



The Legal 500 Country Comparative Guides

Cayman Islands: Private Equity

This country-specific Q&A provides an overview of private equity laws and regulations applicable in Cayman Islands.

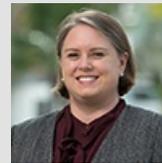
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1. What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?

Over the last 24 months, a significant proportion of M&A transactions involving Cayman Islands vehicles have involved a financial sponsor as either a buyer or seller, and in a number of cases, both, following the general global trends. According to figures published by Bureau van Dijk, the Cayman Islands ranked 13th globally for announced M&A deal targets by measured value during 2019 and 7th during H1 2020, showing the resilience of the jurisdiction during challenging global dealmaking environments.

2. What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?

The vast majority of Cayman Islands M&A activity is cross-border, with underlying target entities usually located onshore. As a result, the drivers of a financial sponsor are aligned with those prevailing in its own jurisdiction as well as those of the underlying target, and transactions are usually structured with the intent of ensuring a 'clean exit' for a financial sponsor, in order to ensure maximum certainty of sale proceeds for prompt distribution to investors. As with onshore transactions, the complexity of business separation in an acquisition from a trade seller requires more involved structuring. In a sale of a sponsor-backed vehicle, it is likely that the sellers will provide more limited warranties, with broader business warranties being provided by management - in contrast, trade sellers will usually provide both.

3. On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?

Shares in Cayman Islands companies are intangibles and not capable of transfer by delivery. Transfer is effected by execution and delivery of an instrument of transfer, and appropriate entries being made in the register of members of the company. Usually, shares of Cayman Islands companies are uncertificated, and where the subject company is listed on a recognised stock exchange, the Companies Law (2020 Revision) of the Cayman Islands facilitates transfers in accordance with the rules and regulations of the relevant stock exchange.

4. How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?

It is common for financial sponsors to use a newly formed special purpose vehicle (an "SPV") as a purchasing entity, and in those circumstances, financial sponsors typically provide comfort to a seller in the form of commitment letters, in relation to both the equity funding to be provided to the SPV and any debt component of the purchase price. Such commitment letters are generally delivered at signing to provide comfort that the acquiring SPV will be adequately funded at closing, and in the case of debt funding, may be accompanied by an

agreed form of interim facility agreement. Reverse termination fee provisions are common in deal documentation, supported by a guarantee from the financial sponsor in relation to the SPV's obligations.

5. How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?

For Cayman Islands buyers, 'locked box' pricing mechanisms are more prevalent where the target entity is a UK or European business, and less common for US or Asian targets. The locked box model is attractive to financial sponsor sellers, due to the avoidance of the need for closing accounts, and ability to limit post-closing disputes which may arise with their preparation. Locked box pricing also assists financial sponsor sellers with certainty as to sale proceeds and amounts available for distribution to investors as a result, due to the reduced need for retentions for post-closing adjustments. Transactions with trade sellers are, as in other jurisdictions, less suited to locked box pricing, due to the complexities of business separations and carve-outs.

6. What are the typical methods and constructs of how risk is allocated between a buyer and seller?

Risk allocation for transactions involving a Cayman Islands buyer or seller usually follow the market standard for the jurisdiction where the underlying target is primarily located. Following US and UK market standards in particular, deal certainty is addressed through use of termination fees and appropriate closing conditions, whilst business risk is addressed via representations, warranties and indemnification, often backed by W&I insurance. In competitive bid scenarios, 'clean exit' deals are preferred, and conditions to closing extending beyond competition/anti-trust and other regulatory consents are resisted by sellers, as are escrows for contingent liabilities. In these deals, increasingly R&W insurance is replacing more traditional post-closing holdbacks for indemnity claims.

7. How prevalent is the use of W&I insurance in your transactions?

As noted above, transactions involving a Cayman Islands buyer or seller usually follow the market standard for the jurisdiction where the target is primarily located. This is particularly true where W&I insurance is required, and its use and availability is largely determined by the standards in the applicable onshore jurisdiction. As such, its use has become more prevalent for US-based targets and is common for private equity exits for UK-based businesses.

8. How active have financial sponsors been in acquiring publicly listed companies and/or buying infrastructure assets?

2019 was the most active year since 2007 for take-privates, according to deal data from Dealogic, with the announced deal value for H1 2019 nearly equal to the entire announced

deal volume for 2018. Early 2020 also experienced increased take-private activity, with private equity firms racing to taken advantage of COVID-19 driven share price dips. However, market recoveries in late Q2 and ongoing market uncertainty and volatility have somewhat limited the ability for Cayman Islands companies listed on major exchanges to obtain the requisite shareholder approval for a take-private transaction. One area of continued take-private activity involving financial sponsors, however, is the trend of US-listed Cayman Islands incorporated parents of Chinese-facing business to go private - not just driven by the potential high trading multiples upon relisting in Asia and recent political and trade tensions between China and the US resulting heightened regulatory scrutiny of US-listed Chinese businesses, but also to reduce compliance costs and increase control over the shareholder base.

9. Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?

The Cayman Islands has certain local company control laws which require majority Caymanian ownership of local business, absent specific regulatory consent. However, given that the vast majority of Cayman Islands M&A activity involves target businesses located outside the Cayman Islands, such controls are not usually applicable to M&A transactions involving Cayman Islands entities. However, to the extent that the target business does involve Cayman Islands operating entities, change of control consents would usually be required.

10. How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?

Risk of merger clearance for M&A transactions involving Cayman Islands entities is usually an onshore matter, as unless the target group includes a Cayman Islands operating company, Cayman Islands regulatory consent will not be required. Following the usual position in the relevant onshore jurisdiction, deal documentation will likely include appropriate risk mitigation provisions, including, for example, split signing and closing to allow merger clearance to be obtained, or a 'hell or high water' provision for the merger clearance.

11. Have you seen an increase in the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside?

Minority deals have become more common as a partial exit strategy for existing financial sponsor backed portfolio companies, and for Cayman Islands vehicles, are predominantly structured as equity investments, both as common share investments with limited approval rights or preferred equity structures with conversion rights, less commonly coupled with warrant issuances. Following onshore trends, consortium deals among a number of financial

sponsors are finding more favour.

12. How are management incentive schemes typically structured?

Management incentive schemes for Cayman Islands vehicles are structured in a number of ways, being flexible enough to allow optimal tax treatment for onshore based participants. For schemes with key US-based participants, equity participations structured so as to qualify as profits interests are very common, with phantom equity provisions for participants in jurisdictions where direct participation is less than optimal. Cayman Islands law is flexible enough to accommodate fulsome equity and stock incentive plans, which allow for option schemes to sit alongside restricted stock units and phantom units. While specific structuring of incentive schemes is very deal-specific, terms often include staggered time-based and performance-based vesting, and full vesting upon exit provided a certain IRR and cash exit multiple is achieved by the financial sponsor.

13. Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?

The Cayman Islands currently has no form of income, corporate or capital gains tax and no estate duty, inheritance tax or gift tax. Structuring of management incentive schemes for Cayman Islands vehicles is largely driven by the desire to achieve optimal tax treatment for onshore based participants, and Cayman Islands law is flexible enough to allow for scheme structures which accommodate a number of differing jurisdictional considerations.

14. Are senior managers subject to non-competes and if so what is the general duration?

Employment contracts for management will rarely be Cayman Islands law governed, and non-competes will generally be driven by the applicable employment law and market standards in the jurisdiction in which the employee is located.

15. How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?

Shareholder governance rights are contained in the constitutional documents of the Cayman Islands vehicle and any associated shareholders agreement. Key control mechanisms include director or manager appointment rights, and inclusion of prescribed "reserved matters" over which certain shareholders or classes of shareholders have consent or veto rights. Such rights and controls are often expressed to apply not only at the level of the Cayman Islands vehicle, but also at the portfolio company level and any intermediate subsidiaries. Often, the shareholders agreement has a governing law other than Cayman Islands law, and care needs to be taken to ensure that the agreed contractual position is adequately addressed in the constitutional documents to avoid conflict of law complications.

16. Is it common to use management pooling vehicles where there are a large number of employee shareholders?

Use of management pooling vehicles in Cayman Islands deals varies depending on the onshore jurisdiction in which employees are located. Pooling vehicles and employee benefit trusts are more common in structures with a significant number of Asian-based employees or where the vehicle has a very large number of equity incentive participants, while US-based employees are more likely to participate directly. If a management pooling vehicle is used, it is also likely to be a Cayman Island vehicle.

17. What are the most commonly used debt finance capital structures across small, medium and large financings?

There are a number of different structuring options available to entities in small, medium and large capital financings. Cayman Islands law is very flexible and creditor-friendly in terms of pre and post insolvency treatment. As such, we see financings being at all levels of fund and corporate structures including fund level financings, GP and manager financings, portfolio or investment company structuring as well as the use of bankruptcy remote vehicles. In the last 12 months, we have seen a large increase particularly in the use of bankruptcy remote vehicles and hybrid facilities with credit levels and borrowing base determined by the ultimate investors in the structure or the clear, identifiable assets and downstream securities capable of valuation.

18. Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?

There is no statutory provision under the Companies Law (2020 Revision) of the Cayman Islands that mirrors the statutory prohibitions on financial assistance contained in the English Companies Law. In the absence of such a statutory provision, financial assistance is not in and of itself unlawful. The directors of a Cayman Islands company must, however, ensure that a transaction is in the best interests of the company and is carried out on a proper commercial basis; otherwise, the transaction can be impugned on the basis of breach of fiduciary duty.

19. For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?

There is no standard form of credit agreement used across financing transactions. The form of credit agreement varies from deal to deal and depends upon who are involved as the lenders and as their onshore counsel, as those parties will typically have their own preferred precedent form of agreement, assuming they are not looking to use the industry form of agreement (LMA or ISTA forms). Negotiation of the commercial terms is led by onshore counsel. Typically, the Cayman Islands -specific points subject to negotiation are limited to a few key items, unless the security package includes Cayman Islands law governed security, in

which case the negotiation of the Cayman Islands -specific items becomes more significant.

20. What have been the key areas of negotiation between borrowers and lenders in the last two years?

The key areas of negotiation of Cayman Islands-specific items have been the terms of any Cayman Islands law governed security and compliance with regulatory requirements. New regulatory regimes introduced in the Cayman Islands over the past two years, including a beneficial ownership registration regime and a private funds law regime, have placed new obligations on borrowers that need to be addressed by the transaction documentation and legal opinions. A standard market position takes time to develop with respect to new regulatory developments, though we are seeing the language of the relevant provisions standardising quickly across transactions.

21. Have you seen an increase or use of private equity credit funds as sources of debt capital?

Yes. There has been a large increase in the use of private credit funds throughout 2020 and this is anticipated to further increase through 2021. The traditional financing model known to the market is becoming more sophisticated and diverse with a large number of non-financial institutional entities looking to take advantage of the use and benefits of offshore credit funds.