

FUND FINANCE FRIDAY

Economic Substance – Should a Lender Care? A Cayman Perspective

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There has been much written about the new economic substance legislation being introduced in a number of offshore jurisdictions. The Cayman Islands introduced the International Tax Co-Operation (Economic Substance) Law, 2018 (ES Law) in January 2019. Though regulations and guidance notes were issued in February 2019, the guidance remains subject to change. The ES Law requires certain entities incorporated or registered in the Cayman Islands and carrying on “relevant activities” to have “adequate substance” in the Cayman Islands. A high-level summary of entities that are potentially in scope of the ES Law and of “relevant activities” for the purpose of the substance test is included at the end of this article.

So, why should a lender care about economic substance? Akin to an entity failing to be in good standing, failure to comply with the requirements of the ES Law may ultimately lead to an entity being struck off the register of companies. This creates obvious consequences for an in scope debtor or pledgor entity in a financing transaction—potentially a Cayman Islands corporate borrower or pledgor that is not covered by the definition of “investment fund,” or a Cayman Islands corporate blocker vehicle (particularly in a cascading security structure where funding obligations are meant to flow through a chain of entities).

Given that a number of entities are currently out of scope of the ES Law, we do not believe that it will necessarily have a wide-ranging effect on fund finance facilities at this stage. However, we would recommend that lenders monitor compliance with the ES Law by Cayman obligors in a fund financing.

It would be prudent to: (i) ask a fund manager or general partner to confirm whether any Cayman entities in a fund financing are subject to the ES Law and, if so, how such entities are

meeting the ES Law requirements, and (ii) consider whether additional comfort should be included in transaction documents to cover off any related risks.

High-Level Summary

The ES Law applies to “relevant entities” that conduct any “relevant activity.” Such entities must establish “adequate substance” in the Cayman Islands and will be subject to administrative penalties and, ultimately, strike off for failure to comply.

What are relevant entities?

Relevant entities include (i) Cayman companies (including exempted companies and limited liability companies), (ii) limited liability partnerships, and (iii) non-Cayman companies that are registered in Cayman (which would include a foreign company that acts as a GP of a Cayman ELP (Foreign GP)), but *exclude*

(x) investment funds, and (y) entities that are tax resident outside of the Cayman Islands. Exempted limited partnerships, which continue to be the most commonly used Cayman investment fund vehicle, are currently out of scope. Limited liability partnerships are not commonly used as vehicles in this space.

While all “relevant entities” as set out above are required to declare their ES Law status in their annual filing, only those entities that are carrying on “relevant activities” are required to comply with economic substance requirements.

What are relevant activities?

There are nine relevant activities under the ES Law, the most relevant for our purposes being “holding company business” and “fund management business.”

Practical Relevance for Fund Finance Transactions

We expect Cayman corporate blocker entities or corporate vehicles that are not classified as investment funds and not otherwise tax resident outside of the Cayman Islands to be subject to the economic substance requirements. A corporate vehicle carrying on “holding company business,” which is defined as “pure equity holding business”—*i.e.*, only holding equity participations in other entities and only earning dividends and capital gains—is in scope, but is subject to a reduced economic substance test. In practice, this should be met by its ongoing compliance with existing statutory obligations. Compliance by other corporate vehicles should, however, be initially assessed and all corporate vehicles should be monitored on an ongoing basis for continued compliance with the ES Law.

A foreign corporate GP registered in the Cayman Islands would be considered a “relevant entity” but would not likely be carrying out a “relevant activity” such as “fund management business” (except in unusual situations). As such, while it would need to declare its status in its annual filing, it would not be required to actually comply with economic substance requirements.