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Legal Insights

Preference shares and redemption rights in the Cayman Islands – an overview

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Background

It has become increasingly popular in recent years for venture capital (VC) and private equity (PE) firms to set up exempted companies limited by shares in the Cayman Islands for the purposes of pre-IPO equity financing rounds.

Why the Cayman Islands?

Other than offering a tax neutral jurisdiction for international investors, the Cayman Islands benefit from financial and political stability, a business-friendly regulatory environment, a sophisticated legal regime based on English common law with a respected court system and a pool of highly-skilled professional service providers; all of these factors combine to make it a jurisdiction of distinction for equity financing.

A quick word on exempted companies in the Cayman Islands

The flexibility of Cayman Islands exempted companies is certainly one of their main appeal. For example, Cayman Islands' corporate law does not require any director or officer of the exempted company to be resident in the Cayman Islands. An exempted company which is not regulated is not required by statutory law to hold an annual general meeting of its shareholders. Equally, there is no statutory requirement for a non-regulated exempted company to undertake an annual audit. More on the advantages of using Cayman Islands exempted companies for investment purposes here: [Advantages of Using Cayman Islands Exempted Companies for Investment Purposes and to... - Loeb Smith](#)

Exit strategies

Whilst investors in PE and VC investment companies would ordinarily look to realise their investment within 3-6 years, these exit strategies have been severely impacted in recent years by macro-economic factors and geopolitical developments, which have made it increasingly difficult for investors to exit their investment. In this economic landscape, investors may have to explore less traditional routes to exiting their investment. In this article, we seek to provide some insight on how investors can navigate the not-so-unconventional waters of exit enforcement when issued with preference shares in a Cayman Islands exempted company.

Preference shares provisions

In usual circumstances, the memorandum and articles of association of the exempted company as well as the subscription and shareholders' agreements are drafted to include various investor protection provisions such as preference dividend rights, liquidity preference rights, exit rights on the occurrence of certain events, and rights to redeem preference shares in the event that anticipated trigger events for an exit do not materialize.

Share rights limitations

Investors in Cayman Islands exempted companies ought to be aware that under Cayman Islands law, dividends can only be paid out of available profits or from the company's share premium account, however, in the latter case, such payment can only be made if immediately following the date on which the distribution or dividend is proposed to be paid, the company is able to pay its debts as they fall due in the ordinary course of business. More on dividends and on what constitutes profits here: [Payment of dividends by a Cayman Islands company and what constitutes "profits" - Loeb Smith](#)

Similarly, it should be noted that the Cayman Islands' Companies Act (As Revised) prescribes that share redemptions and share buybacks can generally only be funded out of profits, out of a company's share premium account or out of the proceeds of a fresh issue of shares. However, in limited circumstances, a company can make a payment out of capital provided that immediately following the date on which the payment out of capital is proposed to be made, the company is able to pay its debts as they fall due in the ordinary course of business.

Interestingly, in what is a leading authority on the matter, the Cayman Islands Court of Appeal has held that the cash flow test of solvency mentioned above is not confined to consideration of debts that are immediately due and payable, but also permits consideration of debts that will become due and payable in the reasonably near future.

The provisions on distribution of the company's assets on a winding up or a liquidation under Cayman Islands law are also drafted so as to prioritise creditors over shareholders, and within this group, in particular, preferential and secured creditors. The law of voidable preference which is written into the Companies Act may also be invoked in the event the directors of the exempted company had paid a particular shareholder or a redeemed shareholder ahead of other creditors at a time when the company was unable to pay its debts with a view to giving such redeemed shareholder a preference over the creditors. In such circumstances, such transactions would be voidable upon the application of the company's liquidator if made within six (6) months of the commencement of the company's liquidation.

Directors' duties

Against this backdrop of limitations on dividends, redemptions and distributions are directors' fiduciary duties. The duties of directors of a Cayman Islands exempted company are found in the common law and include, amongst others, the duty to act in good faith in the best interest of the company. It is important to note that whilst in many circumstances the best interest of the company align with the best interest of its shareholders, this is not always the case, particularly when a company is nearing insolvency. In those circumstances, the directors, as part of their duties, will likely put the company's creditors' interests ahead of the interests of its shareholders and may find themselves unable to satisfy redemption requests from shareholders. This is in spite of the

investor protection provisions which may have been negotiated into the preference share financing documents.

Redemption requests

Notwithstanding the above, there may be benefits in submitting early redemption requests in situations where the company is in financial difficulty. As a first step, however, any shareholder looking to submit a redemption request should familiarize themselves with the procedure and, if necessary, consult with their legal counsel as procedural compliance can often be the difference between a simple shareholder and a creditor. The company's articles of association and/or shareholders' agreement usually set out a detailed procedure where certain steps must occur within a strict timeframe for the redemption request to be valid.

Where there has been a valid redemption request which has been accepted but the company has failed to satisfy, such failure has the important effect of raising the investor's status to that of an unsecured creditor as opposed to a mere shareholder. At this point, the investor/unsecured creditor has the option to either (i) commence legal proceedings, or (ii) issue a statutory demand to the company requiring it to pay the sums owed under the accepted redemption request within twenty-one (21) days of the date of service.

Option (i) (i.e. the commencement of formal legal proceedings), will be subject to whatever terms regarding dispute resolution were contractually agreed between the investor and the company in the preference share financing documents. Arbitration is often found in these types of agreements. Whilst commencing legal proceedings against the company may cause the company to pay the sums owed, these proceedings are often time-consuming and expensive and, in the event such proceedings are successful and the investor comes out with a judgment or an arbitral award in its favour, even then it may be difficult for the investor to enforce judgment that against the company if the company is insolvent as preferential and secured creditors would take priority under Cayman Islands insolvency law.

Option (ii), on the other hand, only requires the investor to issue the company with a formal letter in a prescribed form called a "statutory demand" requiring it to pay the debt owed within a prescribed period or dispute the debt. Should the company fail to engage, this provides rebuttable evidence that the company is unable to pay its debts as they fall due and such evidence can be used as the basis for winding up proceedings against the company. The next step would then be to petition the Cayman Islands court to wind up the company. It should be noted, however, that a public notice will be advertised which will give other interested parties the opportunity to join the proceedings. The scheduled hearing may result in the company being placed into liquidation unless it can raise a substantive defence as to why the debt has not been paid. Once the company is in liquidation, the appointed liquidator will look into its accounts, realise the company's assets and pay the creditors in ranking order.

"Legally available funds"

One of the defences that companies often raise in winding up proceedings is that of lack of "legally available funds". This is due to the fact that when it comes to negotiating the initial set of documents for the preference share financing, provisions restricting the payment of redemptions to situations when the company has "legally available funds" will often be drafted into the articles of association and/or the shareholders' agreement. It then becomes a question of interpretation as to what "legally available funds" actually means in that particular context. Cayman Islands

courts have held such term to mean funds owned by the company or funds that the company could obtain by exercising its legal rights, however, such funds would not include any monies which are required for the company's ordinary course of business. Generally speaking, to the extent that wording has been drafted into the documents and the company does not have sufficient legally available funds to satisfy the redemption requests, Cayman Islands courts are inclined to hold such a defence as a genuine and substantive dispute of the debt and have set aside winding up proceedings on that basis.

Jurisdiction over the dispute

As mentioned at option (i) above, arbitration clauses are often drafted into preference share finance documents and Cayman Islands courts would ordinarily grant a stay of a winding up petition based on a disputed debt where the underlying dispute falls within the scope of an arbitration clause. Importantly, however, the stay of winding up proceedings in favour of arbitration is not automatic and the Cayman Islands courts will first need to be satisfied as to the existence of a *bona fide* dispute on substantial grounds prior to being able to exercise their discretion to stay the petition in favour of arbitration. In other words, the Cayman Islands courts will not stand for any delaying tactics where there does not appear to be a genuine dispute of the debt.

Alternative dispute resolution

If a company has run into financial difficulties, there may be scope for the company and the investors to come together and agree to a voluntary restructuring. Where a consensual solution cannot be reached with all interested parties, the agreement may take the form of a court-supervised process such as a scheme of arrangement which may have the potential for a better return to investors than a liquidation of the company.

The corporate team at Loeb Smith has extensive experience in advising companies and investors on the negotiation of these finance documents, the enforcement of redemption requests and the implementation of suitable strategies and solutions for financially-stricken companies.

Further Assistance

This publication is not intended to be a substitute for specific legal advice or a legal opinion. If you require further advice relating to the matters discussed in this Briefing, please contact us. We would be delighted to assist.

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