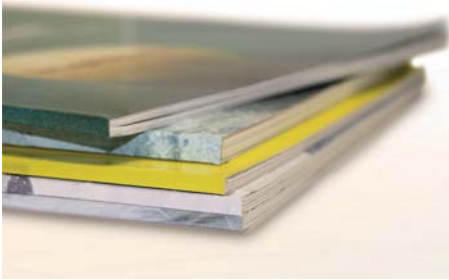


## The Cayman Islands: Different Structures for a Challenging Regulatory Environment



BY JULIAN BLACK AND SIMON RAFTOPOULOS

Securitisation is an essential part of the post financial melt-down environment, and it is an essential component for the re-establishment of lending in the global economy. This is recognized at all levels. Academics recognize its significance, and in initiating the TARP Programme to support these types of transactions there is also recognition at the Federal Government level in the United States. Due to capital constraints, banks won't be able to sustain lending at anything like pre-Credit Crunch levels, unless there is a live and active primary Securitisation market.

A Collateralised Loan Obligation (“**CLO**”) is a particular type of Securitisation that packages loans made to large corporate credits. It should be noted that none of the Collateralised Loan Obligations (“**CLO's**”) that have been issued in the last decade ended up defaulting during the credit crisis, despite some tranches trading as low as 60 cents in the Dollar in the midst of the crisis. CLO's are now trading back near par, and the recovery of the product in the secondary market has for a long time been complete.

CLO's should not be confused with Collateralised Debt Obligations (“**CDO's**”), which packaged sub-prime mortgage and other low-grade assets. The latter defaulted very significantly, and that product will not be reappearing on the financial landscape.

The forecast is for a number of CLO transactions to get done during the course of 2010. In many of the banks and law firms in New York and London, teams are still in place to execute and close transactions, if somewhat smaller than before. And investor appetite for product is beginning to re-emerge.

### THE EXEMPTED COMPANY

Prior to the financial melt-down, CLO's were generally carried out using the familiar Cayman Islands Exempted Company. The Exempted Company can be incorporated in a couple of days, and market participants are generally familiar with the issues surrounding it.

In the aftermath of the financial crisis, new head-winds to closing CLO transactions have blown up, to make the execution of transactions that much more difficult. These have come in different shapes and forms. There are the impending financial reforms due in the US, UK and elsewhere, including capital and liquidity requirements and a plethora of other proposed changes. There is a requirement for Lead Managers to hold “skin in the game”, and retain exposure to the equity of the deal. Naturally, each Investment Bank has other internal compliance hurdles to surmount before a deal can be brought to market, and investors are faced with equivalent additional hurdles.

These changes are leading market participants to look at structuring transactions using different Cayman structures. In different quarters, participants are looking at using Cayman Islands unit trusts, Cayman Islands exempted limited partnerships and even Cayman Islands limited duration companies. Using these different Cayman vehicles gives rise to issues with which market participants are generally less familiar.

## THE TRUST STRUCTURE

As a result of the above, many structured finance transactions have adopted a Cayman Islands trust as the issuing vehicle. Unlike in Delaware, the Cayman Islands trust does not have a separate legal personality and accordingly the contracting party on the deal is the trustee, acting in respect of the trust. As a result, there is significant amount of real reliance on the limited recourse provisions in the documents – without which noteholders and other contracting parties would have full recourse to all of the assets of the trustee, whether within the trust or not.

The unit trust is constituted by the trustee declaring a trust over a certain assets, in favor of the unitholders. The trustee that acts on the deal is usually a Cayman Islands trustee who needs to be licensed pursuant to Section 5 of the *Banks and Trust Companies Law (2003 Revision)*. Licensing is quite a lengthy process, so it is generally not suggested that a new trustee is established in respect of each deal but rather that an existing licensed trust company carries out the deal in its own name. This is subject to the obligations being limited in recourse to the assets of the trust. Once constituted, the trustee can issue limited recourse debt of various levels of subordination and can acquire the portfolio of assets in the usual way. The trust can be registered voluntarily with the Registrar of Trusts, and an application is made to the Governor in Council for a 50-year Tax Undertaking.

The subordinated piece can be in the legal form of debt or in the form of an equitable trust certificate. Whilst a note is contractual right against the trustee, a trust certificate represents a right in *rem* in the trust assets subject to the terms of the Declaration of Trust.

## THE LIMITED PARTNERSHIP

The limited partnership under Cayman Islands law can be in one of two forms, a limited partnership pursuant to the *Partnership Law (2002 Revision)* (the “**LP**”) or the more regularly used Exempted Limited Partnership (the “**ELP**”) pursuant to the *Exempted Limited Partnership Law (2007 Revision)*, and the *Exempted Limited Partnership (Amendment) Law (2009 Revision)*. Like the trust, the limited partnership does not have a separate legal personality under Cayman Islands law and is a partnership between one or more general partners who have unlimited liability for the obligations of the limited partnership and one or more limited partners whose liabilities is limited. The general partner must be a Company or Partnership established in the Cayman Islands or be a foreign Company registered in the Cayman Islands.

For the purposes of a traditional securitization or a CLO, a limited partnership can (like the exempted company and the trust) be crafted to match the desired deal structure: it can issue notes with various levels of subordination. As with the exempted company and the trust, the “subordinated piece” can again be in the form of notes or it can be in the form of “Limited Partnership Interests”. Each investor in these interests would subscribe for and acquire limited partnership interests in the partnership and have the benefit of the rights set out in the partnership agreement. With the right legal advice and a robust legal opinion, investment bankers and investors in these transactions have got - and continue to get - comfortable with this legal structure.

## THE LIMITED DURATION COMPANY

The Exempted Limited Duration Company (the “**LDC**”) operates in similar terms to an exempted company, and, like an exempted company, the LDC has the convenience of administration of a corporate entity, and the possibility of tax transparency in the United States.

There are however, significant differences as between an ordinary exempted company and an LDC, as follows: (1) the Memorandum and Articles of

Association (the “**M&A**”) of the LDC must limit the life of the company to a period of 30 years or less, after which time the LDC is deemed to have commenced winding-up. This gives enough head-room for the maturity of the Notes, even for the longest maturity deals (2) the LDC must at all times, like a partnership, have no fewer than two members; (3) the M&A of the LDC may prohibit share transfers, or provide that no shares may be transferred without the agreement of all the shareholders; and (4) finally, the M&A of an LDC may provide that the management of the company is vested in the members. For a CLO, the latter two mechanics would generally be excluded, and not used.

## CONCLUSION

The financial crisis has led a hiatus in the issuance of asset-backed paper to sophisticated investors, and a reappraisal of the nature of the investment and the form that the investment should take. This is going on at the same time as the regulatory environment is

changing dramatically in real-time, presenting a plethora of new hurdles to getting deals closed. However, this doesn’t alter the basic premise, recognized by most, that Securitisation is an essential tool in the loan markets going forward, to keep the loan markets open and liquid.

This has left people eager to surmount the not inconsiderable hurdles that are in place, which in turn requires innovative thinking in the regulatory, accounting and legal fields. People are examining the structural alternatives open to them of the Limited Partnership, the Unit Trust and the Limited Duration Company, as structures with which to move forward. The Cayman Islands, with its user-friendly legislative regime and the commercial acumen of its professionals, is well placed to help investment bankers and their principal counsel in relation to these challenges, and to help provide robust and workable legal and structural solutions.

Authors:

**JULIAN BLACK**  
Corporate & Commercial, Partner  
+1 345 814 2717

**SIMON RAFTOPOULOS**  
Corporate & Commercial, Partner  
+1 345 814 2748

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