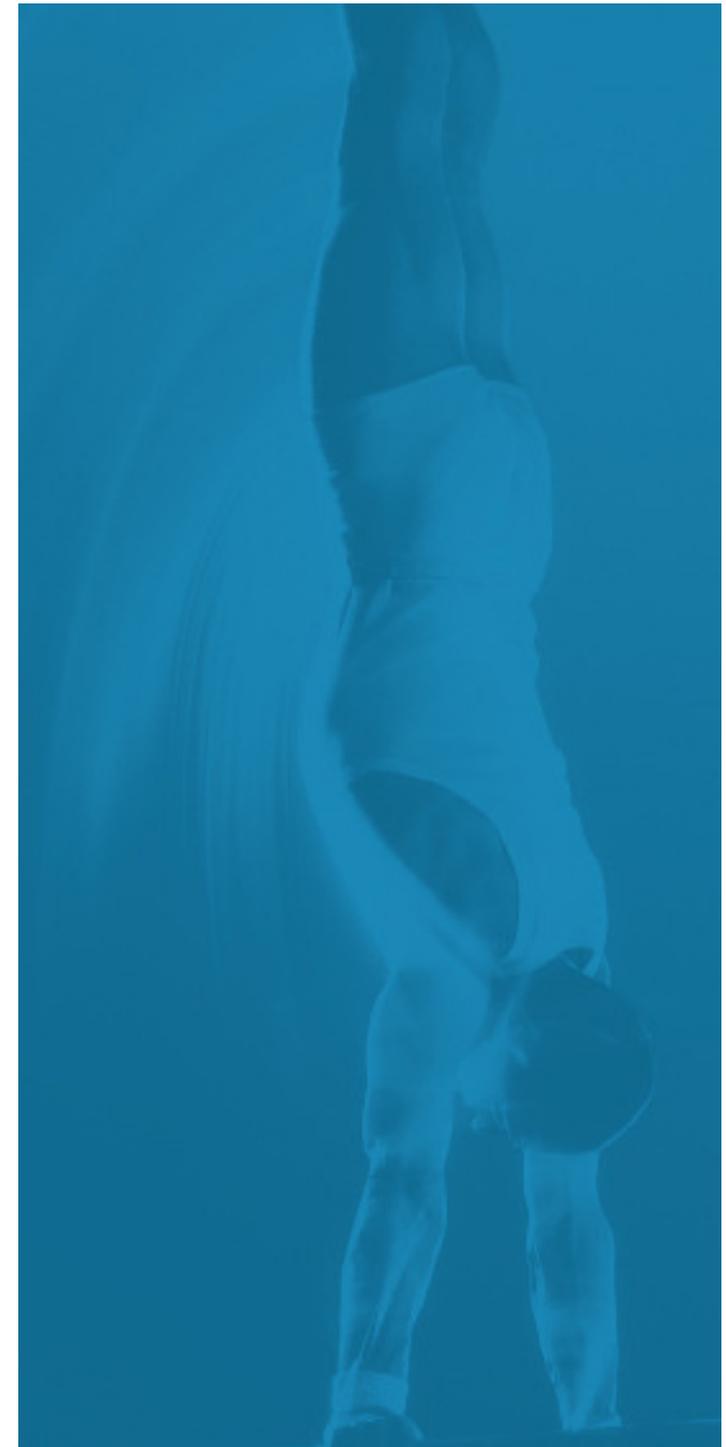




Structuring a Cayman Islands PE or VC Fund Limited Partnership

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Harney Westwood & Riegels



Harneys in Asia

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- Based in Hong Kong
- Leading offshore firm covering Cayman, BVI and Cyprus laws
- Offshore services company (Harneys Asia (Offshore) Limited)
- Deep Cayman funds experience – Asia team led by 3 partners being Cayman lawyers rated by leading directories with experience of working in the Cayman Islands
- Advise in English, Mandarin and Cantonese

Summary

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- **Introduction to Cayman**
 - Advantage Cayman
 - Closed Ended Fund Regulation in Cayman
- **Structures**
 - Nature of an Exempted Limited Partnership (*ELP*)
 - Role and liability of the General Partner (*GP*)
 - Role and liability of the Limited Partners (*LPs*)
- **The Partnership Agreement**
 - Drafting Focus – Hurdle, Information rights, Side letters, Indemnities, Default
- **Acting for Lenders – taking security**



Trust

SECTION ONE

Introduction

Advantage Cayman

- **Regulatory Environment - modern legislation with freedom of contract paramount**
- **Speed, Cost and Flexibility – excellent service providers, low establishment and maintenance fees**
- **Tax**
- **Courts, Stability and Sovereign Risk – Privy Council**
- **AML Standards**
- **Investor familiarity**

Closed Ended Fund Regulation

- Regulation of Mutual Funds
- Definition of a Mutual Fund
 - “*equity interests in company, partnership or trust, pooling of investor funds, sharing profits, interests redeemable at investor’s option*”
- Cayman Islands Monetary Authority’s definition of closed ended fund
 - “*no regular redemption date, redemptions in limited circumstances or an extensive lock-up period*”
- No regulation as a fund if closed ended



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SECTION TWO

Nature of Limited Partnership

Nature of an Exempted Limited Partnership

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- **Definition of partnership**

“ two or more persons carrying on a business in common with a view to profit...”

- **Nature of an ELP**

No separate legal entity

- Acts through GP

- Meaning and implications of “exempted”

Role and Liability of General Partner

- Holds ELP's assets on statutory trust
- Transacts business and enters into contracts on behalf of ELP with third parties
- Manages ELP assets but has power to delegate to service providers
- Duty of Care
- Unlimited liability for ELP's obligations
- One GP must satisfy residency requirements

Role and Liability of Limited Partners

- No management function
- May participate internally in investment decisions via investment committee role or generally applicable voting rights
- Other rights may include voting on changes to Partnership Agreement, removal of GP
- Liability limited to capital contributions agreed to be committed but note liability to repay distributions made when ELP insolvent and any cancellation of commitment prior to insolvency will not relieve liability – vulnerability period – 6 months
- Should not transact with third parties on behalf of ELP to avoid losing limited liability



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SECTION THREE

The Partnership Agreement

The Partnership Agreement

- **Some key issues to consider:**
 - Investment Policy
 - Investment Restrictions
 - Leverage
 - Capital Commitments
 - Management Fees and Carried Interest
 - LP Voting Rights and Advisory Committees
 - Transfers of Interests
 - Default and Indemnification
 - Termination/Exit Strategy
 - Service Providers
 - Clawback

Drafting focus – Information rights

- No Cayman requirement to prepare audited accounts of ELP if closed ended fund
- GP must keep proper books of account for 5 years from date of preparation
- LPs have right to request true and full information in respect of the business and financial condition of the LP **unless this right is excluded in the partnership agreement** – specifically set out what information LPs are entitled to and exclude any other rights

Drafting Focus – the Hurdle

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- If LPs are entitled to fixed hurdle return before carried interest is due, usual to include a GP “catch-up” clause
- Remember to draft to cover 20% of the sum of hurdle payments to LPs **plus** payments made to GP under catch-up clause, not just 20% of payments made to LPs (*See next slide for example*)

Hurdle Example

- **Example (20% Carried Interest, 8% hurdle, 1 year)**
 - US\$100M returned to LPs by way of return of contribution
 - Hurdle payments of US\$8M due to LPs
 - So in catch-up clause GP should get US\$2M being 20% of total profit (US\$8M hurdle payments and US\$2M due to GP) NOT US\$1.6M being 20% of hurdle payments made to LPs

Drafting Focus – Side Letters

- What is a side letter?
- Power to enter into side letters must be fully disclosed in Partnership Agreement and offering document
- GP’s “best interests of Partnership” obligation
- Generally acceptable – information obligations, confirmation of representations, statements of general intent as to exercise of powers
- Unacceptable – preferential treatment of individual Partner which adversely affects other Partners, for example, changes in cost sharing or indemnities
- “Most favoured nation” clause

Drafting Focus - Indemnities

- **Privity of Contract – parties not party to a contract can have no rights or obligations under that contract**
- **Implications for service providers to Partnership - covered in indemnity but cannot enforce rights under it**
- **Indemnity Letter Agreement for service provider/officer – deed poll alternative**
- **Third Party Rights Bill 2012 – change to Cayman’s privity laws proposed**

Drafting Focus – Default Provisions

- GP's overriding obligation to act in good faith in the interests of the ELP – including to pursue debt claim and remedies against defaulting LPs – Selective action possible depending on circumstances
- Partnership Agreements can include range of default provisions including forfeiture, reduction of capital accounts, etc.
- General rule against penalties – remedy should constitute “reasonable pre-estimate of the loss suffered on default” – little Cayman case law on the point - more extreme remedies may be subject to challenge by LPs
- Key considerations “*clause freely entered into, respective bargaining position of parties, commercial justification, reasonable compensation and not simply deterrent, is result “unconscionable”*”
- Reorganisation - where many investors default, or have indicated intention to default, a reorganisation of the ELP may be best option

Example – Suggested Representation

I/We represent that we agree that (i) my/our acceptance of all of the remedies applicable on any default of a Limited Partner set out in Clause [] of the Partnership Agreement is a precondition to my/our admission to the Partnership and such generally applicable terms are also required by me to protect against the consequences of default of other Limited Partners; (ii) certainty of provision of agreed funding is fundamental to the Partnership's business; and (iii) that the same remedies are reasonable in recognition of the risk and speculative damages my/our default would cause the other Partners and the difficulty or impossibility of ascertaining and quantifying the losses which the Partnership might incur as a result of any default at the time of such default.

Example - Default Provision

1.1) If a Limited Partner **fails to make any Capital Contribution** in full by its due date, the General Partner may give seven days' notice in writing requiring such Limited Partner to remedy such default by paying to the General Partner on behalf of the Partnership the amount due in full, together with Default Interest on such outstanding amount. The Default Interest shall accrue daily from the payment due date up to and including the actual date of payment. Failure by a Limited Partner to remedy such default may result in the General Partner, in its sole and absolute discretion, doing any or all of the following on behalf of the Partnership:

- 1.1.1 **commencing legal proceedings** to enforce the obligation of the Defaulting Limited Partner to pay its outstanding Capital Contribution(s), together with the Default Interest on such outstanding Capital Contribution(s) plus all costs and expenses incurred by the Partnership as a result of such default on the part of the Defaulting Limited Partner including, without limitation, costs and expenses incurred in instituting such an action and collection costs;
- 1.1.2 **cancelling** the whole or a portion of the unpaid balance of the Defaulting Limited Partner's **Capital Account**;

Example – Default Provision (continue)

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- **1.1.3 reducing the Defaulting Limited Partner’s Capital Account** balance by up to 50% of the amount contained therein as at the close of business on the date of reduction **and allocating the same among the other Partners pro rata** by reference to their respective Capital Accounts without reflecting such allocation as a Distribution (after deducting such amount as the General Partner may specify to compensate the Partnership for loss suffered by the Partnership as a result of the delay in payment); and/or
- **1.1.4 expelling the Defaulting Limited Partner** from the Partnership, forfeiting all of its existing Capital Account balance (as determined by the General Partner in its sole and absolute discretion) **and allocating the same among the other Partners pro rata** by reference their respective Capital Accounts without reflecting such allocation as a Distribution (after deducting such amount as the General Partner may specify to compensate the Partnership for loss suffered by the Partnership as a result of the delay in payment).

Example – Default Provision (continue)

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1.2) Any amount payable in addition to the Capital Contribution under Clause [] will not be reflected in the Capital Account of the Defaulting Limited Partner or as a Distribution for any purpose of this Agreement but will be reflected in the Capital Accounts of the other Partners. **Each Limited Partner irrevocably consents to the application to it of the remedies provided in this Clause [] in the event it is in default, notes that its acceptance of such terms are a precondition to admission to the Partnership, that certainty of provision of agreed funding is fundamental to the Partnership's business and agrees that the same remedies are reasonable in recognition of the risk and speculative damages its default would cause the other Partners. Each Limited Partner further agrees that the availability of such remedies does not preclude any other remedies available at law, in equity, by statute or otherwise in respect of any default by such Limited Partner in the performance of its other obligations under this Agreement.**



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SECTION FOUR

Taking security

Acting for lenders Security over Capital Calls

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- **Security over the GP's rights to make capital calls is often taken by lenders - ideally Partnership Agreement should be checked to confirm that it permits the assignment of such rights by way of security to third party lenders to avoid any arguments that such rights are personal to the GP and non-assignable**
- **Priority will be determined by common law rules, no statutory system of gaining priority**

Taking security over GP interest

- The GP potentially has unlimited liability for the ELP's liabilities (which is particularly relevant in default scenarios)
- So taking security over a GP interest may not be advisable
- Consider instead taking security over shares in GP – liability as shareholder is limited.

Drafting focus – Taking security over LP interests

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- **Section 7(7) of the ELP Law sets out priorities in relation to security interests granted over limited partner interests.**
 - Chargee must serve copies of the executed security agreements together with a notice of the security interest at the registered office of the ELP and must pay any fee specified by the LPA.
 - Security interest created must be entered into the **Register of Mortgages and Charges** of the ELP.
 - Priority is dictated by entry in the Register of Mortgages and Charges.
 - The LPA should be checked to see if the creation of security interests require consents or other steps to be taken.



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ANY QUESTIONS?

The above discussion and analysis is for general information purposes only and not intended to be relied upon for legal advice in any specific or individual situation.

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Harneys Funds Practice

- **Quality of Work** – exceed client requirements – attention to detail – commercially aware
- **Responsiveness** – both material transactional work and corporate housekeeping completed on timely basis
- **Feedback** - Looking to serve clients better – open to feedback, maintain active service dialogue
- **Fees** – tailored to meet client requirements to provide transparency and certainty

Clients' feedback

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“an attentive, proactive and commercially aware team that is able to get things done at a speed and level of quality that far exceeds your expectations.”

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