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Cayman LLC - A New Form of Overseas Private Equity Fund

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The Cayman Islands (the "**Caymans**"), one of the world's premier offshore financial centers, has long been attractive to investors due to its tax incentives, mature legal system, and corporate secrecy, and has become one of the most popular places for establishing international private equity funds. The *2016 Limited Liability Companies Law* ("**Cayman LLC Law**") [1], effective on July 8, 2016, provides for a new alternative entity form for organizing Cayman funds-the limited liability company ("**Cayman LLC**")[2]-in addition to the exempted company, exempted limited partnership ("**Cayman ELP**"), and unit trust. In the past two years, an increasing number of Cayman LLCs have come into public view.

A highlight of the Cayman LLC is that it adopts features of the Cayman exempted company to be recognized as an independent legal person and to afford limited liability protection to its members. In addition, the Cayman LLC adopts corporate governance and profit and loss sharing mechanisms by reference to the Cayman ELP, which provides for more flexibility than the Cayman exempted company. The Cayman LLC is derived from the U.S. Delaware limited liability company ("**Delaware LLC**") and has been modified based on the existing Cayman legal system.

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[1] The 2016 Limited Liability Companies Law, as amended from time to time.

[2] It should be noted that Delaware LLCs and limited liability companies under PRC law are significantly different, particularly with respect to taxation. Under U.S. federal tax law, a Delaware LLC that has two or more members is by default regarded as a partnership (and thus is not required to pay federal income taxes at the entity level), a Delaware LLC with only a single member is considered disregarded as an entity separate from its member (a "disregarded entity," which is also not subject to entity-level taxation). For Cayman entities, U.S. federal tax law by default deems Cayman LLCs and exempted companies to be corporations and Cayman ELPs to be partnerships. Entities that are not deemed "per se corporations" (e.g., a PRC company limited by shares) may elect to be treated as either a corporation or a partnership by filing Form 8832 to make a so-called "check-the-box" election. Thus, Delaware LLCs and the Cayman entities we discuss in this article can elect either partnership or corporate treatment under U.S. tax law, depending on the interests and objectives of the investors involved.

This article focuses on the main features, advantages and practical applications of the Cayman LLC, and compares the Cayman LLC with the Delaware LLC and Cayman ELP in order to provide readers with an overview of the Cayman LLC's characteristics and practical applications.

I. The main features Cayman LLCs and the advantages

i. Independent legal personality

Unlike the Cayman ELP, the Cayman LLC has legal personality, which is the same as the Cayman exempted company and the Delaware LLC. The Cayman LLC Law clearly specifies that a Cayman LLC is to be regarded as a body corporate with legal personality that is independent of its members. Similarly, the Delaware Limited Liability Company Act ("**Delaware LLC Act**") expressly provides that Delaware LLCs are regarded as separate legal entities.

ii. Limited liability protection and statutory obligation to return distributions

1. Limited liability protection

Cayman LLC and Delaware LLC members by default have limited liability, although other arrangements can be made in the LLC Agreement (i.e., the LLC organization document).[3] Pursuant to the Cayman LLC Law, Cayman LLC members are not required to individually assume any debt, obligation or liability of the Cayman LLC, unless otherwise agreed in the LLC Agreement or other agreements. The contributions of Cayman LLC members need not exceed their capital commitments as provided in the LLC Agreement or other agreements. Similar provisions can be found in the Delaware LLC Act. However, according to the *Exempted Limited Partnership Law (2018 Revision)* ("**Cayman ELP Law**"),[4] the general partner of a Cayman ELP is subject to unlimited liability for a Cayman ELP's debts and obligations, which cannot be excluded by agreement. Limited partners that do not actively participate in the operation of the Cayman ELP only assume limited liability for the Cayman ELP's debts and liabilities, unless otherwise stipulated in the partnership agreement or with respect to the return of distributions in accordance with the Cayman ELP Law (see below for the details).[5]

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[3] Limited Liability Company Agreement, also known as the Operating Agreement. It should be noted that the Delaware LLC Act does not obligate the Delaware LLC to have a written LLC agreement.

[4] Exempted Limited Partnership Law (2018 Revision), as revised from time to time.

[5] According to the Cayman ELP Law, if a limited partner was actively involved in Cayman ELP's operations when the Cayman ELP became insolvent, the limited partner may be subject to unlimited liability with respect to transaction counterparties who knew of the limited partner's participation in the business operations and believed that the limited partner was a general partner with respect to the debts and obligations that the company incurred during the limited partner's active participation in the operation of the company.

2. **Statutory obligation to return distributions**

Limited liability does not apply to the statutory obligation of members to return distributions, and this obligation applies to Cayman LLCs, Delaware LLCs and Cayman ELPs. Specifically, in a Cayman LLC or Cayman ELP, the members' statutory obligation to return distributions is triggered if the company is insolvent (including where the insolvency is caused by the distribution or a release from obligations) at the time when the members have received distributions or are exempt from certain obligations. With respect to Delaware LLCs, the statutory obligation to return distributions is triggered if the LLC's outside obligations exceed the fair value of the company's assets following a distribution to its member (which do not include the obligations of LLC members with respect to their LLC interests or the rights of creditors to specific assets of the LLC).

For all three types of entities, an investor must have been aware of the entity's insolvency in order to be subject to a distribution return obligation. Merely the fact that the enterprise became insolvent does not necessarily trigger a distribution return obligation, which indicates that all three types of entities provide substantial protections to investors. The largest difference among these three entities is the time period within which an investor may be subject to a distribution return obligation. Specifically, there is no time limit for Cayman LLCs, which means that the company may require its members to return distributions at any time. For Delaware LLCs, the time limit is three years after the corresponding distribution is made, unless otherwise required by the LLC Agreement. For Cayman ELPs, the time limit is six months after the corresponding distribution is made. In practice, most mature funds will further clearly stipulate about the investors' obligations to return distributions in their organizational documents, but in no way should such provisions exclude the statutory distribution return obligation.

iii. Easy registration process

First, compared to the Cayman ELP, a key advantage of the Cayman LLC is that its establishment only requires the registration of one Cayman entity, while the establishment of a Cayman ELP necessarily requires the registration of not only a Cayman ELP entity, but also at least one local entity in the Caymans to act as a general partner (which may be a foreign company or a foreign partnership in accordance with Cayman law). The Cayman LLC and Delaware LLC have no requirements for residency of their members, which means all Cayman LLC and Delaware LLC members can be investors either registered or residing outside of the Caymans.

Second, compared to the Delaware LLC, Cayman LLCs are subject to simpler registration procedures, with the process being quite similar to that of the Cayman ELP. Specifically, one only needs to submit a registration statement containing basic information to the Cayman LLC Registry to register a Cayman LLC and pay the required filing fee. No LLC agreement is required to be submitted as part of the registration process, and the registration statement itself may be used as the LLC agreement if so agreed by the members. Both Cayman LLCs and Cayman ELPs are required to have a registered office in the Caymans, but need not designate a registered agent responsible for receiving documents. Delaware LLCs, however, must designate a registered agent for receiving the official and legal documents.

iv. Flexible corporate governance

As mentioned above, the Cayman ELP is managed by a GP, and LPs are not allowed to actively participate in business operations as a condition to having limited liability. The Cayman LLC is very different in this respect. Both Cayman LLC and Delaware LLC members can freely select the management structure that they find most appropriate. The LLC may be managed by one or more members, by one or more managers elected from outside the members or by a management team that comprises both. Members who serve as managers are still be entitled to limited liability despite their management duties. Thus, managers are not required to assume any debt, obligations or liabilities of the LLC in their own name, unless otherwise agreed in the LLC Agreement. In addition, both LLC managers in Cayman and Delaware are entitled to statutory indemnification for their management services unless otherwise agreed in the LLC Agreement.

In terms of management rights, the management of a Cayman LLC shall be vested in its members acting by a majority in number, unless otherwise stipulated in the LLC Agreement. By default, members holding a majority of the profits interests of a Delaware LLC have decision-making authority.

v. Minimum duty of good faith

One of the issues that most influences the choice of fund entity are the fiduciary duties and duty of good faith imposed on managers. The Cayman ELP, Cayman LLC and Delaware LLC all have different statutory requirements in this regard.

1. Cayman ELP

According to the Cayman ELP Law, the GP of a Cayman ELP is obligated to act in good faith with respect to the Cayman ELP, and is required to act in the interests of the Cayman ELP unless as otherwise expressly provided in the partnership agreement.

2. Cayman LLC

According to the Cayman LLC Law, a manager is only obligated to act in good faith, unless the LLC Agreement otherwise stipulates. This duty of good faith can be limited but cannot be excluded by the LLC Agreement. Managers do not have any other legal obligations to a Cayman LLC, such as fiduciary duties, etc.

3. Delaware LLC

Under the Delaware LLC Act, the managers or members have obligations to the Delaware LLC and to other managers and members, including fiduciary duties. Except for the implied contractual covenant of good faith and fair dealing, the LLC Agreement can limit or exclude the obligations of the managers or members. [6]

In summary, all three entity types may limit the obligations of managers through a partnership agreement or an LLC agreement, but managers are subject to a duty of good faith under the applicable laws.

vi. Flexible equity ownership and capital contribution and distribution methods

One of the biggest highlights of LLCs is that they allow the management of the company to be governed to the maximum extent by its organization documents (i.e., the LLC Agreement). Both the Cayman LLC and the Delaware LLC allow members to freely decide on various matters, including capital contributions, voting rights and distributions, while also ensuring the limited liability of each member and maintaining the independent legal personality of the LLC. For example, members of LLCs are required to pay contributions only in accordance with the LLC agreement. Pursuant to the LLC agreement, such contributions may be made in the form of cash, property or other assets, and in the form of services (e.g., contributions of labor). Cayman LLCs may establish capital accounts for members, share profits and losses and make distributions according to the LLC agreement rather than based upon proportionate ownership. Such distributions are not subject to “same shares, same rights” restrictions. Cayman LLC ownership interests can be divided into different classes, with each class carrying different economic benefits and management rights.

vii. Advantageous tax preference

The Cayman islands are a tax neutral jurisdiction, which creates special advantages for Cayman entities, including Cayman LLCs and Cayman ELPs. The Caymans do not currently levy taxes on the profits, income or gains of Cayman LLCs or their members, which is the same for Cayman ELPs. The Cabinet may on application give Cayman LLCs

[6] Black’s Law Dictionary：implied contractual covenant of good faith and fair dealing refers to an implied covenant to cooperate with the other party to an agreement so that both parties may obtain the full benefits of the agreement; an implied covenant to refrain from any act that would injure a contracting party’s right to receive the benefit of the contract.

a tax undertaking certificate that will exempt the Cayman LLC from income and inheritances taxes for a period of up to 50 years should the Caymans enact legislation that would otherwise impose taxes on the Cayman LLC.

II. Advantages of forming private equity funds using the Cayman LLC form

The Cayman LLC combines the features and advantages of the Cayman exempt company and the Cayman ELP, and it has similarities with the Delaware LLC, which is familiar with private equity industry insiders and brings certain unique advantages for the formation of private equity funds:

i. Limited liability protection and independent form, flexible internal governance and assignment of rights and interests

As mentioned above, the Cayman LLC is similar to the Delaware LLC in that it integrates the flexibility of a Cayman ELP while retaining the legal personality and limited liability of a Cayman exempt company. The LLC agreement, like a Cayman ELP partnership agreement, can be used to freely agree upon almost all Cayman LLC internal governance mechanisms and the assignment of rights and interests. Cayman LLCs can set up capital accounts for members and can flexibly agree on investment obligations, income distributions, loss sharing and accounting mechanisms without the restriction of affording the same rights to the same shares in the case of the Cayman exempt company. These features are quite important for fund entities, especially for common tax distributions (that is, making distributions to individual investors to meet their tax obligations).

ii. Managers need only to act in good faith and are not required to undertake burdensome fiduciary duties

As stated earlier, unless the LLC agreement stipulates otherwise, a Cayman LLC manager is required only to undertake a minimum duty of good faith. This advantage is particularly reflected in the case of an LLC manager that manages multiple funds. For many large institutions, the more funds they manage, the greater possibility of conflicts of interest may occur, which will place increasing pressure on fund managers to undertake fiduciary and due diligence duties. With a Cayman LLC, the fund manager can agree on its obligations and those of the fund on the basis of a minimum statutory duty of good faith, which will bring convenience to the operation of the fund.

iii. Convenient formation of onshore-offshore fund structures

The Cayman LLC is, to a large extent, a new type of entity form that the Cayman authorities have provided in response to market demand, with much of that demand deriving from the requirement of U.S. fund managers that the interests of both onshore and offshore investors be as consistent as possible. In view of the wide adoption of the LLC form in the United States (particularly Delaware LLCs), the similarities between the Cayman LLC and the Delaware LLC have greatly facilitated the design of onshore-offshore fund structures by U.S. fund managers to ensure that the obligations of both onshore and offshore investors may be substantively uniform. The use of similar structures can simplify the relevant documents and reduce drafting and review costs.

III. Applications for Cayman LLCs

Due to the advantages of the Cayman LLC, it has become widely used in the establishment of funds and has been welcomed particularly by U.S. fund managers.

Based on data published by the Cayman Islands Government General Registry, 1,073 Cayman LLCs have been formed since their introduction until the end of February 2018. While it is difficult to say how many of these Cayman LLCs are fund entities, we believe that both private equity funds and mutual funds have considered utilizing the Cayman LLC form and that Cayman LLCs will continue to be established. In addition to be used as fund entities, Cayman LLCs have increasingly been accepted as entities of conventional fund general partners and fund managers.

The Cayman LLC presents a number of advantages in theory as a vehicle for private equity and mutual funds, although it has not yet become widely adopted due to the limited time since its introduction to the market. Clearly, the Cayman LLC still requires a certain amount of time for acceptance by the industry, but longer term many of its advantages may attract more fund managers to form Cayman LLCs.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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