

## **CAYMAN ISLANDS COMPANIES LAW APPLICABLE TO EXEMPTED COMPANIES**

*This Memorandum provides only a brief and general overview of the relevant law. It is not intended to be comprehensive and is not a substitute for professional advice in the context of a particular set of circumstances.*

### ***Exempted Companies***

A Cayman Islands exempted company is a particular type of company that is not permitted to conduct local business in the Cayman Islands and is able to obtain an undertaking from the Cayman Islands Government that in the event that direct taxation were ever introduced in the Cayman Islands, the company would be free from such taxation for a period of 20 years from the date of the undertaking provided. An exempted company is not able to offer its shares to members of the public of the Cayman Islands.

### ***Framework***

The principal legislation in the Cayman Islands relating to the operation and governance of Cayman Islands exempted companies is the Companies Law. Regard must also be had to the common law, the memorandum and articles of association of the company and any applicable contracts e.g. a shareholders agreement.

### ***Memorandum of Association and Articles of Association***

The constitutional documents of an exempted company comprise the memorandum of association and the articles of association. They are two separate but connected documents. The memorandum of association sets out the objects and powers of the company and the articles of association set out the internal rules and regulations of the company encompassing such matters as the powers of the board, the procedures for holding and conducting directors and shareholders meetings and the rights and restrictions attaching to shares. The articles of association constitute a contract between the shareholders and the company.

### ***Limited Liability***

Subject to a narrow range of exceptions, the liability of shareholders in an exempted company is limited to the amount of any unpaid share capital. Once a shareholder's shares are fully paid, a shareholder has no liability to creditors of the company in the absence of fraud, the company being a sham or similar circumstances in which the court would not respect the limited liability of the shareholders.

## ***Share Capital and Shares***

Cayman Islands law distinguishes between authorised share capital and issued share capital. Authorised share capital represents a ceiling on the amount of issued share capital that an exempted company may have. Once all of the authorised share capital has been issued, the authorised share capital must be increased by shareholder resolution before further shares can be issued.

In the Cayman Islands, the annual government fee paid by an exempted company is based upon the authorised share capital rather than the issued share capital. The lowest government fee band is for authorised share capital up to US\$50,000 (or currency equivalent) and therefore, wherever possible, it is desirable for the authorised share capital not to exceed US\$50,000 (or currency equivalent). However, this does not impose any practical restriction on an exempted company because shares can be created with a nominal value of a fraction of a dollar or even a fraction of a cent. It is therefore, common for the authorised share capital to be US\$50,000 divided into US\$5,000,000 shares of US\$0.01 nominal value each.

Other than by a court approved reduction of share capital or a lawful redemption or repurchase of shares (where such a redemption or repurchase is permitted by the articles of association), issued share capital may not be returned to shareholders prior to a winding up of an exempted company.

Whilst an exempted company may have shares without nominal value, it is more common for an exempted company to have shares with a nominal value. Where a shareholder subscribes for shares in an exempted company at a premium to their nominal value (e.g. US\$100 for a share of a nominal value of US\$0.01), the premium must be transferred to a share premium account. It can be useful to create a healthy share premium account because the Companies Law permits an exempted company to pay dividends or make other distributions out of share premium account provided that the directors are satisfied that the company can pay its debts as they fall due in the ordinary course of business ie the company is solvent on a going concern basis.

The means by which shares in an exempted company may be transferred will be set out in the articles of association. Articles of association frequently provide that any transfer of shares is subject to the approval of the board of directors.

## ***Dividends***

The articles of association will generally contain provisions dealing with the payment of dividends by an exempted company. Usually, an exempted company will be permitted to pay dividends out of profits and, as mentioned above, out of share premium account provided that the company is solvent.

## ***Directors and Shareholders***

Whilst the shareholders own an exempted company, the day to day management and control will be in the hands of the board of directors. The directors act collectively as a board rather than individually (except to the extent that the board has delegated specific functions e.g. to a Managing Director) and have the authority to manage the company in the company's best interests. Because of the collective responsibility of the board, it is important that transactions and associated agreements and documents are always approved by the board at a board meeting or by written resolution signed by all directors. It is not appropriate for a single director to approve or sign unless authority to do so has been conferred upon him at a board meeting or by written resolution signed by all directors.

The directors are subject to a number of fiduciary duties and to a duty of care and skill (please see separate note entitled "Duties of Directors of Cayman Islands Companies").

Most articles of association provide that all powers of the company are vested in the directors except for those specifically reserved to the shareholders either under the Companies Law or under the articles of association. The Companies Law sets out a number of more major decisions (e.g. amending the articles of association or winding up the company) which are to be passed by a resolution of the shareholders. Some of the specified decisions must be passed by a special resolution of the shareholders (generally, a two thirds majority of shareholders present in person or by proxy at the meeting) and others can be passed by an ordinary resolution (generally, a more than 50% majority of shareholders present in person or by proxy at the meeting). For details of those decisions which require a special resolution and those which require an ordinary resolution, please see separate note entitled "Matters under Cayman Islands law which require an Ordinary Resolution or a Special Resolution of the Shareholders".

A director may also hold an office with the company (e.g. President or Vice President). However, under Cayman Islands law, the office does not confer any particular authority. It is the position of director which confers the authority.

## ***Directors Meetings***

There is no specific requirement under the law as to the frequency with which board meetings must be held. Instead, the law requires that board meetings are held sufficiently frequently to enable the directors to fulfill their obligations to the company.

Subject to the company's articles of association, board meetings can be held over the telephone or by video conference or can be replaced by written resolutions signed by all directors. However, it is always important to obtain onshore legal advice to ensure that the method by which meetings are held or resolutions passed or the physical location of directors during a meeting, does not give rise to tax or regulatory problems.

Subject to the company's articles of association, a director can appoint a proxy or alternate to attend a board meeting in his place.

It is always important to check that any board meeting is quorate in accordance with the provisions of the company's articles of association.

Minutes of each board meeting must be prepared, signed by the Chairman and kept on the minute book.

### ***Indemnification of Directors***

It is usual for the articles of association to indemnify the directors out of the assets of the company in respect of any personal liability that they may incur in acting as a director of the company. Generally under the articles of association, a director will be indemnified for all losses other than those arising from his or her actual fraud or wilful default.

### ***Shareholders Meetings***

Again there is no specific requirement under the law as to the frequency with which shareholders meetings must be held. An annual shareholders meeting is not uncommon but is not a legal requirement unless stipulated in the articles of association. Shareholders meetings held between annual general meetings to deal with any special business are known as extraordinary general meetings.

Voting at a shareholders meeting is usually on a show of hands unless a poll is demanded in which case, votes are determined by numbers of shares held.

Proxies can be appointed for shareholders meetings.

It is always important to check that any shareholders meeting is quorate in accordance with the provisions of the company's articles of association.

Minutes of each shareholders meeting must be prepared, signed by the Chairman and kept on the minute book.

It is important to remember that most articles provide that a shareholders meeting is called by the directors and therefore the holding of board meeting would be the first step in calling any shareholders meeting.

Where the shares of an exempted company are divided into different classes, it may be necessary to hold separate class meetings in addition to a full shareholders meeting depending upon the nature of the business to be considered.

### ***Execution of Documents***

As mentioned above, generally, any document to be executed by the company must be first approved by the board at a board meeting or by written resolution signed by all directors. The articles of association will set out how a document which is to be executed as a deed must be signed and therefore the relevant provisions should always be checked before any deed is signed and the method of execution reflected in the relevant board minutes or written resolution.

### ***Winding Up***

There are extensive provisions in the Companies Law which set out the steps involved in winding up an exempted company. Those provisions are beyond the scope of this note. Expert advice should always be sought whenever a winding up is contemplated.

### ***Segregated Portfolio Companies***

The Segregated Portfolio Company (“SPC”) is a particular type of exempted company which is able to create one or more segregated portfolios or cells. A cell might be thought of as a silo or sealed compartment within the company but is not a separate legal entity in its own right.

There is no restriction on the number of cells that an SPC can create but each cell must be separately identified and include the word “Segregated Portfolio” in its name. The word “Segregated Portfolio” must always be used in full and not abbreviated e.g. “SP” would not satisfy the legal requirement.

The key feature of the SPC is that the assets and liabilities of each cell are statutorily “ring-fenced” from the assets and liabilities of all other cells of the SPC. Therefore, a creditor of one cell may only have recourse to the assets of that cell and not to the assets of any other cell. It is this ring-fencing which makes the SPC ideally suited, for example, for captive insurers with multiple programs and in particular where programs are offered to more than one insured.

Any assets of an SPC which are not held in a cell are referred to in the Companies Law as general assets and are also referred to, colloquially, as assets of “the core”. A creditor of the core may only have recourse to the assets of the core and not to the assets of any of the cells.

The Companies Law provides that if the assets of any cell are insufficient to meet in full the claim of a creditor of that cell, the creditor may, in respect of the shortfall, have recourse to the assets of the core but only to the extent that the assets of the core exceed the minimum regulatory capital specified by the Cayman Islands Monetary Authority. However, the Companies Law does permit any SPC to “opt out” of this provision by

stipulating in its articles of association that under no circumstances are the assets of the core available to meet the claims of any cell creditor.

Where any of the SPC's assets are held outside the Cayman Islands, legal advice should always be obtained in the relevant jurisdiction to ensure that the structure would be recognised and it is always desirable that all contracts and transactions entered into by the SPC are governed by Cayman Islands law and made subject to the jurisdiction of the Cayman courts.

An SPC may issue shares in respect of any cell as a means to identify the economic ownership of the cell. Alternatively, that economic ownership may be reflected not by shares but by contractual arrangements between the SPC and the economic owner. Whether the economic ownership is reflected by shares or contractual arrangements, the SPC would invariably enter into a participation agreement with the economic owner to regulate the relationship between them.

Directors of SPCs are subject to certain specific statutory duties as follows:-

1. Directors must have procedures in place to segregate, and keep separate and identifiable, cell assets from core assets and to segregate, and keep separate and identifiable, the assets of one cell from the assets of another cell. Therefore, it is important that the core and each cell has its own bank account, securities account, custody account etc. Physical segregation rather than accounting segregation is essential. Any co-mingling of assets across the cells and/or the core is likely to be a fatal blow to the integrity of the structure.
2. Directors must also have procedures in place to ensure that assets and liabilities are not transferred between cells otherwise than at full value.
3. Where any contract, deed or other document is being entered into by the SPC in respect of a particular cell, the contract etc must be signed by or on behalf of the directors and the directors must ensure that the contract etc clearly identifies the relevant cell and that the execution of the contract etc is in the name of, or by, or for the account of that cell. Any director who is in breach of this duty incurs personal liability under the contract etc unless relieved of liability by the court. The court will only relieve the director of liability if satisfied that the director ought fairly to be relieved either because he was not aware of the circumstances giving rise to his liability (and, in being not so aware was not fraudulent, reckless or negligent and did not act in bad faith) or because he expressly objected and tried to prevent the circumstances giving rise to his liability.

Whilst an SPC is an attractive option in many situations it is always important to bear in mind that there are potential shortcomings. If the directors breach any of their duties outlined above, and in particular the duty to ensure physical segregation of all pools of assets, there is the very real risk that the integrity of the structure could be compromised

and the SPC treated as a regular company without the benefit of statutory ring-fencing. It is also important to point out that SPCs do not exist in most jurisdictions and the legal effectiveness of ring-fencing specific pools of assets and liabilities within a single company has not been subject to detailed judicial scrutiny in any jurisdiction. Accordingly, there is a risk that upon such review a court may not be willing to uphold the limited liability feature of the SPC. A final point to mention is that whilst a creditor of a cell may only have recourse to the assets of that cell, there is nothing to prevent that creditor from petitioning for the winding up of the entire SPC. Therefore the actions of a creditor of a single cell could lead to the premature liquidation of the assets of all cells and the core.

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