

The Cayman Islands Unit Trust – Demystifying the Investment Vehicle that "Does Not Exist"

As investors from the world's third largest economy continue to make significant investments into global assets, Nick Harrold examines the key features of the Cayman Islands unit trust - the preferred investment vehicle for many Japanese investors.

Why is the Cayman Islands unit trust popular with Japanese investors?

Japanese investors wish to invest through a unit trust structure for various reasons, including investor familiarity (Japanese investment trusts, which are commonly used by Japanese investors to make investments, are also structured as unit trusts). The Cayman Islands unit trust can also provide additional flexibility to implement more complex investment strategies, due to the ability to denominate classes of units in non-JPY currencies and to pay distributions out of principal, without restriction, among other factors.

Crucially, a Cayman Islands unit trust is also a tax efficient means for many Japanese investors to access global investments. It is typically regarded as a foreign investment trust for the purposes of the Act on Investment Trusts and Investment Corporations of Japan (Act No. 198 of 1951) and if more than 50% of the assets of the unit trust are regarded as 'Securities' or 'Securities-related Derivatives' within the meaning of the Financial Instruments and Exchange Act of Japan, (Act No. 25 of 1948) the unit trust is able to obtain securities investment trust tax status.

What are the origins and legal structure of the unit trust?

The unit trust has its foundations in trusts law. The law of trusts first developed in the 12th century, during the Crusades. When a landowner left England to fight in the Crusades, he conveyed ownership of his lands (the trust property) to an acquaintance (the trustee). The trustee would hold legal title to and manage the lands, paying and receiving feudal dues, on the understanding that the ownership would be conveyed back to the original owner (the beneficiary) on his return.

The unit trust has at its heart these same core trust principles. In order to establish a valid unit trust, the so called 'three certainties' must be present: a trustee, holding trust property (fund assets) on trust for beneficiaries (unit holders).

How is a unit trust established?

A unit trust is typically established through the execution of a trust deed that documents the terms on which the trustee will hold the trust assets on trust. When establishing a unit trust, it is possible to use either a trust deed to which only the trustee is a party (a single party declaration of trust) or a trust deed to which both the trustee and the manager are party (a two party trust deed). In the case of public offerings in Japan, it is a well-established practice to have the manager responsible for the issue of units in the unit trust's constitution which is a de facto requirement for a two party trust deed to be

used. However, for private placements in Japan, either a single party declaration of trust or a two party trust deed can be used.

Whether a unit trust has been validly established - and continues to be in existence - is not solely a question of whether a trust deed has been executed. Instead, it depends if the three certainties are present at the relevant time. A common misconception in the market is that a Certificate of Registration issued by the Registrar of Trusts confirms the existence of a trust, although in practice, it only evidences that the parties have registered what purports to be a trust, as an exempted trust, with the Registrar.

It follows that, at the end of a unit trust's life, a unit trust can be terminated by either repurchasing all of the units in issue or by the trustee paying a final distribution to unitholders, either of which would mean that two of the three certainties are no longer present: no trust property (fund assets) and no beneficiaries (unitholders). This contrasts with terminating other Cayman Islands fund vehicles where a formal striking off or voluntary dissolution procedure is often required in order to terminate the relevant vehicles.

Trust companies (other than private trust companies) must be licensed under the Banks and Trust Companies Law (2020 Revision) of the Cayman Islands. Applications for licensing are made to, and reviewed in detail by, the Cayman Islands Monetary Authority ("CIMA"). Trust licenses will only be issued to those involved in the direction or management of the relevant trustee company who have the necessary experience in trust and fiduciary businesses.

What is meant by a unit trust having no separate legal personality?

Under Cayman Islands law, a trust is not a legal person and it does not exist as a separate legal entity. The unit trust is instead the name given to the collection of assets that are being held on

trust by the trustee. In the same way that a bank account, another collection of assets, is unable to make investments, enter into agreements or sue or be sued in its own name (each a "Transaction"), neither can a unit trust. Instead, it is the trustee (or its delegate) who must enter into all Transactions 'for the account' of the unit trust.

It is important to note that when a trustee (or the investment manager on behalf and in the name of the trustee) enters into a Transaction, the trustee is bound as principal with full liability to the counterparty for all claims arising under the Transaction. The law does not recognise or distinguish entry into a Transaction by a trustee as 'trustee', i.e. this is not a separate contracting capacity such that the counterparty's claim is automatically limited to the net assets of the trust. This is notwithstanding the fact that most trustees will seek to execute transactions, "solely in our capacity as trustee". In practice, these words only signify that the trustee (or the investment manager as its delegate) is intending to enter into a Transaction for the account of the unit trust and its unitholders.

What are the key consequences of not having a separate legal personality?

As a unit trust does not have a separate legal personality, any counterparty to a Transaction can only legally bring a claim against the trustee, as the legal owner of the unit trust's assets and the party who has entered into the Transaction as principal.

In the ordinary course of events, the trustee will have a right of indemnity and recourse to the assets of the unit trust in order to indemnify itself against claims from the counterparty. There may, however, be circumstances where the counterparty's claim exceeds the available net assets of the trust. In such circumstances, in the absence of additional structuring, the trustee will be liable to pay the full amount of the counterparty's claim, meaning it will be liable to pay any shortfall to the counterparty out of its

own assets. This situation is understandably not acceptable to a trustee since it would mean that the trustee is underwriting the liabilities of the unit trust out of its own proprietary assets. In a worst-case scenario, if the trustee does not have sufficient proprietary assets, it could mean the trustee is forced into insolvent liquidation which would impact on its entire business.

In order to address this potential exposure to personal liability, a well-advised trustee will seek to include contractual 'limited recourse' language into the terms of all Transactions that it enters into. Such language seeks to contractually limit the relevant counterparty's recourse to the net assets of the unit trust, thereby protecting the trustee from becoming exposed to any additional liability in respect of its proprietary assets. While often subject to negotiation, properly drafted limited recourse seeks to do no more, or less, than put a counterparty to a Transaction in exactly the same position it would be in if it were entering into a Transaction with a corporate fund, i.e. the counterparty has recourse to the available assets in the fund and once those assets are exhausted its claim is extinguished – to the extent claims exceeding available assets will result in the corporate being put into liquidation.

What is an umbrella unit trust?

An umbrella unit trust is the name given to a collection of sub-funds, typically established pursuant to a common master trust deed. Each sub-fund is established through the execution of a supplemental trust deed to the master trust deed which incorporates the terms of the master trust deed by reference. While it is possible to establish the master trust itself as a trust, in its own right, there are often good reasons not to do so. The key point in such a structure is that each sub-fund of the umbrella is established as a separate and distinct trust. Unitholders in one sub-fund have no recourse to the assets in any other sub-fund.

Is there a risk of cross-contamination between sub-funds in an umbrella structure, including if the assets of one sub-fund are insufficient to settle all creditor claims?

No, as long as the master trust deed is properly drafted and the trustee is operating the sub-funds in accordance with the terms of the trust deed.

The reason why there is effective segregation between the sub-funds is that: (i) as noted above, it is only possible for a counterparty to a Transaction to bring an action against the trustee, as the legal owner of the assets (it is not possible for a counterparty to bring a claim against a sub-fund since the sub-fund is not a legal person); and (ii) under the terms of a typical trust deed, the trustee only has a right of recourse and indemnity out of the assets of the relevant sub-fund to indemnify itself against liabilities incurred when acting as trustee in respect of that sub-fund. The trustee does not have a right of recourse against the assets of any other sub-fund.

Conclusion

The Cayman Islands is a preeminent jurisdiction for establishing investment funds and offers a full range of fund structuring vehicles, including the exempted company, the limited liability company and the exempted limited partnership. However, for Japanese and certain other investors, a Cayman Islands unit trust may be a more desirable structure.

Further Information

The Maples Group is at the forefront of structuring, forming and providing legal, fiduciary and administration services to promoters and service providers of Cayman Islands unit trusts. Should you require any assistance or advice please contact the author or your usual Maples Group contact.

About the Author

Nick Harrold is a partner of the Hong Kong Funds & Investment Management team at Maples and Calder, the Maples Group's law firm. He specialises in all aspects of investment funds, advising an international client base, with a particular focus on advising clients who wish to target the Japanese market. Nick is recommended by Legal 500 Asia Pacific as a standout funds specialist who has the "ability to quickly understand very complicated structures" and whose "strength lies in his ability to apply legal principles to some of the most complex, novel and challenging commercial issues". He is also recognised as "client-friendly, innovative and commercial" and having an "in-depth knowledge" of the Japanese market.

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September 2020

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