

# International Securitization & Finance Report

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## Lands of Opportunity - Why Cayman and Delaware Entities Rule in Structured Finance

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In recent years, both the Cayman Islands and Delaware have enjoyed steady increases in the number and sophistication of securitization transactions involving entities formed under their laws, due largely to their modern, flexible and business-friendly legal environments. Delaware has long been a favored domicile in US domestic transactions. Similarly, the Caymans have become a preferred jurisdiction for offshore securitizations. This article briefly examines some of the key characteristics of the entities most commonly used in each jurisdiction for structured finance and securitization deals.

A securitization transaction converts a pool of income-producing assets into marketable securities, such as notes, bonds or preference shares. In the simplest form of transaction, a special purpose, bankruptcy-remote issuer ("SPE") is formed to purchase receivables, corporate bonds, loan participations or other assets, which may include derivatives, the cash flow from which funds payments on the securities. The assets are generally pledged as collateral. Collateralized debt obligations ("CDOs") are a securitization structure in which sequential tranches of senior and subordinated debt are backed by a managed pool of underlying assets and/or derivatives.

A number of factors drive the situs decision for the issuer. The most attractive domiciles offer a variety of entity forms adaptable to the needs of a particular deal, predictable legal outcomes and favorable tax treatment. Rating agencies generally require that the issuer and any SPE parent are insulated from the risk of substantive consolidation in the event of an affiliates' bankruptcy or insolvency. Finally, the parties seek high-quality, sophisticated local service providers to establish and manage the SPE. As discussed below, both Delaware and the

Cayman Islands have successfully capitalized on the needs of the marketplace and become the optimal location for SPEs.

### Delaware

Delaware's reputation as a preeminent jurisdiction for entity formation is well-deserved. Delaware alternative entities are popular for structured finance and securitization transactions, largely because of Delaware's policy to promote flexibility and freedom of contract, ensuring that Delaware entities can be adapted to a myriad of transactions. Rating agencies are familiar with Delaware entity laws and the legal opinions that Delaware lawyers can issue. Moreover, Delaware entity laws are continually updated to ensure that the legislation remains state-of-the-art and that market concerns (including rating agency concerns) are addressed as they develop.

Delaware is also appealing because it does not aggressively tax non-Delaware source income. Alternative entity statutes piggyback on federal tax rules, thus ensuring that the Delaware tax treatment will yield no surprises. Most alternative entities can issue interests without requiring a capital contribution.

The Delaware judiciary, particularly the Court of Chancery (a business and equity court), is well respected for its sophistication. A U.S. Chamber of Commerce annual poll of judges and lawyers has ranked Delaware courts as the best and fairest in the country for five consecutive years. In addition, the Delaware Division of Corporations (the "Division") strives to remain technologically advanced and customer-service oriented, offering expedited processing within hours.

A summary of the features and benefits of the Delaware entities most commonly-used in securitizations follows:

## *Delaware Statutory Trust*

Delaware statutory trusts (“DSTs”) are often used as issuers in securitization transactions. A DST is created pursuant to the Delaware Statutory Trust Act, 12 Del. C. 3801 et seq. (the “DST Act”). The DST Act (originally, the Delaware Business Trust Act) was drafted to ensure predictability of treatment and separate legal existence of issuers in deals previously using Delaware common law trusts. The DST Act acknowledges that a statutory trust need not conduct active business, thus ensuring that a passive trust nonetheless has entity status. Accordingly, a DST has the power to contract in its own right and to sue and be sued in its own name, and assets can be titled in the trust’s name.

A DST is formed pursuant to a governing instrument by filing with the Division a certificate of trust signed by all trustees. The governing instrument may be entitled “declaration of trust,” or “trust agreement,” or may be composed of several instruments (including bylaws) providing for the creation, governance and/or operation of the trust. The governing instrument is not publicly filed, so the only data of record is the name of the DST and the name and address of a Delaware resident trustee. Every DST (other than an investment company registered under federal securities laws) must have at least one trustee that is an individual residing in Delaware or an entity with its principal place of business in Delaware. A trustee that is not a natural person must also have appropriate trust powers. The Delaware trustee may actively manage the business and affairs of the trust, or may be a passive trustee, with management performed by an agent or a co-trustee. The DST Act confirms that a non-Delaware entity serving as a trustee of a DST need not qualify to do business in Delaware.

The DST Act permits a broad spectrum of protections and control mechanisms in a governing instrument. Many of the DST Act’s provisions may be varied by contract, so the parties may arrange rights, priorities and obligations as appropriate within the boundaries of public policy. In the absence of an applicable provision in the DST Act or the governing instrument of a DST, general trust law serves as a “gap filler.”

While management authority is vested in the trustee(s), a DST offers much greater governance flexibility than a common law trust. The governing instrument may authorize a beneficiary or other person to direct the trustee in management without becoming a de facto trustee or assuming liability to the trust or its beneficiaries. Finally, a trustee may delegate its authority to manage the business and affairs of the trust, by agreement or otherwise.

Neither beneficial owners nor trustees have personal liability for the obligations of the DST unless so specified in the governing instrument. While the DST Act does not adopt a standard of care for trustees or others

managing the business and affairs of the trust, the Act exculpates a trustee or agent acting in good faith in reliance upon the terms of the governing instrument. Additionally, the DST Act permits the governing instrument to expand, restrict or eliminate the duties (including fiduciary duties) and liabilities of trustees and agents (except the implied duty of good faith and fair dealing) and acknowledges a DST’s power to indemnify in accordance with the governing instrument.

The DST Act also permits a governing instrument to vary the rights and obligations of trustees and beneficiaries by class or series. A DST may segregate and protect assets associated with a series from the liabilities associated with other series or the trust generally. In order to insulate assets and related income from interseries liabilities, a DST’s certificate of trust must contain specific disclosure language. The assets associated with each series must be held and accounted for separately from other property of the trust, with separate and distinct records being maintained for each such series. The DST Act provides little guidance on implementing these requirements, other than acknowledging that series assets may be held directly or indirectly through a nominee. The DST Act contains verbiage tailored to registered investment companies, to ensure that they comply with applicable law. The series provisions can ensure that, with proper structuring, the cash flow generated by a pool of income-producing assets remains dedicated to the obligations intended to be paid from that source.

From a tax-planning perspective, the classification for federal tax purposes controls the treatment of the DST for state and local tax purposes. Accordingly, the parties structuring a transaction can determine whether the DST should be taxed as a corporation, a partnership or a trust (including a grantor trust) in reliance upon the advice of their U.S. federal tax advisor without concern about inconsistent state tax treatment. Delaware provides an income tax deduction to resident trusts for accumulated income to be distributed in future years to non-resident beneficiaries.

Various provisions of the DST Act support use of a DST as a bankruptcy-remote SPE. By adopting perpetual life as the default term, the DST Act eliminates concerns about the “rule against perpetuities,” which required complicated drafting to avoid the trust’s invalidation under common law principles. In addition, under the DST Act, no person may cause the termination or revocation of a DST in violation of the governing instrument, and the creditors of beneficial owners or trustees (in their individual capacities) have no recourse to the assets of the DST for claims unrelated to the trust. The death, incapacity, dissolution, termination or bankruptcy of a beneficial owner does not cause the dissolu-

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tion or termination of the DST. Because the trustee is generally unrelated to the sponsor and its affiliates, eliminating control by the sponsor or its affiliates helps a nonconsolidation analysis. Finally, while a “business trust” is an eligible debtor under federal bankruptcy law, a DST not actively conducting a trade or business may not satisfy the definition of a “business trust” under federal law, thus further insulating the DST from bankruptcy risk

## *Limited Liability Company*

The Delaware limited liability company (“DLLC”) offers limited liability and unparalleled structuring flexibility. Like the DST Act, the Delaware Limited Liability Company Act (“LLC Act”) provides default rules applicable when the LLC agreement is silent, but permits the parties to contractually alter most standards applicable to the DLLC’s internal affairs. The agreement binds the DLLC, even if it is not a party.

A DLLC is formed by filing a certificate of formation with the Division and adoption of an LLC agreement. The public filing must include only the name of the DLLC and the name and address of its agent for service of process. The LLC agreement is not filed, ensuring that deal terms can be easily altered and that the terms of nonpublic deals remain private.

Management and operational matters are determined by the LLC agreement. There are no eligibility limits for members (i.e., owners) of DLLCs, except by contract. No members, managers, place of business or records need be in Delaware.

Unless the LLC agreement states otherwise, a DLLC is managed by its members in proportion to their interests in profits. However, members may delegate some or all of their authority to one or more managers. The parties must contractually address the authority of the managers, including the manner of exercising such powers. A manager has the power to delegate its authority to agents, officers and employees, as permitted by the agreement. No member, manager or agent has liability for DLLC debts or obligations, unless otherwise agreed. Similarly, members, managers and agents are protected for good faith reliance on the LLC agreement. The agreement may expand, restrict or eliminate common law duties (including fiduciary duties) other than the implied duty of good faith and fair dealing. DLLCs also have broad inherent indemnity powers, subject to the LLC agreement terms.

A DLLC may have separate series of members, managers or interests, and may limit interseries liabilities similarly to a DST provided that notice of this limitation is disclosed in the certificate of formation, separate and distinct records are maintained and the assets are segregated.

For Delaware tax purposes, a DLLC is treated as a partnership unless it is regarded differently for federal

income tax purposes, in which case the federal classification controls. U.S. federal law currently taxes a DLLC as a partnership, unless the DLLC elects corporate tax treatment. Partnership tax treatment results in items of income, gain, deduction, credit and loss being passed through to the members. The State of Delaware imposes nominal annual fees on DLLCs.

Several unique features of the Delaware LLC Act afford comfort to rating agencies that the DLLC will withstand attack by creditors of other parties. A judgment creditor of a member cannot execute upon the member’s interest in a DLLC. A member’s creditor can only obtain a charging order, which entitles the creditor to distributions to which the member would have been entitled in respect of its interest. The creditor cannot compel a distribution or exercise remedies with respect to the assets of the DLLC.

The LLC Act’s dissolution provisions preserve the integrity of the deal structure should an affiliate suffer a disabling event. A DLLC has perpetual existence unless the LLC agreement provides otherwise. In addition, unless otherwise agreed, the death, incapacity, dissolution, bankruptcy or termination of a member does not dissolve the DLLC, unless it terminates the membership of the last remaining member. The parties can draft to prevent or cure the unintended dissolution of a DLLC, leading to the evolution of several rating agency-approved drafting approaches providing for the automatic admission of a member.

U.S. federal law rather than state law controls which entities are eligible for bankruptcy protection. An LLC agreement can provide that a bankrupt or insolvent member is not disqualified from membership. DLLCs used in structured finance transactions are typically structured with one or more independent managers, whose participation is required in order for the entity to voluntarily seek bankruptcy protection or implement certain other changes to the DLLC or LLC agreement. This mechanism has been upheld and enforced in the few litigated cases involving such provisions.

## **The Cayman Islands**

Cayman Islands law is based on English common law; as a result it is appealing not just to U.S., U.K. and Canadian parties, but also more broadly due to the general acceptability of English common law in international business transactions. Additionally, the Cayman Islands has developed an overlay of progressive, business-friendly statutes resolving problematic features of English common law. For instance, the law concerning directors’ responsibilities and corporate capacity is analogous to English common law, but restrictions on share capital, particularly regarding the return of capital, have been substantially relaxed.

The Cayman Islands is tax neutral (there is no income tax, capital gains tax or corporation tax). Further-

more, to ensure that Cayman Islands entities, once established, will remain free from taxation the Cayman Islands government will issue a tax exemption certificate guaranteeing freedom from taxation for a period normally exceeding the life of the transaction (see below as to details). Likewise, there are no foreign exchange controls and there is no particular form required for financial statements, so parties may choose the most appropriate accounting standards.

The Cayman Islands are a creditor friendly jurisdiction. There is no equivalent to U.S. bankruptcy protection, reorganization, or administrative receivership. Cayman Islands insolvency proceedings do not interfere with the rights of secured creditors. Rights of contractual subordination, contractual netting and set off are statutorily confirmed, both prior to and after insolvency, ensuring that the ranking of senior and junior debt and the integrity of payment waterfalls will be enforced.

Rating agencies are comfortable with Cayman Islands entities and the required associated legal opinions. Standard & Poor's has published structured finance criteria for Cayman Islands special-purpose entities. An added attraction is the Cayman Islands Stock Exchange ("CSX") with streamlined rules for listing CDOs and exempted company preference shares. Since the U.K. Board of Inland Revenue granted the CSX status as a "recognized stock exchange," companies with securities listed on the CSX can pay interest on their securities without deduction of U.K. tax pursuant to the "Eurobond Exemption."

Below is a summary of the benefits and characteristics of commonly-used Cayman entity forms:

### *Cayman Islands Exempted Company*

The Cayman Islands exempted company is a corporate entity that generally serves as the issuer in a securitization. An exempted company can be established under the Companies Law within one working day by filing memorandum and articles of association with the Registrar of Companies. No statutory minimum capital is required. The register of shareholders need not be held in the Cayman Islands, although doing so avoids the risk that the jurisdiction in which the register is maintained will interfere with the rights or priorities of shareholders.

Proper structuring ensures that the SPE issuer's assets and liabilities are excluded from the originator's balance sheet. The traditional method is for the SPE issuer's shares to be held by a Cayman Islands trustee under a charitable trust. Alternately, to provide greater structuring flexibility, Cayman Islands law has developed a unique vehicle known as a "STAR Trust," which permits use of residual profit for the benefit of noteholders while ensuring off-balance sheet treatment.

Experienced company managers or corporate administrators are available in the Cayman Islands to provide independent directors to ensure that SPEs are independently managed and controlled from the Cayman Islands. This helps preserve the integrity of the structure and ensure that the SPE is not consolidated with the originator.

A tax-transparent SPE known as an exempted limited duration company may be created. Two of its defining characteristics are that it is required to have at least two members and its duration is limited to a maximum of 30 years. An exempted limited duration company qualifies for pass-through treatment for U.S. tax purposes.

Typically, the exempted company applies for and secures an undertaking from the Cayman Islands Government that it will remain exempt from income tax, capital gains tax or corporation tax for a period of 20 years (with a possible 10-year extension). Although the Cayman Islands imposes stamp duty, duties can be avoided by keeping the original documentation outside the Cayman Islands. Even where stamp duty applies, for instance, when original documentation is brought to or executed within the Cayman Islands, it is normally capped at relatively low levels.

Exempted companies are popular in CDO transactions due to favorable provisions of the Companies Law. Following an FASB ruling denying off-balance sheet treatment where the junior tranche is a debt instrument, parties began structuring CDO issuers as exempted companies issuing redeemable preference shares as the junior tranche. These subordinated preference shares have traditional equity features, but are redeemable from capital, provided the company is solvent. However, two recent European initiatives, the Prospectus Directive and the Transparency Directive which place additional burden on issuers of preference shares, may cause the reversal of this trend in Europe.

### *Cayman Islands Limited Partnership*

A Cayman limited partnership is another tax-transparent issuer sometimes used as an alternative to an exempted limited duration company, for instance, where the applicable tax laws of another jurisdiction do not recognize or afford the desired treatment to a limited duration company. A limited partnership is constituted by agreement between one or more general partners (with unlimited liability for the obligations of the limited partnership) and one or more limited partners (with limited liability). Limited partnerships may be either a limited partnership registered pursuant to the Partnership Law ("CLP") or an exempted limited partnership registered pursuant to the Exempted Limited Partnership Law ("ELP"). Certain factors influence which is preferable in a particular transaction. Examples follow. If the partnership will be tax resident in the U.K., the

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Inland Revenue has recognized a CLP as qualifying for tax transparent treatment, but the treatment of an ELP is less clear. However, an ELP may apply to the Cayman Islands Government for an undertaking that it will remain free of income tax, capital gains tax or corporation tax for a 50-year period. Also, a limited partner in an ELP may play a greater role in managing the ELP than its counterpart in a CLP. Finally, while return of capital is permitted in a solvent ELP not rendered insolvent as a result of the payment, a limited partner in a CLP may not draw or receive return of any part of his contribution during the life of the partnership.

A limited partnership, whether a CLP or an ELP, is managed exclusively by the general partner. The general partner is typically a corporate vehicle specially formed for the purpose of acting as general partner, such as a Cayman Island exempted company or a foreign limited liability entity registered in the Cayman Islands.

## *The Cayman Islands Exempted Trust*

A Cayman Islands exempted trust is advantageous where investors and the originator will have an interest in the asset pool. Notably, a Cayman Islands trust is not a separate legal entity; consequently, all documentation is executed by the trustee, in its capacity as trustee for the trust. To deny noteholders and other involved parties recourse to the trustee's assets, the documentation must contain language limiting recourse for trust obligations to the assets of the trust.

To form an exempted trust, the trustee, generally a Cayman Islands corporate trustee licensed pursuant to the Banks and Trust Companies Law, executes a trust deed, declaring a trust over certain assets in favor of the unit holders. The resulting "unit trust" then becomes an exempted trust by registering with the Registrar of Trusts. An exempted trust, like an exempted limited partnership, may apply to the Cayman Islands Government for an undertaking that it will remain free of income tax, capital gains tax or corporation tax for a 50-year period.

## **Conclusion**

The foregoing factors make Delaware and Cayman Islands entities superior choices in structured finance and securitization transactions. As long as they continue to remain on the cutting edge, improving and innovating their entity laws, these jurisdictions will continue to predominate in the jurisdictional competition for structured finance transactions. □

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