is an agreement[23] to create a legal mortgage[24] pursuant to which the mortgagor retains title to the secured shares until required by the secured party to transfer such shares into its name or the name of its nominee on enforcement of the mortgage.

3.027 An equitable mortgage is created over registered shares by the execution of a mortgage agreement between the mortgagor and the secured creditor[25] which is expressed to be an equitable mortgage only. An equitable mortgage may also be created unintentionally where there is an intention to create a legal mortgage but the required formalities have not been complied with (i.e where title to the secured shares has not been effectively transferred into the name of the secured party or its nominee).

3.028 An equitable mortgage is not capable of being "perfected" because the security interest created is not conditional on the transfer of legal title to the secured party and there are no other formalities required to protect the security interests created by the equitable mortgage agreement. However, an equitable mortgage agreement will typically require the delivery on execution by the mortgagor of one or more of the following documents to facilitate enforcement and improve the quality of the security:[26]

(a) an undated share transfer form executed by the mortgagor in favour of the secured party or its nominee[27] which can be dated by the secured party and delivered to the company for registration upon enforcement of the security;

(b) an irrevocable proxy[28] to enable the secured party to attend and vote the shares at general meetings of the company following the security becoming enforceable in accordance with its terms;

(c) an undated resignation letter signed by each existing director of the company together with a letter of authority addressed to the secured party authorising it to date the letter of resignation on enforcement of the security;[29]

(d) a deed of undertaking given by the company to the secured party acknowledging the equitable mortgage and undertaking to register all share transfers delivered to the company by the secured party pursuant to the equitable mortgage agreement; and

[23] Usually executed as a deed as the document will generally contain a power of attorney and, in some situations, there may be concerns about lack of consideration.

[24] The intention being to create a legal mortgage on the occurrence of an event specified in the mortgage agreement and/or the applicable finance documents, including a declared event of default.

[25] The secured party may prefer an equitable mortgage to avoid one or more of the disadvantages of a legal mortgage mentioned in paragraph 3.037.

[26] Sometimes referred to as "self-help remedies".

[27] Commonly left blank as to the name of the transferee.

[28] Note that an irrevocable proxy will only be effective where it is provided for in the articles of association of the company. The English case of *Cousins v International Brick Co Ltd* [1931] 2 Ch 90 (CA), which has persuasive authority in the Cayman Islands courts, is authority for the general rule that a shareholder attending and voting at a general meeting of a company will take priority over and to the exclusion of a proxy holder in attendance and wishing to vote at the same meeting.

[29] Generally only applicable if the equitable mortgage creates a security interest over all of the shares of the company.

(e) a letter of direction from the company to its registered office service provider[30] instructing it to enter up on receipt any share transfers delivered by the secured party pursuant to the equitable mortgage agreement in the register of members of the company.

3.029 In addition, the equitable mortgage agreement will typically include[31] an irrevocable power of attorney[32] granted by the mortgagor[33] in favour of the secured party enabling it to complete the share transfer form in respect of the secured shares and any other documents requiring execution on enforcement of the security.

3.030 As an additional step, provided the secured shares owned by the mortgagor have sufficient voting rights to enable the mortgagor to pass a special resolution of the company,[34] the equitable mortgage agreement will generally require the mortgagor to amend the articles of association of the company to facilitate enforcement of the security by making some or all of the following amendments:

(a) removing any discretion the directors may have to refuse to register transfers of shares made pursuant to the mortgage agreement;

(b) obliging the company to take notice of and recognise security interests created under the equitable mortgage agreement;[35]

(c) providing for process under which a notation to be added to the register of members at the request of a secured party to the effect that the shares are subject to the security interest created under the equitable mortgage agreement;

(d) making any lien the company has over the secured shares subject to the security interest created under the equitable mortgage agreement;

(e) disapplying any forfeiture rights or call on shares subject to the security; and

(f) providing a procedure for the recognition of irrevocable proxies granted by a shareholder.[36]

3.031 As a further (but less common) protection against the attempted transfer by a company of secured shares in breach of the terms of the mortgage agreement, the secured party

[30] The registered office of a company in the Cayman Islands is typically provided by a licensed third party service provider that (unless the register is maintained elsewhere) will maintain the company's register of members and update it when instructed to do so by or on behalf of the company.

[31] The power of attorney may be included within the mortgage agreement or contained in a separate document.

[32] Section 4(1) of the Powers of Attorneys Law (1996 Revision) provides that where a power of attorney is expressed to be irrevocable and is given to secure the performance of an obligation owed to the donee, then, so long as the obligation remains undischarged, the power share not be revoked by the donor without the consent of the donee.

[33] Powers of Attorneys Law, section 2(1) – an instrument creating a power of attorney shall be executed as a deed or as an instrument under seal.

[34] The statutory definition of a special resolution is one that has been passed by a majority of at least two-thirds (or such greater majority as may be specified in the articles of association of the company) of such shareholders as, being entitled to do so, vote in person or by proxy at a general meeting of the company or, if authorized by the articles of association of the company, it has been approved in writing by all the shareholders entitled to vote at a general meeting.

[35] Typical articles of association entitle a company to treat the registered holder of any share as the absolute owner and not be bound to recognise any equitable claim to, or interest in, any such shares by any other person.

[36] See footnote 24.

obligation of the secured party to act in good faith[48] and to sell the shares for the best price reasonably obtainable when exercising its power;[49]

(c) an application to court for an order authorising the secured party (or the receiver) to sell the shares where the mortgage agreement either contains no express power of sale or the power of sale provision is flawed or otherwise uncertain; or

(d) an application to the court for a foreclosure order so that the secured party is confirmed as being the absolute owner of the secured shares and the equity of redemption of the mortgagor is extinguished.[50]

7. Fixed and Floating Charges

(a) Introduction

3.040 A Cayman Islands company may grant a charge over a particular asset or class of assets as security for the satisfaction of a debt or other obligation. Charges are characterised as being either fixed or floating and, in practice, where a company has a range of different types of asset available to secure its debts or other obligations, fixed and floating charges will be created within a single charge document.[51]

3.041 Whether a charge is characterised as fixed or floating under the Cayman Companies Law depends principally on the level of control the chargor retains over a particular asset and the label attached to the charge will not be conclusive of whether a court will regard the charge as fixed or floating. In relation to certain assets this has historically given rise to tension as to whether the charge created is actually a fixed charge, or whether (despite being expressed as a fixed charge) it should be recharacterised as a floating charge. This issue arises most frequently in relation to trade receivables and cash in bank accounts which, by their nature, fluctuate in normal course of business. There is little Cayman Islands case law on the nature of fixed and floating charges and English authorities will generally be followed in determining the correct characterisation of a particular charge. The House of Lords brought some clarity to this area of the law[52] when it held that the essential test of whether a charge was a fixed charge related to the chargor's power to continue to deal with the asset. In order to preserve the status of a charge as a fixed one, the secured party must exercise actual control over disposal of the asset. If the chargor is able to deal with the asset, such as by drawing from the account in which charged funds are kept, or into which the

[48] An express power of sale should always be included in the mortgage agreement. In the absence of such power or on a breach of good faith by the secured party, the mortgagor may apply to the court to prevent any attempt to sell the secured shares.

[49] When selling the secured shares the secured party may not aim merely to recover the amount of the secured obligation because the mortgagor retains an equity of redemption and is entitled to receive any proceeds of sale in excess of the secured obligations and permitted costs.

[50] A foreclosure order will usually only be granted after the court has first ordered the sale of the secured shares and such sale has been unsuccessful.

[51] Sometimes referred to as, or contained in, a debenture.

[52] *National Westminster Bank plc v Spectrum Plus Ltd* [2005] UKHL 41, which will be highly persuasive in the Cayman Islands courts.

proceeds of trade receivables are deposited, then the holder of the charge does not have effective control. The House of Lords held that, if the chargor company is able to use the proceeds in the ordinary course of its business without the consent of the secured party, this is inconsistent with the status of the charge as fixed and the charge could only take effect as a floating charge.

3.042 As noted above, the principal characteristic of a fixed charge is that it gives the secured party sufficient control over a specific asset, without which the charge will be deemed to be floating. The types of asset upon which a fixed charge may be taken are those that are not disposed of and replaced in the normal course of business (such as shares and other securities, equipment, deposit accounts, intellectual property etc). Typically the terms of a fixed charge will:

(a) prevent the chargor from disposing of the asset without prior consent of the secured party;

(b) grant the secured party a power of sale over the secured asset;

(c) enable the secured party to apply the proceeds of sale of the asset against the secured obligations in priority to other creditors; and

(d) require the chargor to maintain the value of the asset whilst in its possession.

3.043 In contrast a floating charge is a security interest over assets of a company that is said to "float" over the charged assets until such time as it "crystallises" and is converted into a fixed charge. Prior to crystallisation the terms of the charge will permit the chargor to continue dealing with the assets in the ordinary course of its business without consent of the secured party. On crystallisation, a floating charge will convert into a fixed charge over all the assets of the company that are subject to such charge and the chargor will cease to have power to deal with such assets without the consent of the secured party. Typically crystallisation will take place on receipt by the chargor of notice from the secured party following the occurrence of an event of default which is continuing or automatically upon the occurrence of certain events, including insolvency proceedings or attempted sales of assets in breach of the terms of the security document.

3.044 The practical significance of correctly characterising a charge is apparent on the insolvent winding up of the company. In such an event, which would be subject to limited and minor exceptions, claims by the holders of fixed charges will rank in priority to the claims of creditors preferred by statute[53] (including certain specified debts due to employees, bank depositors and certain taxes due to the Cayman Islands government) and to the holders of floating charges.[54]

3.045 Because of their lower priority, floating charges are often created as "back-up" security to the purported fixed charges which are taken over assets of the company intended to be secured under the security document to safe guard against the possibility of a fixed charge being invalid or of questionable characterisation.

[53] Companies Law, section 141(1) and Schedule 2.

[54] Companies Law, section 141(2)(b).

4.019 There are no requirements to obtain the approval of any authority in the Cayman Islands for the issue or transfer of shares of a Cayman Islands company acting as a listing vehicle.

4.020 The corporate approvals required for a listing will normally consist of resolutions of the directors and shareholders. The directors' resolutions will normally address the following:

(a) the share swap and, where necessary, any redenomination of the currency of the par value of the shares of the listing vehicle;

(b) the form of prospectus, application forms and notices to appear in the newspapers;

(c) the underwriting agreement;

(d) the form of consent letters to be issued by the various professionals advising the company and named in the prospectus;

(e) material contracts entered into with the professional parties assisting with the listing, including sponsors and share registrar agreements;

(f) verification notes;

(g) the form of advice on various issues provided by the accountants and lawyers;

(h) authorisation of a committee of directors to deal with matters arising in connection with the listing including settling lists of allottees; and

(i) authorisation of the filing of the prospectus and forms in Hong Kong with the relevant authorities.

4.021 Shareholder approvals will typically address the following matters:

(a) increase in authorised share capital of the company to allow for the reorganisation and issue of shares under the public offering and, where necessary, any redenomination of the currency of the par value of the shares of the listing vehicle;

(b) the issue of shares under the reorganisation, the capitalisation issue and offer;

(c) the adoption of new memorandum and listing articles;

(d) a share option scheme; and

(e) mandates to issue and repurchase shares.

(d) Prospectus Requirements

4.022 There are no prospectus publication or filing requirements for a Cayman company. Unless shares of a Cayman company are to be listed on the Cayman Islands Stock Exchange, no offering of shares may be made to the public in the Cayman Islands. Where a Cayman company looks to offer securities to other Cayman companies, the prudent approach would be to ensure that the offer is made to an address in Hong Kong. That said, the Cayman Law does not have provisions similar to Hong Kong providing

that that the reference to the "public" includes "any section of the public".[8] Accordingly, where a Cayman company after listing proceeds with a rights issue or open offer and it has one or two shareholders whose registered addresses are in the Cayman Islands, it is unlikely that the prohibition is to apply. "Public" would take its normal meaning which as something which is "open to all".[9]

(e) Underwriting Agreements

4.023 It is not difficult for the listing vehicle to enter into underwriting agreements with its underwriters and it has become common practice to do so. However, there are a couple of areas where practitioners should be careful.

(i) *Force Majeure*

4.024 *Force majeure* clauses in an underwriting agreement permit underwriters to be relieved of their contractual obligations under the agreement in certain prescribed circumstances which could potentially prevent a party from fulfilling their obligations under the contract. It is common practice to phrase such a clause widely so that it could be argued on any day that there is a *force majeure* event. There is no difficulty with enforceability of such a provision. However, care should be taken with respect to the expiry of the *force majeure* clause.

4.025 As a matter of best practice, the *force majeure* period should expire: (a) prior to the dispatch of share certificates; and (b) prior to any entry being made on the register of members of the company whose shares are to be listed.

4.026 In the event that share certificates are dispatched prior to the expiry of the *force majeure* period, there is potential liability on the listing vehicle (and, it is submitted, its directors, on the basis that where directors knowingly allow a company to be put in such a position, it is questionable whether they are acting in the best interests of the company) against third party purchasers for value or purchasers of shares in reliance of the share certificates. In the event that underwriters invoke *force majeure*, the shares of the listing vehicle are never issued. However, as the listing vehicle has permitted the issue and dispatch of share certificates, it will be estopped from denying that the shares are in issue and liable to the purchaser for damages.

4.027 Despite the best practice referred to above, it is now common practice in public offerings in Hong Kong that the underwriting agreements will not become unconditional until 8.00 a.m. on the day of the actual listing itself. The resolutions approving the allotment and issue of the shares of the listing vehicle will generally provide that such shares are only issued upon the underwriting agreements becoming unconditional i.e. at 8.00 a.m. on the day of the listing. In an effort to protect the listing vehicle against the risk of having despatched share certificates ahead of such time, it is common for prospectuses to contain a statement that share certificates, despite being despatched, will only become valid certificates of title at 8.00 a.m. on the date of listing, provided that: (i) the listing becomes unconditional in all respects; and (ii) the right of termination granted to underwriters under the underwriting agreement has not been exercised and has lapsed.

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[8] See section 48A(1) of the Hong Kong Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32).

[9] See Black's Law Dictionary (Sixth Edition).

- deregistration of a company by continuation into a foreign jurisdiction;[11] and
- voluntary winding up of a segregated portfolio company which is subject to a receiver order given by the Court.[12]

5.003 As the heading to this section indicated, these matters are considered to require what is commonly known as an ordinary resolution of shareholders, meaning a resolution passed by a majority of the shareholders to attend and vote at the meeting. There is however no specific reference to "ordinary resolution" in the Companies Law. The ordinary resolution voting standard follows what is statutorily required in other countries[13] and reflects the general company law position of majority rule.[14] The lack of a definition also permits the memorandum and articles of association of a company to impose another (higher)[15] voting threshold for these matters, including requiring that they also require a special resolution (see below). There is also nothing in the Companies Law precluding the memorandum and articles of association from permitting a written resolution to approve an ordinary resolution to be passed by less than unanimous approval.[16]

(b) Issues for which Cayman Islands Law Requires Approval by a Super Majority of Votes by Shareholders

5.004 The following actions in respect of exempted companies incorporated under the Companies Law, are required by the Companies Law to be passed by "special resolution" (as such phrase is defined in the Law and varied by the Articles of Association of each such company):

- an alteration of the Memorandum of Association;[17]
- a reduction of share capital;[18]
- the alteration or addition to the Articles of Association;[19]
- the adoption of Articles of Association;[20]
- the changing of the name (or dual foreign name, if any) of the company;[21]
- the appointment of an inspector to examine the affairs of the company;[22]

[11] Companies Law, section 206(2)(k). Subject to authorization required in the Memorandum and Articles of Association.
[12] Companies Law, section 224(5).
[13] See for example section 282(3), UK Companies Act 2006, and section 563 of the Hong Kong Companies Ordinance, (Cap 622 of the laws of Hong Kong).
[14] *Foss v Harbottle* (1843) 2 Hare 461.
[15] A lower majority would seem to offend the principle against majority rule. Commercially, if this objective were required, it can be achieved by weighted voting rights.
[16] Although, as indicated above, this should be at least a majority.
[17] Companies Law, section 10.
[18] Companies Law, section 14(1).
[19] Companies Law, section 24.
[20] Companies Law, section 25(2).
[21] Companies Law, section 31.
[22] Companies Law, section 67.

- requiring the Court to wind up the company under the Companies Law;[23]
- to wind the company up voluntarily under the Companies Law;[24]
- a consolidation or merger of a company with another company;[25]
- the making of amendments to Memorandum and Articles of Association upon registration by way of continuation into the Cayman Islands;[26]
- deregistration of a company by continuation into a foreign jurisdiction;[27] and
- conversion of existing exempted companies into a segregated portfolio company, authorising the transfer of assets and liabilities into segregated portfolios;[28]

5.005 For purposes of these corporate actions, the Companies Law provides that a resolution is a special resolution where:

> "(a) it has been passed by a majority of at least two-thirds of such members as, being entitled to do so, vote in person or, where proxies are allowed, by proxy at a general meeting of which notice specifying the intention to propose the resolution as a special resolution has been duly given, except that a company may in its articles of association specify that the required majority shall be a number greater than two-thirds, and may additionally so provide that any such majority (being not less than two-thirds) may differ as between matters required to be approved by a special resolution; or
>
> (b) if so authorised by its articles of association, it has been approved in writing by all of the members entitled to vote at a general meeting of the company in one or more instruments each signed by one or more of the members aforesaid, and the effective date of the special resolution so adopted shall be the date on which the instrument or the last of such instruments, if more than one, is executed."[29]

5.006 The voting threshold is therefore set at a two-thirds majority or higher majority[30] for a special resolution or through a unanimous written resolution. The reference in the section to "*such members as... vote in person or... by proxy...*" means that the majority is to be calculated from those members who actually attend and vote at a meeting as opposed to the absolute number of shareholders. Unlike an ordinary resolution, it is not possible to pass a special resolution as a written resolution unless it has been signed by all shareholders.

[23] Companies Law, section 94(1)(a).
[24] Companies Law, section 116(c).
[25] Companies Law, section 233(6).
[26] Companies Law, section 203.
[27] Companies Law, sections 206(1) and 206(2)(k).
[28] Companies Law, section 214(1)(b).
[29] Companies Law, section 60(1).
[30] Note that any higher majority must be set out in the articles as opposed to the memorandum of association.

In particular, any agreements by directors to support a bid or procure shareholder approval for a bid will need to be subject to directors' duties to act in the best interests of the company and that directors are not permitted to fetter their future discretion.[5]

(c) Types of Duty Owed

6.006 At common law a director owes two types of duty to the company; a fiduciary duty and a duty of skill and care. The fiduciary duty requires a director to act in good faith, for a proper purpose; directors' interests must not conflict with those of the company and directors must not take secret profits.

(i) *Duty to Act in Good Faith*

6.007 The courts have held that directors must act bona fide in what they consider–not what a court may consider–is in the interests of the company.[6] Generally, a court will only interfere with the directors' decisions if there is evidence of:

(a) bad faith, tending to prejudice the interests of the disadvantaged shareholders;

or

(b) having taking every option into account, no reasonable director could possibly have concluded that a particular course of action was in the best interests of the company.[7]

(ii) *Duty to Act for a Proper Purpose*

6.008 In general, directors are not allowed to exercise their powers in such a way as to prevent a majority of the members from exercising their rights as such. Even if the directors are acting in good faith in the interests of the company as a whole, they must still use their powers for the purposes for which they were intended. Accordingly, directors have been found in breach of their duties in circumstances where they have issued shares in order to defeat a hostile takeover bid[8] or to assist a takeover to take away control from an existing majority.[9] Unlike the duty to act with reasonable care and skill which has a subjective element, the determination of whether the directors are acting for a proper purpose is an objective one and the fact that directors have acted reasonably may not prevent a corporate action taken as not being considered for a proper purpose.

6.009 In a recent case, the Grand Court found that a group of directors of a company, constituting a majority of the board, did not act for a proper purpose when removing one of its number as chairman. In this case, the majority of the board (who also represented certain minority shareholders) argued that the removal related to proper business purposes, namely concerns that the chairman had failed to turn around the financial condition of the company. The Court confirmed that:

[5] See *John Crowther Group plc v Carpets International plc* [1990] BCLC 460; see also *Rackham v Peek Foods Ltd* [1990] BCLC 895 and for an alternative approach, see *Fulham Football Club v Cabra Estate plc* (1992) 1 BCLC 145.
[6] *Smith & Fawcett Ltd* [1942] Ch 304.
[7] *Thompson v J Barke & Co (Caterers) Ltd* [1975] SLT 67.
[8] *Hogg v Cramphorn* [1967] Ch 254.
[9] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

> "Where there is a dispute about the purposes for which a decision was made, the Court is entitled to look at the situation objectively in order to ascertain whether the purpose relied upon was the true purpose."

6.010 The learned judge then quoted a statement in the opinion of the Privy Council in *Smith v Ampol Petroleum Ltd* [1974] UPC 3:

> "…when a dispute arises whether directors of a company made a particular decision for one purpose or for another, or whether, there being more than one purpose, one or another purpose was the substantial or primary purpose, the court, in their Lordships' opinion, is entitled to look at the situation objectively in order to estimate how critical or pressing, or substantial or, per contra, insubstantial an alleged requirement may have been. If it finds that a particular requirement, though real, was not urgent, or critical, at the relevant time, it may have reason to doubt, or discount, the assertions of individuals that they acted solely in order to deal with it, particularly when the action they took was unusual or even extreme…".

6.011 The Court found it significant that office of chairman carried with it the power to call an extraordinary general meeting under the articles of association. Removing the director from his office as chairman was an effective means to prevent the majority shareholders from having an opportunity to vote on resolutions to remove the majority on the board and this was the real reason for the removal.

(iii) *Conflicts of Interest*

6.012 Directors must not put themselves in a position where there is an actual or potential conflict between a personal interest and their duty to the company. For instance, if adirector were to agree through a third party to sell an interest in a property, while all the time concealing their interest, they would be in breach of their fiduciary duty.[10]

6.013 However, a director may enter into a contract where a conflict of interest might arise if the articles of association allow it or the company gives its approval in a general meeting.

(iv) *Secret Profits*

6.014 Directors' fiduciary position precludes them from taking a personal profit from any opportunities that result from the directorship, even if the director is acting honestly and for the good of the company. Any profit arising in such circumstances must be paid over to the company. Where directors have used their position to obtain in their own names a contract which should have benefited the company, they will be liable to account.[11] A director must also account for any profit received for a contract that has risen as a result of his/her position as a director, even where the company would not have had the benefit of the contract in any event.[12] Although it is not a defence that the director acted honestly and in good faith, the company in general meeting can often

[10] *Chesterfield and Boythorpe Colliery v Black* (1877) 26 WR 207.
[11] *Cook v Deeks* [1916] 1 AC 554.
[12] *Industrial Development Consultants Ltd v Cooley* [1972] 2 All ER 162.

thumb and every effort should be made to secure a good attendance at the meeting by shareholders. There must also be no improper manipulation of the vote to meet the applicable voting thresholds.[27]

7.029 The statutory thresholds apply to each class of share. A class will be created if shareholders have rights against the target company which are so dissimilar as to make it impossible for them to consult together with a view to their common interest. The test is a test of the way in which those rights are affected by the scheme and does not depend upon the similarity or dissimilarity of their interests deriving from such rights.[28] Different commercial entitlements between members of the same class do not result in different classes.[29] Undertakings by scheme shareholders to vote, even if irrevocable, do not usually constitute a separate class unless they involve those scheme shareholders receiving special inducements or benefits under the scheme.

7.030 The makeup of any classes will normally be settled at the directions hearing[30] but this determination is not necessarily binding on the Grand Court at the subsequent petition hearing.

7.031 The statutory majority of shareholders must also act bona fide with no coercion of minority shareholders and the scheme must be one that an intelligent and honest man acting in respect of his interests in the relevant class of scheme shares might reasonably approve.

7.032 If there are dissentient shareholders who hold more than ten percent of the scheme shares, there is a *possibility* that the court may not exercise its discretion to sanction the scheme on the ground that the scheme constitutes a takeover and requires a 90 percent acceptance to effect a compulsory acquisition.[31] However in the ordinary course the court can be expected to respect the choice of structure employed to effect the takeover in acknowledgment of the fact the attractiveness of the lower thresholds applicable to a scheme of arrangement is balanced by the need for class consents, the head count test to be met and a court order to be obtained.[32]

7.033 Unlike a general offer these thresholds cannot be reduced or waived; if they are not met, the scheme will fail.

7.034 An *indicative* timetable setting out the major steps is set out below:

Day 1: File draft petition/summons for directions

Day 21: Directions hearing (depends on court availability)

[27] *Re PCCW Ltd* (unrep., CACV 85/2009) where shareholdings were split to meet the headcount test. However genuine cases which result in the enfranchisement of beneficial owners will be permitted.

[28] Bowen LJ in *Sovereign Life Assurance Company v Dodd* (1892) 2 QB 573; see also *Re Hawk Insurance Company Ltd* [2001] EWCA Civ 241.

[29] *Re Hawk Insurance Co Ltd* [2001] 2 BCLC; see also *Eurobank Corporation (In Liquidation)* [2003] CILR 205.

[30] Pursuant to Practice Direction 01/2002 of the Grand Court: "3.2 In every case the court will consider whether it is appropriate to convene class meetings and, if so, the composition of the classes so as to ensure that each meeting consists of shareholders or creditors whose rights against the company which are released or varied under the scheme, or the new rights which the scheme gives in their place, are not so dissimilar as to make it impossible for them to consult together with a view to their common interest. It follows that the supporting affidavit must contain all such information as may be necessary to enable the court to make this determination. The applicant should also raise at the first hearing any other matter which may affect the conduct of the meeting(s)."

[31] *Re Hellenic & General Trust Ltd* [1976] 1 WLR 133; see also *Re National Bank Ltd* [1966] 1 WLR 819.

[32] *TDG plc, Re* [2008] EWHC 2334 (CL), (2009) 1 BCLC 445; see also *Re BTR plc* [1999] 2 BCLC 675, [2000] 1 BCLC 740.

Day 25: Despatch composite scheme document

Day 55: Court Meeting to approve the scheme and EGM to approve the reduction in capital (cancellation scheme)

Day 56: File chairman's report of the Court Meeting

Day 66: Petition hearing to sanction the scheme and capital reduction

Day 69: Effective Date - file court order with Registrar of Companies

7.035 The scheme will be effective when a copy of the court order is delivered to the Registrar of Companies for registration.

7.036 Amalgamations may also be effected through a "special" scheme of arrangement, although in practice these are comparatively rare. The scheme of arrangement must have been proposed for the purpose of or in connection with: (i) the "reconstruction" or "amalgamation" of the offeror and the target; and (ii) the transfer of the whole or any part of the undertaking of the parties concerned in the scheme of arrangement. It is only in such a case that the Grand Court may then give effect to the reconstruction or amalgamation by making an order providing for:[33]

(a) the transfer of the whole or any part of the undertaking and property or liabilities of the target company;

(b) the allotment or appropriation by the offeror of any shares, debentures, policies, or other interests;

(c) the continuation of any legal proceedings pending;

(d) the dissolution of the target company;[34]

(e) the provisions to be made for any dissentient shareholders of the target company; and

(f) such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation is fully and effectively carried out.

7.037 It has been acknowledged that the terms "reconstruction" and "amalgamation" are commercial terms, and that their meanings are not exact or definite:

> 'What does "reconstruction" mean? To my mind it means this. An undertaking of some definite kind is being carried on, and the conclusion is arrived at that it is not desirable to kill that undertaking, but that it is desirable to preserve it in some form, and to do so, not by selling it to an outsider who shall carry it on – that would be a mere sale – but in some altered form to continue the undertaking in such a manner as that the persons now carrying it on will substantially continue to carry it on. It involves, I think, that substantially the

[33] Companies Law (2013 Revision), section 87(1).

[34] This does not involve a winding-up. Companies Law (2013 Revision), section 87(1)(d).

surviving company or consolidated company must make a written offer (fair value offer) to each dissentient shareholder to purchase their shares at a price determined by the company to be their fair value.[79]

7.067 If the company and the dissentient shareholders fail to agree the price within 30 days of the fair value offer (negotiation period), then within 20 days of the expiry of the negotiation period the company *must* (and any dissentient shareholder *may*) apply by petition to the Grand Court to determine the fair value of the shares held by all dissentient shareholders who served a notice of dissent and who have not agreed the price with the company.[80]

7.068 The petition must be accompanied by a verified list containing the names and addresses of all dissentient shareholders who have served a notice of dissent and with whom an agreement as to the fair value has not been reached.[81]

7.069 A copy of the petition must be served on the other party to the proceedings. Where a dissentient shareholder has filed a petition, the company must provide a verified list of the other dissentient shareholders within 10 days of the date the petition was filed.[82]

7.070 At the hearing of the petition, the Grand Court will determine the fair value of the shares of such dissentient shareholders as the court finds are involved in the proceedings together with a fair rate of interest, if any, to be paid by the company on the amount determined to be the fair value.[83]

7.071 The costs of the proceeding may be determined by the Grand Court and taxed as the Grand Court deems equitable in the circumstances.[84] Upon application of a member, the Grand Court may order all or a portion of the expenses incurred by a shareholder in connection with the proceedings, including reasonable attorney's fees and the fees and expenses of experts to be charged pro rata against the value of the shares which are the subject of the proceedings.[85]

(d) Mergers & Consolidations with Overseas Companies

7.072 The first case on appraisal rights in a Cayman merger decided in the Grand Court was *In the Matter of Integra Group* on 28 August 2015.

7.073 Integra traded on the London Stock Exchange (LSE) as a result of an IPO in February 2007 which was 10 times over-subscribed and resulted in a market capitalisation of US$2.4bn or US$8.37 per share. As a result of various disposals and a spin off by way of dividend in specie the market capitalisation fell significantly and by December 2013 the average share price was around US$7.87 per share.

7.074 In December 2013 the board of Integra received a privatisation proposal (structured as a merger) led by management at a price of US$10.00 per share. The board established a special committee of independent directors who engaged Deutsche Bank which produced a fairness opinion.The merger consideration of US$10.00 per share was a 45% premium to the average trading price of the GDR's (each representing 2 shares) during the 30 trading days prior to the announcement.

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[79] Companies Law, section 238(8).
[80] *Ibid*, section 238(9)(a).
[81] *Ibid*, section 238(9)(b).
[82] *Ibid*, section 238(10).
[83] *Ibid*, section 238(11).
[84] *Ibid*, section 238(14).
[85] *Ibid*, section 238(14).

7.075 The merger was approved by around 80% of shareholders at the requisite EGM. Three investment funds managed by East Capital International AB, which acquired a stake of 17.3% in the IPO, exercised their right to have the fair value of their shares appraised by the court.

7.076 The fair value determined by the Grand Court was US$11.70 per share, 17% above the merger consideration. The total award, including interest, amounted to approximately US$19.2m.

7.077 By direction of the court each party nominated an expert witness on valuation *who was entitled to access to all the company's books and records* (via a data room and meetings with management) and produced a report to the court. Thereafter a joint report was prepared and also produced to the court.

7.078 The court referred to the definition of "fair value" in the *International Valuation Standards (2013)* published by the *International Valuation Standards Council* in the United Kingdom and rejected the accounting definition of "fair value" in the *International Financial Reporting Standards* promulgated by the *International Accounting Standards Board*.

7.079 Essentially the court found that:

> "...a dissentient shareholder is entitled to his proportionate share (without any minority discount or increase in value as a result of the power of compulsory acquisition) of the business valued as a going concern without taking into account any enhancement in value (or reduction in value) as a result of the merger."

7.080 The court acknowledged that the relevant measurement of value or the valuation model will depend on the circumstances and may differ from case to case. In this case the court recognised a market approach, an income approach and a cost or asset based approach (the latter being disregarded). The court indicated that it was not particularly helpful to be given a range for the fair value (in this case a range of US$70m to US$100m was presented on behalf of Integra). The court also held that:

> "...it is open to the court to determine that the fair value is less than the merger consideration in any particular case."

7.081 In this particular case the shares were thinly traded and trading was dominated by a small number of large state owned enterprises such that the court thought that a market valuation and control premium based on the share price on the LSE was not necessarily indicative of the fair value. Note that the liquidity of the shares was measured by reference to: (i) the annual trading volume as a percentage of the free float, excluding management and insiders (in 2014 Integra: 9%; CAT: 156%; EDC: 100%); (ii) the number of days the GDRs were *not* traded (in 2013 Integra: 112; CAT: 0; EDC: 0); (iii) the median bid-ask spread on the LSE (in 2014 Integra: 7.3%; CAT: 0.8%; EDC: 0.4%); and (iv) the dollar value of the daily trading (Integra: US$59,000; CAT: US$4.192m; EDC: US$9.653m; if the non-traded days are included, the average for Integra falls to US$29,000 over the 180 days prior to the announcement). The shares were therefore judged to be illiquid.

7.082 Instead the court preferred to apply a weighted valuation model whereby the fair value was determined by reference to a discounted cash flow model and the traded share price (including by reference to the share prices and public financial/market

8.022 In addition to the above documentation, CIMA requires that all operators who wish to be appointed to a licensed fund must also provide the following documents:

1. Personal questionnaire;
2. One financial reference from a financial institution at which the operator has satisifactorily maintained an account for a minimum of 2 years;
3. Two character references, each from a person who is independent of and without a vested interest, in the appointment of the operator, and who has known the operator for a minimum of 3 years. The reference must address the honesty, integrity and reputation of the operator, as well as their competence and capability in fulfilling the proposed role; and
4. Police certificate or affidavit of no convictions

8.023 CIMA states that it takes approximately five business days to register a mutual fund and four to six weeks to license a mutual fund once all the documentation has been received.

(h) Audited Accounts and Annual Returns

8.024 The Mutual Funds Law requires an annual audit of the accounts of every regulated mutual fund by an auditor approved by CIMA.[19] The audited accounts must be filed with CIMA within six months of the end of the fund's financial year, although CIMA may allow an extension of time.[20] An exempted fund is not required to file audited accounts.

8.025 CIMA may either absolutely or conditionally exempt a regulated mutual fund from filing audited accounts in respect of a whole or a part of any financial year.[21] CIMA will usually accept a first financial year of up to 18 months.

8.026 CIMA requires the filing of audited accounts in electronic format. While it is the responsibility of the operator of a regulated mutual fund to submit audited accounts, it is mandatory for the auditor in the Cayman Islands to attend to the filings through submission on CIMA's Regulatory Enhanced Electronic Forms Submission (REEFS) portal. In addition, the filing will also consist of a fund annual return (FAR) which will contain general, operating and financial information on the relevant fund, including, changes in the net asset value over the reporting period, the total subscriptions and redemptions, the total assets and the net asset allocations to various types of investments (long-short equities, derivatives etc.), any performance or management fees paid, and the names of service providers.

8.027 CIMA compiles the information gathered from the FARs and produced a report of statistical information on an aggregated basis in the form of the Investments Statistical Digest (ISD). The ISD does not disclose any information on individual regulated mutual funds. By the second quarter of 2015, there were 11,061 Cayman Islands regulated funds consisting of 7,795 registered funds, 2,773 master funds, 390 administered funds and 103 licenced funds.[22] Based on the information in the latest available ISD, the most

[19] Mutual Funds Law, section 8(1).
[20] *Ibid*, section 8(2).
[21] *Ibid*, section 8(4).
[22] CIMA 2015 Statistics.

common form of operating structure appears to be a master/feeder structure which accounted for almost 50 percent of the funds, with a stand-alone structure constitution 28 percent. and a fund of fund structure constituting 23 percent of the funds subject to regulation. Substantially, all fund managers and investment advisors for regulated funds were located outside of the Cayman Islands with 29 percent of the managers being, not surprisingly located in New York followed by the United Kingdom which accounted for 16 percent., Hong Kong only accounting for 3 percent and Japan and Singapore accounting for 2 percent. each.[23]

(i) CIMA's Supervisory Powers

8.028 CIMA is charged under the Mutual Funds Law with administering the law and CIMA has extensive powers in relation to any regulated mutual fund which:

(a) is or is likely to become unable to meet its obligations as they fall due;
(b) is carrying on or attempting to carry on business or is winding-up its business voluntarily in a manner that is prejudicial to its investors or creditors;
(c) in the case of a licenced mutual fund, is carrying on or attempting to carry on business without complying with any condition of its mutual fund licence;
(d) the direction and management has not been conducted in a fit and proper manner; or
(e) a person holding a position as a director, manager or officer is not a fit and proper person to hold the respective position.[24]

8.029 Such powers include cancelling any mutual fund licence, or any registration of an administered fund, a registered fund or a master fund, or imposing conditions or further conditions on a mutual fund licence to amend or revoke those conditions; requiring the substitution of any promoter or operator of a regulated mutual fund; appointing a person to advise the fund on the proper conduct of its business after which advice CIMA may require the fund to reorganise its affairs or wind-up.[25] CIMA may also appoint a person to assume control of the affairs of the business of the fund.[26] Any person appointed to advise the fund on the proper conduct of its affairs or a person assuming control of the affairs is appointed at the expense of the regulated mutual fund. When assuming control of the affairs of the fund, such person will have all the powers of necessary, to the exclusion of any operator, to administer the affairs of a mutual fund in the best interests of its investors and creditors including, if necessary, to terminate the business of the regulated mutual fund.

8.030 CIMA may further apply to the Grand Court for an order to take such action as it considers necessary to protect the interests of investors in and creditors of the fund[27]

[23] 2013 ISD.
[24] Mutual Funds Law, section 30(1).
[25] *Ibid*, sections 30(3) and 30(11).
[26] *Ibid*, section 30(3)(d).
[27] *Ibid*, section 30(4).

SECTION E: REFERENCES

22.	In respect of each person listed in questions D19, D20 and D21(a):
	The following references are required to be submitted:
	i) 2 character references;
	ii) 1 reference verifying good financial standing; and
	iii) a police or other certificate satisfactory to the Authority certifying that the person has not been convicted of a serious crime or any offence involving dishonesty

SECTION F: FINANCIAL INFORMATION AND INSURANCE

23.	Financial Resources			
	1) Current liquid capital	US$		
	2) Current Shareholders equity	US$		
	3) Issued and paid-up share capital	US$		
	4) Amount and nature of loan capital	US$		
	5) Total assets	US$		
	Where applicable, state how much of the capital of each subsidiary of the applicant constitutes an asset of the applicant.			
	Subsidiary		% of Subsidiary's Capital = Asset of applicant	Amount (US$)

24.	Audited Accounts
	The following is required to be submitted:
	1) in respect of the applicant-
	(a) where the applicant has been established within 6 months of the date of application and has not commenced operations:
	i) a statement from a senior officer of the applicant confirming that the applicant has not commenced trading since the date of establishment and that no accounts have been produced or dividends declared; and
	ii) an audited balance sheet, including the minimum financial resources required under regulation 9 of the Securities Investment Business (Financial Requirements and Standards) Regulations 2003, as at a date not more than 31 days prior to the date of the application.
	12) For all other applicants:
	(a) audited accounts[4] for the 2 financial years immediately preceding the date of application or, if shorter, since the date of establishment; and
	(b) the auditor s reports accompanying the audited accounts
	If the audited accounts are for a period of less than 2 years, the applicant must submit any interim financial statements produced subsequently, indicating whether or not such statements have been audited.
	In respect of any corporate shareholders listed in question 21(2) and the corporate shareholder's parent company, if any, annual accounts for the 2 years immediately preceding the year of application.
25.	Indicate below whether the applicant has cover or arrangements for cover in respect of the following:

		Cover Yes/No	If Yes, Limit	Name of Insurer
	Professional indemnity			
	Directors and Officers			
	Business interruption			
	Other (please provide details below)			

[4] Where the applicant has subsidiaries, the accounts of the applicant and its subsidiaries must be in consolidated form, unless otherwise agreed by the Authority.

10.029 During the period of operation of a receivership order: (a) the functions and powers of the directors of the SPC cease in respect of the business of or attributable to, and the segregated portfolio assets of or attributable to, the segregated portfolio in respect of which the order was made; and (b) the receiver of the segregated portfolio will be entitled to be present at all meetings of the SPC and to vote at such meetings as if the person were a director of the SPC, in respect of the general assets of the company, unless there are no creditors in respect of that segregated portfolio entitled to have recourse to the company's general assets.[42]

10.030 The Grand Court may not discharge a receivership order unless it appears to the Grand Court that the purpose for which the order was made has been achieved, substantially achieved or is incapable of achievement.[43] Upon the Grand Court discharging a receivership order in respect of a segregated portfolio of a SPC on the ground that the purpose for which the order was made has been achieved or substantially achieved, the Grand Court may direct that any payment made by the receiver to any creditor of the company in respect of that segregated portfolio will be deemed full satisfaction of the liabilities of the SPC to that creditor in respect of that segregated portfolio, and the creditor's claims against the company in respect of that segregated portfolio will be thereby deemed extinguished.[44]

10.031 The remuneration of a receiver and any expenses properly incurred by them will be payable, in priority to all other claims, from the segregated portfolio assets attributable to the segregated portfolio in respect of which the receiver was appointed but not from any other assets of the SPC.[45]

10.032 The Cayman Islands Court of Appeal considered the winding-up of a SPC and the appointment of receivers in *ABC Company (SPC) v J & Co Ltd* (unrep., May 2012). Unlike the winding-up of the SPC itself, in respect of any individual segregated portfolios the only remedy available for shareholders or creditors is to petition the Court to appoint a receiver on the grounds of insolvency. A receiver may not therefore be appointed over a segregated portfolio on just and equitable grounds. This distinction was central to the decision of the Cayman Islands Court of Appeal in *ABC Company (SPC) v J & Co Ltd.*

10.033 The Court of Appeal's decision upheld the segregation of assets and liabilities of ABC Company (SPC) (ABC) on the insolvency of one of its segregated portfolio, thus confirming a tenet of the SPC structure, namely that the insolvency of one segregated portfolio should not affect the other segregated portfolio(s) and lead to the winding-up of a SPC.

10.034 The background to the case is that in 2008 ABC suspended the subscription and redemption of shares of certain segregated portfolios investing in real estate (Real Estate SPs). The Real Estate SPs accounted for less than one third of the combined Net Asset Value (NAV) of all the segregated portfolios of ABC.

10.035 The petitioner was a registered shareholder in one of the Real Estate SPs and whose investment represented less than 1 percent of the Real Estate SPs' combined NAV. The petitioner presented a winding-up petition for ABC on the grounds that the suspension

[42] Companies Law, section 226(6).
[43] *Ibid*, section 227(1).
[44] *Ibid*, section 227(3).
[45] *Ibid*, section 228.

of the subscription and redemption of shares meant that ABC had "lost its substratum" and so it was just and equitable that ABC be wound up.

10.036 The petitioner relied upon Cayman Islands authorities[46] for the argument that an open-ended fund which did not permit redemptions and which was unwilling to accept subscriptions had lost its substratum as the purpose for which it was formed could no longer be carried out. In addition, if by suspending redemptions in order to provide for the orderly liquidation of the assets, it could be said in the context of an open-ended corporate mutual fund that the circumstances are such that it has become impractical, if not impossible, to carry on investment business in accordance with the reasonable expectation of the investors, then having lost its substratum, it would be just and equitable for a winding up order to be made. In the Grand Court the judge reaffirmed his judgment in *Re Belmont* that whenever it is proved a company established as an open-ended mutual fund is no longer viable as such, for whatever reason, the Court will ordinarily conclude that it is just and equitable to make winding-up order.

10.037 The judge in the Grand Court, Justice Jones, took the view that it was arguable the Companies Law conferred jurisdiction to make an order the effect of which was to wind up a segregated portfolio in circumstances where the court was satisified it had lost its substratum and ceased to operate as a viable economic entity on the following basis:

> "(a) a receivership under section 224(1) of the Companies Law in respect of an individual segregated portfolio on the just and equitable ground, notwithstanding that the segregated portfolio is or is likely to become insolvent; or
>
> (b) on a contributory's petition to wind-up the SPC, it would be open to the court to conclude that it would be just and equitable to make a winding-up order on the basis that some, but not all, of its segregated portfolios have ceased to operate as viable entities in accordance with the reasonable expectations of the shareholders and thus, by way of an alternative remedy under section 95(3) of the Companies Law, 'achieve a result which is equivalent to making a winding up in respect of the portfolio in question'."

10.038 On appeal, the petitioner accepted that it could only present a receivership order under section 225(1) of the Companies Law on the grounds set out in previous section 224(1) of the Companies Law are satisfied (i.e. insolvency of the relevant segregated portfolio, not on any just and equitable basis). The petitioner also accepted that the Companies Law did not permit the winding-up of an individual segregated portfolio.

10.039 On the question of whether there is a free-standing jurisdiction to wind-up a segregated portfolio company under section 95(3) of the Companies Law, the Court of Appeal concluded that, although an order may be made under that section as an alternative to a winding-up order, there is no jurisdiction to make such an order in circumstances in which the Court would, if the alternative were not available, refuse to make a winding up order on the just and equitable ground.

[46] Including *Re Belmont Asset Based Lending Ltd* [2010] 1 CILR 83 and *Re Heriot African Trade Finance Fund Ltd* (unrep., 4 January 2011).

(e) Dissolution

11.030 The death, bankruptcy or permanent incapacity of a limited partner shall not cause the dissolution of the limited partnership.[28]

11.031 The dissolution of a limited partnership shall be dealt with by the general partners, unless the court orders otherwise and no payments of capital shall be paid to the limited partners until such time as all creditors of the limited partnership have been paid in full.[29]

11.032 Final dissolution of the limited partnership shall happen on the filing of a notice of dissolution with the Registrar and publication thereof in the Cayman Islands Government Gazette.[30]

4. Exempted Limited Partnerships

(a) What is an Exempted Limited Partnership?

11.033 Similar to limited partnerships, the ELP Law provides that an exempted limited partnership must consist of one or more general partners and one or more limited partners, and that in the event that the assets of the exempted limited partnership are inadequate, the general partners are liable for all debts and obligations of the exempted limited partnership. Limited partners are not liable for the debts and obligations of the exempted limited partnership, save to the extent that they may become liable where they take part in the management of the exempted limited partnership or they receive distributions of contributions in circumstance where the exempted limited partnership is insolvent.[31]

11.034 Unlike limited partnerships, the ELP Law also provides that an exempted limited partnership must not undertake business with the public in the Cayman Islands other than as may be necessary for carrying on its business outside the Cayman Islands.[32]

11.035 Aside from this limitation, there are no further restrictions on the type of lawful business that a Cayman Islands exempted limited partnership may carry on. An exempted limited partnership may also carry on its business by electronic means from any place of business in the Cayman Islands or through an internet service provider located in the Cayman Islands.[33]

(b) Nature of General Partners and Limited Partners

11.036 Participation in an exempted limited partnership is not restricted to individuals and as such a body corporate, with or without limited liability, and a partnership or limited partnership may be a general or a limited partner.[34] A general partner of an exempted limited partnership may also be a limited partner of the exempted limited partnership.[35]

[28] Section 52(4) of the Partnership Law.
[29] Section 54(6) of the Partnership Law.
[30] Section 52(6) of the Partnership Law.
[31] Section 4(2) of the ELP Law.
[32] Section 4(1) of the ELP Law.
[33] Section 47 of the ELP Law.
[34] Section 4(3) of the ELP Law.
[35] Section 4(2) of the ELP Law.

11.037 While there is generally no requirement for the general partners or limited partners to be resident, domiciled, established, incorporated or registered in the Cayman Islands, at least one of the general partners must:

(i) if an individual, be resident in the Cayman Islands;

(ii) if a company, be registered under the Cayman Islands Companies Law or registered as a foreign company pursuant to the Companies Law;

(iii) if a partnership, be registered in accordance with requirements of the ELP Law; or

(iv) be a limited partnership or limited liability partnership established in a jurisdiction outside of the Islands and registered as a foreign limited partnership under the ELP Law.[36]

(c) Registration of an Exempted Limited Partnership

11.038 In order to register an exempted limited partnership in the Cayman Islands, the general partner must submit to the Registrar of Exempted Limited Partnerships (the "ELP Registrar") a statement in terms of Section 9 of the ELP Law (the "Statement") signed by or on behalf of the general partner together with the required fee, setting out the following:

(i) The name of the exempted limited partnership. Every exempted limited partnership must have a name which includes the words "Limited Partnership" or the letters "L.P.". The use of certain words is restricted and the ELP Registrar may decline to register a name which for any reason is calculated or likely to mislead. An exempted limited partnership may have an additional dual foreign name which either precedes or follows its name;[37]

(ii) The general nature of the business of the exempted limited partnership;

(iii) The address of the registered office;

(iv) The term, if any, for which the exempted limited partnership is entered into or, if for an unlimited duration, a statement to that effect and the date of commencement;

(v) The full name(s) and address(es) of the general partner(s) and, where the general partner is (a) a corporation, a certificate of incorporation and a certificate of good standing must be filed; (b) a partnership registered under the Law, a certificate of registration and a certificate of good standing must be filed; and (c) an individual, photographic evidence of the general partner's identity and evidence of his residential address must be filed; and

[36] Section 4(4) of the ELP Law.
[37] Section 6(1) of the ELP Law.

12.007 The principal features of a valid private and charitable trust will be outlined in turn, paving the way for an understanding of how STAR trusts creatively combine aspects of both.

(a) Private Trusts

12.008 A valid private trust under Cayman Islands law must satisfy the "three certainties" i.e. of intention, subject-matter and objects and be validly constituted.

12.009 Certainty of intention is established by proving, to the usual civil standard, an intention on the part of a person (who may be a settlor or the intended trustee) to create a trust rather than some other obligation known to the law or, indeed, rather than no obligation at all.

12.010 This requirement highlights a key point which is that establishing a trust necessarily and most fundamentally entails the imposition or acceptance of an *obligation*. That obligation is best understood as an equitable duty to account to some other or others (the objects or beneficiaries of the trust) in respect of one's ownership (legal or equitable) of specific property (the trust fund).

12.011 Describing the obligation in this way immediately allows it to be distinguished from similar institutions such as agency where, typically, although equitable duties will be owed (by the agent) to another (the principal), they need not relate to specific property and, even if in a particular case they do so, they will not ordinarily relate to ownership of that property by the agent. Correspondingly, where title to specific property is given to an "agent" subject to an equitable duty to account to another, then that will necessarily involve a trust and the agent will be a trustee (perhaps amongst other things) irrespective of the label applied to him in the transactional documents.

12.012 In the case where a trust is established by a settlor who gives property to another to hold on trust, there is generally no room for doubt about subject-matter since, by definition, the subject-matter of the trust obligation will be all and only the property actually given to the trustee to be held on the terms of the trust.

12.013 Where, however, a trust is created by a person declaring himself to be trustee of his own property for the benefit of another, it must be clear (i.e. certain) to which parts of his patrimony the trust obligation is intended to apply: there must be some kind of identification or segregation, appropriate to the kind of property in question, which puts the matter beyond doubt. This requirement can be seen as flowing from the idea of a trust as an obligation to deal with title to *specific* property for the benefit of another. In paragraphs [12.076–12.080], the application of this rule to Cayman Islands shares is examined in particular.

12.014 As regards certainty of objects, a distinction is drawn between fixed and discretionary trusts. Where it is intended to confer a distributive discretion on a trustee i.e. to decide upon the identity of recipients of benefit from the trust fund from among a stated class, it must be possible to say in principle (i.e. of any given postulant) who is within or without the class, even if it is not possible to name or list all members of the class.[3] This test applies also to powers to benefit persons, whether under trusts or otherwise.[4] A trust for, or power to benefit, employees of a named enterprise and their

[3] *McPhail v Doulton* [1971] AC 424.

[4] *Re Gulbenkian's settlement* [1970] AC 508.

relatives and dependants will meet this requirement,[5] as will a trust for the descendants or issue of named persons or of persons identified by membership of a class which is itself sufficiently certain.

12.015 Where, however, it is not intended to confer any such discretion, it must be possible to name or list all persons who are to benefit under the trust.

12.016 In addition to meeting the certainty requirements, private trusts (as well as charitable trusts) must be properly constituted. This is the requirement that title to the trust property be vested, in the manner appropriate to the kind of property in question, in the intended trustee at the outset. Where a person is declaring himself trustee of his own property, this requirement cannot fail to be met. Where, however, settlor and intended trustee are different persons, it is occasionally the case that, for good or bad reason, the intention to convey the property into the trustee's name is not carried into effect. In such cases, the trust is not constituted and the settlor may deal with the property as his own even if he has (purported) solemnly to declare a trust of it by deed. Further, a failed gift will not be construed as a declaration by the would-be donor of himself as trustee (an aspect of the rule that equity does not assist volunteers).[6]

12.017 Where a Cayman Islands trust is being established with a nominal amount of initial cash, it remains, perhaps surprisingly, a fairly common practice in the Cayman Islands to attach a dollar note of the appropriate denomination to the original trust instrument. There is, however, no magic in that and it runs some risk that the two may become detached such that the evidential purpose of proving that the trust was properly constituted may be defeated or made more difficult. Perhaps more satisfactory nowadays is the creation and maintenance of a proper accounting record that funds held by the trustee at bank, in its general trust account, are held as to a sum in the amount of the initial fund to the (sub-)account of the trust in question. Since funds held at bank are not tangible, there can be no going behind the accounting record which should, therefore, be conclusive on the question of constitution: in an insolvency of the trustee, for example, that will be all there is to go on.

(b) Charitable Trusts

12.018 Cayman Islands law on charitable trusts is, broadly, that which obtained in England and Wales prior to enactment of the Charities Act 1960, discounting the Recreational Charities Act 1958. In other words, it remains an area of jurisprudence wholly based on case law (save to the extent that ordinary trust and related regulatory legislation applies to it).[7]

[5] *Re Baden (No 2)* [1973] Ch 9.

[6] *Milroy v Lord* (1862) 4 De GF & J 264; see also *T'Choithram International SA v Pagarani* [2001] 1 WLR 1 which is a case covering the middle ground where a settlor was found to have made a deathbed gift on trust of shares to an unincorporated body of trustees of which he was one: he was held liable to convey the shares into the names of himself and his co-trustees jointly since: (i) the property in his ownership became subject to an enforceable obligation in his hands as a matter of good conscience and (ii) since the trust bound him, the other intended trustees could insist on a conveyance into all the trustees' names.

[7] At time of going to press, a Non-Profit Organizations Bill is being promoted which, though not expanding the concept of charity, would require registration of a subset of charities operating in the Cayman Islands. The measure is principally motivated by international concerns over money laundering and terrorist financing. It is not yet clear in what form, if any, it will reach the statute books.