



Private Equity

Fund formation and transactions
in 42 jurisdictions worldwide

2009

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Cayman Islands

Stephen James and Simon Raftopoulos

Appleby

1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction?

Private equity funds structured in the Cayman Islands invest in companies at various stages of their development as investors are attracted to the Cayman Islands' tax-neutral status, familiar common law legal system and sophisticated regulatory regime.

As a preferred private equity jurisdiction, commonplace transactions include:

- leveraged buyouts;
- mezzanine funds;
- private investments in public equities;
- fund organisation;
- recapitalisations;
- acquisitions; and
- divestitures.

Direct or synthetic secondary transactions have become increasingly common as they provide liquidity to private equity investors by allowing them to sell positions in private equity funds and liquidate stakes in private equities.

Although exempt Cayman companies are also used, the most commonly utilised structure for private equity funds is the Cayman Islands exempted limited partnership (ELP).

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

Private equity funds seem to now accept that they will come under the scrutiny of the regulators sooner, rather than later. As such, they are aligning their business and corporate governance with best practices expected by the regulators.

The rationale for going private or public is not usually driven by Cayman law concerns, and it is necessary to look at the details of each transaction individually. Obviously, private companies have less of a reporting burden, but public companies will have greater access to capital and liquidity.

3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What is the role of a special committee in such a transaction where management members of the board are participating in the transaction?

Directors of Cayman companies, in their capacity as agents, have certain duties of care, diligence and skill in addition to a fiduciary duty to act honestly, bona fide and in the best interests of the company.

A director need not exhibit in the performance of his or her duties a greater degree of skill than may reasonably be expected from a person of his or her knowledge and experience. The test is partly objective (the standard of the reasonable person) and partly subjective (the reasonable person is deemed to have the knowledge and experience of the particular director). A director is therefore not expected to exercise skill that he or she does not possess.

Decisions of English courts (which will be of persuasive effect in the Cayman Islands) have held directors to be under a duty to act in good faith when giving shareholders advice whether to accept a takeover offer for their shares, whether as members of the board or a special committee. The directors are under no obligation to give such advice; but if they do, the advice should not be given for their own improper reasons.

In determining what is meant by 'the company' when assessing to whom the directors owe the duty, this is normally interpreted to mean the company as a separate legal entity in addition to the shareholders of the company when considered as a whole, both present and future. It may also be that as a company approaches insolvency, the duty of the directors may be extended to include a consideration of the interests of the creditors as well.

There is a general rule that directors are required not to put themselves into a position where there is a conflict (actual or potential) between their personal interests and their duties to the company or between their duty to the company and a duty owed to another person. Special committees comprising directors and management independent of the transaction under consideration are able to provide a more objective review and authorising process. As such, governing boards often delegate their authority to approve and consummate the transaction to these special committees in order to protect themselves from any allegations of conflict or unjust enrichment.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

No specific legal issues arise in connection with disclosure issues in going-private transactions, other than the obligation on the directors to discharge their fiduciary duty as noted in question 3.

5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

There are no specific timing considerations for a going-private or other private equity transaction, other than those concerning business combinations (ie restructuring, buy-out or amalgamation) discussed below.

In transactions involving Cayman companies, there are squeeze-out provisions permitted by the Companies Law (as defined below). Where the holders of not less than 90 per cent in value of the shares affected have approved the transaction, the transferee company may, at any time within two months after the expiration of four months from the date of the offer, give notice to any dissenting shareholder that it desires to acquire such shares from the dissenting shareholder and where such notice is given the transferee company shall, within one month from the date on which the notice was given, be entitled and bound to acquire such shares on the same terms of the scheme or contract as per the approving shareholders. Note that the minority or dissenting shareholder may, within one month from the date it receives notice, make an application to court should it seek to oppose the sale of its shares.

The only provision of the Companies Law dealing with mergers of Cayman companies requires a court-approved scheme of arrangement. Under the Companies Law (2007 Revision) (the Companies Law), a scheme of compromise or arrangement between a company and its creditors or members proposed for the purpose of reconstructing the company or amalgamating two or more companies must be accepted by a majority of creditors or shareholders (representing 75 per cent in value) before the court will exercise its discretion to sanction the proposed scheme or make provisions for compliance with its terms.

While the absence of Canadian or Delaware-style business combination legislation has proved detrimental in the past, it appears this deficiency in the Companies Law is about to be addressed. There is currently a bill before the Cayman Islands' legislature that, when passed, will introduce both Canadian and Delaware-style business combination provisions into the Law.

6 Purchase agreements

What purchase agreement issues are specific to private equity transactions?

Besides the standard terms contained in these types of purchase agreements, we have begun to notice an increasing emphasis on the following provisions:

- scope of representations and warranties;
- indemnification clauses (these have become much wider);
- financial covenants (these are now being looked at with increasing scrutiny); and
- fees (the issue of fees, whether reverse-breakup fees or commissions, have also become the subject of complex and substantive negotiations).

7 Participation of target company's management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues?

The directors may participate and become a part of a compensation-based structure provided:

- any conflict of interest is disclosed;
- they are not placed in a position where they could be seen to be breaching their fiduciary duties to the company; and
- there are no circumstances giving rise to unjust enrichment.

Under Cayman law, directors are required not to put themselves into a position where there is a conflict (actual or potential) between their personal interests and their duties to the company or between their duty to the company and a duty owed to another person. At common law, however, and therefore in Cayman, the company is at liberty to waive completely the rules protecting it as principal in dealings in which the directors have an interest. Most private Cayman companies have articles of association that allow directors to attend, be counted in the quorum and usually also to vote on transactions in which they have an interest so long as their interest is disclosed. There are no statutory disclosure requirements. Generally, however, directors should not use the company's assets, opportunities or information for their own profit.

8 Tax issues

What are the basic tax issues involved in private equity transactions? Can share acquisitions be classified as asset acquisitions for tax purposes?

There are no tax issues in the Cayman Islands. As a matter of law, currently no tax is payable by any exempt company or ELP on any share issues, acquisitions, and dispositions or based on income or capital gain.

9 Existing indebtedness

What issues are raised by existing indebtedness at a potential target of a private equity transaction? How are these issues resolved?

There are no 'unlawful financial assistance' provisions under Cayman law in circumstances where the target company is required to give security for its assets to a new lender to cover the debts of the offeror. This negates the need for a complicated 'whitewash' procedure where the target company is a Cayman company.

Where the target company has indebtedness, this will usually be owing to a lending bank. Accordingly, it will be a part of the agreement that any bank financing the relevant acquisition includes the necessary financing to repay the existing lender in full and any relating security to be released. In this way, the new lender assumes the same position as the departing one.

10 Debt financing structures

What types of debt are used to finance going-private or private equity transactions? Do margin loan restrictions affect the debt financing structure of these transactions?

There are no Cayman-specific issues that arise in relation to the nature of debt used to finance these transactions. That being said, although not a specific issue under Cayman law, the types of debt financing in private equity transactions generally involve secured senior and mezzanine debt. Sometimes, the debt granted to the private equity firm will be in the form of loaned stock or PIK (payment-in-kind) notes. In larger private equity transactions, we see that the debt becomes syndicated.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

It is commonplace to utilise the standard-form generic provisions and no special considerations need to be taken in relation to these documents under Cayman law.

12 Fraudulent conveyance issues

Do private equity transactions involving leverage raise 'fraudulent conveyance' issues? How are these issues typically handled in a going-private transaction?

Under the new provisions of the Companies Law coming into effect 1 March 2009, every disposition of property by the company at an undervalue (ie, either for no consideration or for significantly less than the value of the relevant property) with intent to defraud its creditors shall be voidable at the instance of the liquidator. The burden of establishing an intent to defraud lies with the liquidator and any action to unwind such a disposition must be brought within six years of the disposition.

13 Shareholders' agreements

What are the key provisions in shareholders' agreements covering minority investments or investments made by two or more private equity firms?

Shareholders' agreements (that also include the company as a party) afford all shareholders enforcement rights as against other shareholders and the company. This alleviates the necessity of having to rely on the company to enforce rights pursuant to the constitutional documents or on derivative actions in the face of inactivity by the company.

Due to the limited protection afforded to minority shareholders under Cayman law, the terms of the shareholders' agreement (although usually generic and consistent with the expectations of a US or UK law document) should also contain minority rights clauses (eg, rights to information, to appoint or remove directors, to provide tag-along or drag-along provisions, pre-emption rights on new share issues and transfer of existing shares) to ensure adequate protection for such shareholders.

14 Limitations on transaction size

Do private equity firms have limitations on the size of transactions they may engage in?

No. Recent transactions have extended into the billions of dollars.

Update and trends

The Cayman Islands continue to be the offshore jurisdiction of choice for structuring tax-efficient private equity transactions. In light of the anticipated changes to the Cayman Islands' Companies Law to facilitate Delaware and Canadian-style business restructurings and amalgamations, this trend is likely to continue for the foreseeable future.

15 Exit strategies and investment horizons

How do the exit strategies and investment horizons of private equity firms affect the structuring and negotiation of leveraged buyout transactions?

Although Cayman law is of no direct application, exit strategy and investment horizons are key considerations for private equity firms in leveraged buyout transactions and, accordingly, these provisions are carefully and comprehensively included in all transaction documents. As to whether a clearly defined hard exit date or fulfilment of conditions to exit is reflected in the documents depends on the terms of each specific transaction.

16 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

The accounting treatment afforded to these transactions is a matter that is usually decided on by the relevant auditors using GAAP best-practices and no specific points of Cayman law are, therefore, relevant. As there is no Cayman GAAP, international GAAP, US, UK and Canadian GAAP are specifically utilised according to the genesis of the underlying transaction.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years?

Cayman law has no direct application here. Companies of all manner and all industries incorporated in the Cayman Islands have become target companies, including oil & gas, renewable energy, software, natural resources, biotech and manufacturing, to name but a small sample.

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18 Industry-specific regulatory schemes

Do industry-specific regulatory schemes limit the potential targets of private equity firms?

No. Cayman law has no direct application here.

19 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

Cayman companies currently cannot merge without going through a court-sanctioned scheme of arrangement. However, as discussed in question 5, the bill contemplating both Canadian and Delaware-style business combinations is expected to be presented to the Cayman Islands' legislature in the near future.

There are also no financial assistance restrictions applicable in the Cayman Islands and therefore, save for the merger prohibition described above, as a matter of law, no specific structuring issues arise in respect of cross-border going-private or private equity transactions.

20 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

Cayman law has no direct application here other than the necessity of securing waivers of conflicts from each participant in favour of

the Cayman firm acting for the syndicate. Typically, each participant is advised by its own onshore counsel in the negotiation and review of the transaction materials.

21 Recent credit market disruptions

How have disruptions in the credit markets affected dealmaking?

What specific changes to transaction terms have you seen and do you expect in the future?

Obviously, the current state of the world economy has had a constricting effect on deal-making. Representations and warranties, including long-term financial covenants, are now attracting much more attention and becoming more rigorous. Bank financing has also become increasingly difficult to obtain under present market conditions. Given the tightening of the lending market, management and private equity houses are finding it increasingly difficult to secure reliable financing to close out the deal.

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