Cayman Islands

Chris Humphries and James Smith
Stuarts Walker Hersant Humphries

1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction? What structures are commonly used in private equity investments and acquisitions?

Leveraged acquisitions, management buyouts, development capital investments, fund organisations, divestitures and recapitalisations are all types of private equity transactions that occur in the Cayman Islands.

The most commonly used vehicle for private equity funds in the Cayman Islands is the exempted limited partnership established under the Cayman Islands Exempted Limited Partnership Law (2018 Revision), which affords limited liability status to investors who are limited partners in the limited partnership provided that they do not take part in the conduct of the business of the limited partnership. The fund's sponsor, or an affiliate, typically acts as the general partner and has unlimited liability for the limited partnership's obligations. Some private equity fund managers may choose to establish a fund as a Cayman Islands exempted company or a limited liability company (LLC) where there are good reasons to do so, including as to taxation or to mirror an onshore structure using Delaware LLCs, for example. A Cayman Islands private equity fund would traditionally use exempted companies as portfolio companies for investments and acquisitions, however, since the introduction of LLCs in the Cayman Islands, LLCs have become an alternative option for portfolio companies.

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 later become public companies?

The reporting requirements of overseas fund managers managing private equity funds (for example, reporting requirements of US fund managers who are SEC-registered) has implications for Cayman Islands private equity funds, as those fund managers are aligning their management of the funds and corporate governance generally with best practices expected by the regulators.

The effect of corporate governance rules on companies that, following a private equity transaction, remain or become public, will be subject to the corporate governance obligations imposed by the regulator of the relevant exchange.

3 Issues facing public company boards

What are some of the issues facing boards of directors of public companies considering entering into a going-private or other private equity transaction? What procedural safeguards, if any, may boards of directors of public companies use when considering such a transaction? What is the role of a special committee in such a transaction where senior management, members of the board or significant shareholders are participating or have an interest in the transaction?

In making their decisions at board level, the directors have fiduciary duties to do the following, among other things:

- act in good faith in the best interests of the company;
- act for a proper purpose in accordance with the constitution of the company; and
- avoid circumstances that create a conflict of interests between the interests of the director and the interests of the company.

As a general principle, these duties are owed to the company and not to individual shareholders.

A conflict of interest will arise if the directors' interests do not align with those of the company. In the context of a 'take-private' transaction, directors are under a duty to act in good faith when advising shareholders on the merits of a transaction but are under no obligation to give such advice.

In cases where the controlling shareholder has control of the board or senior management, or members of the board are participating in the transaction, it is the norm for Cayman Islands companies to establish special committees consisting entirely of independent and disinterested directors to negotiate the transaction to ensure arm's-length third-party negotiations and to avoid conflicts of interests.

4 Disclosure issues

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

There are no specific disclosure obligations on the directors of the target company under Cayman Islands law in a 'take-private' transaction, other than the directors' fiduciary duties and their common law duty to act with due care and skill in exercising their functions for and on behalf of the company.

5 Timing considerations

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

The timing considerations for a 'take-private' transaction are subject to the takeover mechanism used to effect the acquisition of the target company in the Cayman Islands. The mechanism most often used is to have a merger (under the merger regime in Part XVI of the Companies Law (2018 Revision) (the Companies Law)) between the target and an acquiring newco (which has been financed for the transaction). Other

legal mechanisms used are schemes of arrangement under sections 86 to 87 of the Companies Law and takeover offers utilising the 'squeeze-out' provisions contained in section 88 of the Companies Law.

In the case of a merger, the timing from commencing the 'take-private' to applying to register the merger (in order for a Certificate of Merger to be issued by the Cayman Islands Registrar of Companies) will depend on the complexity of the transaction and the timing for obtaining tax and regulatory clearances but can be between two and three months, which is usually shorter than the time periods for a scheme of arrangement or tender offer.

In the case of a scheme of arrangement, a precise timetable will need to be agreed with the Grand Court of the Cayman Islands. In practice, this process is likely to take up to three months from the date of settling the scheme document and commencing the court-based scheme proceedings, to sanction of the 'take-private' pursuant to the scheme by the Grand Court. However, the overall time period for a scheme of arrangement from beginning to end often takes significantly longer than three months. The merger regime has a number of advantages over the scheme in terms of timing. For example, the lack of court supervision under the merger regime provides the target company with more manoeuvrability in the event of a competing, unsolicited (or hostile) bid being made because there would be no need for the target company to deal with obtaining court approval for its actions or otherwise to keep the court informed of what it is undertaking and how that might bear on the scheme of arrangement at hand. The approval threshold for a merger is lower than the approval threshold for a scheme of arrangement.

While there is no maximum time period in completing a takeover, if the 'squeeze-out' provisions are being utilised and the bidder meets the 90 per cent minimum acceptance condition within four months of the date of the offer being made, the bidder will (unless the minority or dissenting shareholders make an application to the court) be able to compulsorily acquire the outstanding shares held by the minority or dissenting shareholders one month from the bidder's notice to acquire such shares.

6 Dissenting shareholders' rights

What rights do shareholders of a target have to dissent or object to a going-private transaction? How do acquirers address the risks associated with shareholder dissent?

In respect of the mechanism most often used for a 'take-private' transaction, the merger and consolidation under Part XVI of the Companies Law, in order to implement such a merger, a plan of merger, approved by the directors, must be put to the shareholders of each constituent company for approval. The threshold for such approval is a special resolution of the shareholders, all voting as one class, unless a higher threshold is required under the company's memorandum and articles of association. A special resolution is at least two-thirds majority (or such higher number as may be specified in the constituent company's articles of association). However, under the Companies Law, a member of a constituent company shall be entitled to payment of the fair value of his or her shares upon dissenting from a merger. Such fair value shall be agreed between the company and each dissenting shareholder or, in the absence of such agreement, by the court. The court will then determine the fair value together with a fair rate of interest (if any) to be paid by the target entity upon the amount determined to be the fair value. The costs of these proceedings may be determined by the court and taxed upon the parties as the court deems equitable in the circumstances. *In the matter of the Integra Group* (which is the only Cayman Islands case law on the meaning of 'fair value' in this context) on 28 August 2015, the Grand Court ruled that assessing fair value is a 'fact-based exercise in each case' but that fair value was a member's pro rata share of the value of the company's business as a going concern at the date of the extraordinary general meeting to approve the merger. Crucially, this amount should be without reference to any minority discount or any premium for the forcible taking of the shares. There is no prescribed approach in the Companies Law as to valuation. Accordingly, any techniques or methods that are generally considered acceptable in the financial community should be used. In the *Integra* case, experts were appointed by each party with the court ultimately approving the methodology of the dissenter's experts. Furthermore, the court also ruled that the fact a company's shares are listed on a major stock exchange will not lead the court to determine that a valuation methodology based upon its publicly traded price is necessarily the most reliable approach. Again, it will depend on the facts of each specific case as to whether the court would use this or not. In any event, this procedure ensures that a dissenting shareholder cannot delay the 'take-private' transaction and also enables the directors to take some comfort when considering their fiduciary obligations to ensure the interests of all shareholders are protected.

If a scheme of arrangement is used, under sections 86 to 87 of the Companies Law, a higher threshold of approval is required, being a majority in number of affected (ie, independent) shareholders on a show of hands, whose collective shareholding must be at least 75 per cent of the shares being voted at the meeting. As schemes of arrangement require the consent of a majority in number (as opposed to a vote based on shareholdings in a merger) this can lead to some difficulty in listed companies who might have small numbers of registered shareholders (for example, where shares are predominantly held by nominee shareholders) as this would mean a registered shareholder with a comparatively low shareholding may potentially block the scheme of arrangement. The same issue would not arise with the merger route described above. However, if a scheme of arrangement is approved, any dissenting shareholders are bound by the decision of the majority.

7 Purchase agreements

What notable purchase agreement provisions are specific to private equity transactions?

Private equity buyers will, in addition to the standard terms contained in these types of purchase agreements, seek comprehensive representations and warranties, indemnities, seller or management earn-out provisions, seller rollover requirements or restrictive covenants. On the investment aspects of the transaction, the private equity buyer will seek to have provisions dealing with a number of investor consent matters including borrowing, capital expenditure, financing, control on management remuneration, exit strategy provisions and employee incentivisation plans or schemes.

In contrast, on exit, private equity sellers typically only provide limited warranty protection, with short claim periods and no guarantees or post-completion covenants.

8 Participation of target company management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues? Are there timing considerations for when a private equity acquirer should discuss management participation following the completion of a going-private transaction?

In performing his or her fiduciary duties as a director, a director is under an obligation not to put him or herself in a position where there is an actual or potential conflict between his or her duty to the company and his or her personal interests. Notwithstanding this obligation, a director may participate and become part of a compensation-based structure in a private equity transaction provided that the following occurs:

- any conflict of interest is disclosed and such disclosure and participation by the director is permitted or can be waived under the company's articles of association;
- there has been no breach of fiduciary duties by the participating director; and
- there are no circumstances giving rise to the participating director having used the company's assets, opportunities or information for his or her own personal profit.

There are no statutory or regulatory restrictions or disclosure requirements in relation to principal executive compensation under Cayman Islands law.

9 Tax issues

What are some of the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

Under current Cayman Islands law, there are no Cayman Islands taxes on income or gains of the private equity entity or the portfolio company or on gains on dispositions of shares or partnership interests, and distributions made by the private equity buyer or portfolio company will not be subject to withholding tax in the Cayman Islands.

10 Debt financing structures

What types of debt financing are typically used to fund going-private or other private equity transactions? What issues are raised by existing indebtedness of a potential target of a private equity transaction? Are there any financial assistance, margin loan or other restrictions in your jurisdiction on the use of debt financing or granting of security interests?

There are currently no regulatory restrictions in the Cayman Islands on the use of debt financing for private equity transactions. Secured senior debt, high yield or mezzanine debt, secondary debt, loan notes and payment-in-kind notes are all types of finance mechanisms used in the Cayman Islands to finance 'take-private' or other private equity transactions. There are no financial assistance restrictions in the Cayman Islands.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in going-private transaction purchase agreements for private equity transactions? What other documents typically set out the financing arrangements?

The provisions relating to debt and equity financing will typically be the commonplace terms that are normally negotiated and settled between the parties to the private equity transaction. There are no special Cayman Islands law considerations that are required to be factored into these provisions.

12 Fraudulent conveyance and other bankruptcy issues

Do private equity transactions involving debt financing raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

To the extent that a private equity transaction involving leverage impacts on the solvency of the target and its subsidiaries (all or some of which are typically required to provide security for the financing obligations of the acquirer), there will be 'bankruptcy' related issues, such as the following:

- statutory provision for voidable preferences – which makes invalid every conveyance or transfer of property, or charge thereon, or payment obligation, etc, made, incurred, taken or suffered by the company in favour of a creditor with a view to giving such creditor a preference over other creditors at any time when the company is unable to pay its debts if the conveyance or transfer of property, or charge thereon, or payment obligation, etc, was made, incurred, taken or suffered by the company within six months preceding the commencement of its liquidation;
- statutory provision for avoidance of dispositions at an undervalue – every disposition of property made at an undervalue by or on behalf of the company with an intent to defraud its creditors is voidable at the instance of the company's liquidator; and
- fraudulent dispositions – under the Fraudulent Dispositions Law (1996 Revision) every disposition of property made with an intent to defraud and at an undervalue shall be voidable at the instance of a creditor thereby prejudiced if the action is brought within six years of the disposition happening.

These issues are typically handled by structuring the transaction in such a way so as to avoid fraudulent conveyance or other 'bankruptcy' issues from arising.

13 Shareholders' agreements and shareholder rights

What are the key provisions in shareholders' agreements entered into in connection with minority investments or investments made by two or more private equity firms or other equity co-investors? Are there any statutory or other legal protections for minority shareholders?

The key provisions that drive the structure of shareholder agreements in private equity transactions are focused on retaining control over key operational decisions during the term of the investment, regulation of share transfers (including compulsory transfers in certain circumstances), liquidity and exit procedures. Protections afforded to minority investors include: veto rights over certain operational decisions (ie, restricted matters that require the consent of all the shareholders), pre-emption rights on transfer, tag-along rights, board appointment rights and rights to receive information. As a breach of these protections under the shareholders' agreement would only entitle the aggrieved shareholder to claim damages for breach of contract and not reverse the breach, it is important that these protections are also included in the company's articles of association (which would also then bind any shareholder who is not party to a shareholders' agreement).

Under the Companies Law, special resolutions (which require the approval of at least two-thirds of the shareholders unless the articles of association of the company stipulate a higher threshold) are required for specified actions including: the reduction of the share capital of the company, any amendments to the memorandum and articles of association of the company, any application to wind-up the company; and with respect to the approval of a merger involving the company.

14 Acquisitions of controlling stakes

Are there any legal requirements that may impact the ability of a private equity firm to acquire control of a public or private company?

There is no mandatory takeover offer or minimum capitalisation requirements under Cayman Islands law. However, in order to acquire a controlling stake by way of a takeover utilising the statutory 'squeeze-out' provisions or by way of a scheme of arrangement, the acquirer will need to meet the statutory thresholds set in order to trigger the compulsory acquisition of the remaining shares (which is currently 90 per cent to activate the statutory squeeze-out mechanism and 75 per cent under a scheme of arrangement).

15 Exit strategies

What are the key limitations on the ability of a private equity firm to sell its stake in a portfolio company or conduct an IPO of a portfolio company? In connection with a sale of a portfolio company, how do private equity firms typically address any post-closing recourse for the benefit of a strategic or private equity acquirer?

Provided that appropriate institutional drag-along rights have been included in the shareholders' agreement or articles of association of the company, a private equity firm should be able to sell its shareholding in a portfolio company to a third party without restriction.

Another limitation on the ability of a private equity firm to sell a portfolio company or conduct an IPO of a portfolio company will also be where the fund is in its agreed life cycle. Where a fund reaches the end of its agreed life but still has a portfolio company, an extension of the fund may result in penalties for the fund manager. Accordingly, there may be an incentive to sell the asset for whatever value can be achieved prior to the end of the fund's agreed life rather than attempting to maximise the return in the longer run. A fund seeking a quick exit will usually approach another PE fund as they tend to be the most liquid acquirers. In particular, funds that are underinvested and are approaching the end of the investment period have strong incentives to invest or lose access to the committed capital. Accordingly, a fund's life cycle is a very important factor in relation to any exit, whether by sale or IPO.

Private equity firms will normally seek a 'clean exit' on the sale of a portfolio company rather than at the expiry of claim periods or on the satisfaction of escrow conditions and this would typically be factored into the buyer's offer.

16 Portfolio company IPOs

What governance rights and other shareholders' rights and restrictions typically survive an IPO? What types of lock-up restrictions typically apply in connection with an IPO? What are common methods for private equity sponsors to dispose of their stock in a portfolio company following its IPO?

Once listed, the operations of the portfolio company will be governed by the listing rules and regulations of the exchange and jurisdiction in which the portfolio company is listed. Governance rights and other rights and restrictions typically included in a shareholders' agreement such as board appointment rights, veto rights over restricted matters and special information rights are generally not permitted post-IPO.

There are no restrictions on registration rights for post-IPO sales of shares in the Cayman Islands. Lock-up restrictions for private equity firms vary depending on the circumstances and contractual obligations of the parties, but IPO underwriters typically require in the underwriting agreement or lock-up agreement that private equity firms should not sell any shares in the portfolio company for up to 180 days following the IPO.

Whether a PE sponsor can divest itself of stock following an IPO will largely be driven by both market conditions and listing rules and regulations of the exchange and jurisdiction in which the portfolio was listed. Typically, a sponsor will look to sell down a portion of its shares on the IPO, but where a sponsor has been blocked from selling any or all or its stock the sponsor will need to rely on strong public markets to complete an exit through follow-on public offerings in relation to which it will seek to include its stock in such offering.

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 industry focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

As the Cayman Islands is a popular jurisdiction for a holding company structure, there is a very wide range of companies and industries that have been the target of 'take-private' transactions in recent years. There are no industry-specific regulatory schemes or anti-trust laws in the Cayman Islands that limit the potential targets of private equity firms.

18 Cross-border transactions

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

There are no foreign investment restrictions, minimum capitalisation requirements or financial assistance restrictions in the Cayman Islands which would lead to specific structuring issues in a cross-border 'take-private' or private equity transaction. The tax-neutral status of the Cayman Islands (see question 9) also means that there are no adverse tax consequences from a Cayman Islands perspective.

19 Club and group deals

What are some of the key considerations when more than one private equity firm, or one or more private equity firms and a strategic partner or other equity co-investor is participating in a deal?

There are no specific Cayman Islands legal considerations that would apply to a private equity transaction involving syndicated parties other than the typical general considerations that would include: the valuation of the investment price, pre-emption rights, investor consent requirements, the make-up of investor majority, timing, terms of disposal pre-exit, restrictive covenants and exit provisions.

20 Issues related to certainty of closing

What are the key issues that arise between a seller and a private equity acquirer related to certainty of closing? How are these issues typically resolved?

The key issue relating to certainty of closing arises from the delay between exchange of contracts and closing (with closing happening upon the satisfaction or waiver of a number of conditions precedent in the transaction documents). The principal concern for the seller will be to ensure that the conditions precedent (applicable to the seller) are clear, specific and achievable within the time frame set for closing. The principal concern for the private equity buyer will be to ensure the synchronisation of the conditions precedent (applicable to the buyer) in the finance, equity investment and acquisition documents. For example, the private equity buyer will want to ensure that it is not legally obliged to buy the target until the conditions precedent relating to debt finance and equity finance have been satisfied or waived. These issues are typically resolved through negotiation. There are no Cayman Islands-specific considerations that are required to be factored into such negotiations.

STUARTS
WALKER
HERSANT
HUMPHRIES

Chris Humphries **chris.humphries@stuartslaw.com**
James Smith **james.smith@stuartslaw.com**

Kensington House
69 Dr Roy's Drive, PO Box 2510
George Town
Grand Cayman KY1-1104
Cayman Islands

Tel: +1 345 949 3344
Fax: +1 345 949 2888
info@stuartslaw.com
www.stuartslaw.com