



Securitisation in the Cayman Islands

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Preface

This publication has been prepared for the assistance of those who are seeking information on securitisation or structured finance transactions in the Cayman Islands.

It deals in broad terms with the establishment and operation of special purpose vehicles. It is not intended to be exhaustive but merely to provide brief details and information which we hope will be of use to our clients. We recommend that our clients and prospective clients seek legal advice in the appropriate jurisdiction on their specific proposals before taking steps to implement them.

Before proceeding with the incorporation of an offshore company as part of a securitisation transaction, persons are advised to consult their tax, legal and other professional advisers in their respective jurisdictions.

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1. INTRODUCTION

Modern company, trust, banking, insurance and other related laws have made the Cayman Islands (“**Cayman**”) a leading offshore financial centre. The attitude of the Cayman government towards, and open communication with, the private sector encourages the promotion and maintenance of offshore business. Cayman enjoys sophisticated telecommunications systems, an abundance of professional service providers, as well as economic and political stability. These factors combine to make Cayman one of the jurisdictions of choice for offshore securitisation transactions.

2. SECURITISATION TRANSACTIONS GENERALLY

Securitisation is the process of transforming an asset into a security which can be sold to investors in the capital markets. Securitisation transactions are a fast expanding facility used by businesses all over the world. They provide the opportunity to employ innovative mechanisms for financings of all kinds. If there is an asset – securities, mortgages, receivables, royalties, rentals, or, indeed, just a “thing” – that produces income, then it can be securitised.

In a basic securitisation transaction, a special purpose vehicle (an “**SPV**”) is incorporated and is often owned by a purpose or charitable trust. The SPV then purchases an asset, which usually has some form of regular cash flow, and issues loan notes or preference shares to investors in the capital markets to finance the purchase. The repayment of principal and interest on the notes is then secured by the purchased asset and the accompanying cash flow.

3. ORPHAN SPV TRANSACTIONS

3.1. “Orphan” Special Purpose Vehicles

Although many securitisation transactions involve an SPV that is directly owned by a parent, often a transaction will require an “orphan” SPV, meaning that it is not part of the originator’s corporate group. When an orphan is required, the SPV is incorporated with all the shares issued to a trustee (the “**Share Trustee**”) (also offshore) pursuant to a charitable or purpose trust. The SPV then issues securities such as notes to raise funds to purchase the asset pool from the originator. The asset pool is then “ring fenced” by the grant of a security interest over the asset pool in favour of the indenture trustee. The income flow from the asset pool is used to pay the transaction fees and costs and interest to the noteholders.

3.2. The Trust

As noted above, the shares of the SPV are usually issued to a trustee pursuant to either a charitable or purpose trust. A purpose trust (called a STAR trust in Cayman) is a trust to fulfil purposes rather than one for beneficiaries, while a charitable trust has charities as the beneficiaries.

While both forms of trust would work for a securitisation structure, current market practice in the Cayman Islands is to use a charitable trust. The main advantage of the charitable trust over the purpose trust is primarily one of nexus. It could be argued in some circumstances that a trust appearing to be for a certain purpose or purposes is in fact a trust for the benefit of an ascertainable person. This might give rise to a tax liability in the home jurisdiction of such a person. A properly structured charitable trust from which

distributions are made from a realistically set level of dividend paid by the SPV may therefore be preferable as the charities would be the person deriving a benefit.

3.3. Limited Recourse and Non-Petition

Given the orphan nature of the securitisation SPVs, the directors will need to ensure that any transactions undertaken by the SPV are entered into on a limited recourse basis. This means that any liability of the SPV will be limited to the assets held by the SPV in connection with the transaction. Limited recourse protections will be built into the transaction documents to ensure that the SPV is not put in a position where it incurs liabilities that it would not otherwise be able to meet.

In addition to the limited recourse provisions, the transaction documents should also contain non-petition language. This means that the transaction parties agree not to petition for a liquidation or winding up of the SPV until following the termination of the financing transaction, avoiding the risk of an early termination of the structure as a result of the winding-up the SPV during the life of the transaction. Typically the non-petition protections will extend for a period following the termination of the transaction to ensure that any residual claims are also captured. Non-petition as a concept is enshrined in statute in the Cayman Islands.

4. OFFSHORE SPECIAL PURPOSE VEHICLES

For certain securitisation transactions there may be benefits if the SPV is domiciled offshore. Cayman is a particularly well suited jurisdiction for the implementation of securitisation transactions.

Cayman is a hub of the securitisation industry. For more than twenty years, Cayman has used its leading edge legislative regime, secure political and economic backdrop, and well-earned reputation for innovation in the offshore industry to attract securitisation business.

The following summarises some of the more salient issues when considering a Cayman Islands securitisation:

4.1. Incorporation of the SPV

- (a) Generally incorporated with limited liability.
- (b) No governmental approval is required for the incorporation of the SPV, nor is there any requirement to publicise an intention to incorporate.
- (c) Can be incorporated by a corporate service provider utilising a subscriber share.
- (d) Can generally be completed within 24 hours following KYC clearance.

4.2. Objects

- (a) Can have unrestricted powers and is capable of exercising all the functions of a natural person, irrespective of corporate benefit.

- (b) In order to assuage any concerns that the SPV may carry on other types of business, the SPV usually has restricted objects that limit its activities to those necessary to fulfil its obligations under the securitisation transaction.

4.3. Directors

- (a) The minimum number of directors is one.
- (b) There are no residency requirements for directors. The directors of the SPV are responsible for the conduct of its day-to-day business and management.

4.4. Shareholders

An SPV must have at least one shareholder. For a standard securitisation orphan SPV, the shareholder will typically be a licensed Cayman Islands trust company which holds the shares pursuant to a declaration of trust for charitable purposes.

4.5. Share Capital

- (a) There is no minimum or maximum authorised or issued share capital for an SPV (though it is customary for a nominal US\$250 of share capital to be issued).
- (b) Fractional shares and shares of no par value may be issued. Shares may be issued fully, partly or nil paid.

4.6. Issue and Transfer of Shares or Notes

An SPV can transfer its shares if the transfer is expressly or impliedly permitted by the company's articles of association.

4.7. Dividends

Dividends may be paid from profits or other available distributable reserves. Cayman law allows companies to make a distribution or dividend to shareholders out of share premium account provided that, immediately following the date on which the proposed payment is to be made, the company is able to pay its debts as they fall due in the ordinary course of business.

4.8. Public Offers

Cayman law does not require the issue or publication of a prospectus where an exempted company offers shares to the public. However, subject to certain exceptions shares may not be offered to the "public" in the Cayman Islands, unless the shares are listed on the Cayman Islands stock exchange¹.

¹ For such purposes, the term "public in the Cayman Islands" does not include (a) a sophisticated person within the meaning of the Securities Investment Business Act (as amended); (b) a high net worth person within the meaning of the Securities Investment Business Act (as amended); (c) a person specified in paragraph 2(c) or 3 of the Fourth Schedule to the Securities Investment Business Act (as amended); (d) an exempted or ordinary non-resident company registered under the Companies Act (as amended), or a foreign company registered under Part IX of that act, or any such company acting as general partner of a partnership registered under section 9(1) of the Exempted Limited Partnership Act (as amended), or any director or officer of the same acting in such capacity; (e) a limited liability

4.9. Auditors

Generally, there is no requirement that an SPV appoint an auditor or file financial statements with the Registrar of Companies or any other governmental authority.

4.10. Books of Account and Records of the Company

An SPV must keep proper records of account with respect to all transactions as necessary to give a true and fair view of the state of the company's affairs and explanation of its transactions.

4.11. Annual Fee

An SPV is required to pay a fee in Cayman at the time of its incorporation and each year thereafter. The fee is provided for on a sliding scale. Most SPVs used in securitisation transactions issue minimal capital to the trustee pursuant to the purpose trust and raise other funds by the issuance of notes resulting in the payment of the minimum government fee.

4.12. Exchange Control

There are no exchange controls in Cayman.

4.13. Winding up

Consideration should be given at the outset as to the expected life of the SPV and whether it will need to be wound-up at the end of the transaction. For instance, it may be useful (but not necessary) to have the accounts audited annually and ensure the SPV retains enough funds at the end of the transaction to pay for liquidation and winding-up.

4.14. Taxes

No capital gains, income or withholding taxes are imposed in Cayman upon an SPV or its shareholders. An SPV is entitled to receive an undertaking from the Cayman government such that no law enacted in Cayman imposing any tax to be levied on profits, gains or appreciation or which is in the nature of estate duty or inheritance tax shall apply to an exempted company, or its shares or by withholding for a period of up to twenty years, which is usually renewable for a further ten years upon expiry.

Stamp duty applies in Cayman where original documents are brought to, or executed within, the jurisdiction although the liability of exempted companies is capped in most cases.

5. REGISTRATION OF SECURITY INTERESTS

A key aspect to the securitisation transaction is that the asset pool is protected by the grant of security in favour of the indenture trustee. In Cayman there is no general system of registration of mortgages, charges, or other security interests (other than in respect of some specific asset classes). A security

partnership registered under the Limited Liability Partnership Act (as amended); (f) a limited liability company registered under the Limited Liability Companies Act (as amended); or (g) the trustee of any trust registered or capable of registration under section 74 of the Trusts Act (as amended) acting in such capacity.

interest cannot be filed with the Registrar of Companies nor is there any requirement or facility to do so in order to obtain statutory priority.

Cayman companies are required to maintain their own register of mortgages and charges (which is available only to members and creditors), but failure to record a security interest therein does not affect the validity or priority of the security interest. Registration in the company's own register does not provide constructive notice of the existence of the charge to third parties. Priority of competing charges under Cayman law depends upon the application of conflicts of laws principles which, in essence, look to the law governing the security interest, the law constituting the asset over which the security interest is granted and/or the law of the place in which the asset is situated, depending on the nature of the asset.

6. **“TRUE SALE” OR “NON-CONSOLIDATION”**

Where the transaction is intended to be off balance sheet it is vital that the SPV be regarded as separate from the originator and will not be consolidated for on-shore accounting and regulatory purposes. In order to obtain the off balance sheet accounting treatment the sale of the underlying asset pool by the originator to the SPV must be a true *bona fide* sale. The transaction must not be characterised as a mortgage, which in substance involves the originator raising financing by charging the underlying asset pool. Nor should the SPV be regarded as a subsidiary of the originator.

Accordingly, as mentioned above, the SPV is incorporated with all of the shares issued to a trustee pursuant to a purpose or a charitable trust.

The relevant accounting rules differ depending on the jurisdiction of the originator. While this is primarily an accounting question, factors which may be taken into account include the means by which the originator withdraws profit from the SPV, the extent of influence wielded by the originator over the SPV, the identity of directors of the SPV, the name of the SPV, the extent to which the originator has underwritten the SPV's liability to the investors or other third parties and the ability of the originator to redeem the underlying asset pool at the end of the transaction. Accordingly, most SPVs are organised with unrelated names and directors and officers who are all members of an offshore service provider such as the offshore law firm. For instance, in certain cases, particularly where the entire transaction is the subject of pre-determined contractual obligations, Conyers and its related service companies will provide directors resident in Cayman.

7. **BANKRUPTCY REMOTENESS**

When establishing the structure for the SPV, it is important to ensure that the SPV is bankruptcy remote. In order to achieve bankruptcy remoteness, the issuer will need to be structured in such a way that it is legally independent from both the seller/issuer of the underlying collateral and the investors in the notes, and that none of the other transaction parties is able to exercise any direct control over the issuer. Cayman Islands bankruptcy remote issuers will typically utilise an orphan trust structure.

Although the SPV may be established with very broad objects and powers while the transactions are being negotiated, prior to the transactions being entered into the objects and powers of the SPV should be limited to allow the SPV to only enter into the specific transactions related to the securitisation. This is also necessary if the securities the SPV is issuing are to be rated by one of the rating agencies. The

rating agencies will want to ensure the SPV is not able to carry on any business other than the securitisation.

It is also important that the trustee pursuant to the purpose or charitable trust not be allowed to sell the shares, amalgamate the SPV, continue the SPV into another jurisdiction or make any other structural changes to the SPV such as amending its constitutional documents. If a purpose trust is used, these requirements can be set out in the purpose trust. If a charitable trust is used the trustee may agree pursuant to a separate agreement that it will not change the structure of the SPV. Again, this is one of the advantages of using a purpose trust whereby everything can be set out in one document.

Finally, it is important to ensure that the SPV will not be petitioned into winding up (bankruptcy). The trustee of the purpose or charitable trust will agree not to petition the SPV into bankruptcy. Further, the noteholders, indenture trustee and other service providers such as a collateral manager will agree in the indenture and other transaction documents that they will not petition the SPV into bankruptcy. Also, the transaction documents will usually contain a provision for the extinguishment or diminishment of obligations if at any point the liabilities are greater than the assets so that the liabilities will be extinguished or diminished to be less than the assets. This will ensure that the SPV is at all times solvent and thus could not be petitioned into bankruptcy.

8. CREDIT RATINGS

The rating agencies apply selected criteria to assign credit ratings to companies carrying out structured finance transactions. A blanket statement of what will be considered by the rating agencies is not possible and changes regularly in view of market developments. Many variables are taken into consideration in evaluating the risk involved in a securitisation transaction. However, as a rule, the rating agencies take particular notice of the following factors in assigning a credit rating to international securitisation transactions:

- (a) whether the securitised assets can be sufficiently separated from the transferor so that an insolvency of the transferor will not affect the creditworthiness of the assets;
- (b) the overall creditworthiness of the asset pool being securitised; and
- (c) whether any legal issues may affect the cash flow of the transaction.

Generally speaking, rating agencies must be satisfied that the following steps have been taken to ensure that the SPV's assets are sufficiently protected against both voluntary and involuntary insolvency risks:

- (a) placing contractual restrictions on the activities of the SPV;
- (b) placing contractual debt limitations;
- (c) ensuring that there are contractual limitations on reorganizations or changes of ownership;
- (d) imposing contractual separateness covenants;
- (e) established fixed security interests over the asset pool; and

- (f) restricting the power of the shareholders to wind up the SPV voluntarily and to make amendments to the memorandum and articles of association of the SPV.

These concerns can be addressed in the transaction documents. If the transaction documents are comprehensive and adequately address these concerns, a Cayman Island SPV has the opportunity to achieve a high credit rating, so long as the underlying asset pool is otherwise creditworthy.

9. CONCLUSION

The basic offshore structure, while adding the benefit of no offshore taxation, is not complicated. However, it is very important to ensure that the SPV is properly organised to ensure that the treatment of the underlying asset pool is off balance sheet and there will be no consolidation with the originator, that the SPV is bankruptcy remote and that the SPV will only and can only enter into the specific securitisation transactions.

This publication should not be construed as legal advice and is not intended to be relied upon in relation to any specific matter. It deals in broad terms only and is intended merely to provide a brief overview and give general information.

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