

# Cayman Islands Preference Share Financing and Redemption Rights

## Introduction

Cayman Islands exempted companies are commonly used by venture capital and private equity investors for pre-IPO preference share financings. The Cayman Islands' well-established legal system based on English common law, robust and business-friendly regulatory framework, network of professional service providers and tax neutral environment have all contributed to its status as the pre-eminent offshore jurisdiction for start-up and venture capital financing.

Given the flexibility of the Cayman Islands corporate law regime, many commercial terms can be accommodated. The memorandum and articles of association (M&AA) of the company and other contractual documents used in a preference share financing are usually drafted with various provisions to protect the investors' interests, including, dividend rights, liquidation preferences, and exit rights that anticipate an initial public offering, trade sale or other forms of exit within a specific timeframe (typically two to five years). Such exit rights are often supported by the investors' right to redeem their shares, in the event the anticipated exit event does not materialise.

However, the realisation of these exit strategies has become increasingly difficult in recent years. The financial performance of many companies has been affected by macro-economic factors such as inflation, rising interest rates and shifts in the investment landscape, meaning they may not meet the benchmarks set for a successful exit. Geo-political developments have also disrupted

markets and supply chains and dampened investor enthusiasm, which further complicates the prospects for a timely and profitable exit for investors. Being unable to realise or exit their investments by more traditional means, many investors must resort to enforcing their redemption rights or consider other exit enforcement strategies. Here, we explore some of the main issues related to such enforcement.

## Dividend and Liquidation Preference Issues

Dividend and liquidation preference rights are key features of preference share financings. Dividend rights provide investors with a (regular) return on their investments, while liquidation preference rights ensure that, should the company be wound up and liquidated, preference shareholders receive a return of their initial investment (sometimes a multiple thereof) before the common or ordinary shareholders.

Under Cayman Islands law, the payment of dividends is contingent upon the company's ability to pay its debts as they fall due – which involves not only debts immediately payable, but also includes a "forward looking" component. In addition, in the event of the company's liquidation, only the assets of the company remaining after all creditors have been paid will be distributable to the shareholders.

Directors of Cayman Islands companies are required by their fiduciary duties to act in what they consider to be in the best interests of the

company. In the ordinary course, the best interests of the company will be aligned with the best interests of the company's shareholders. However, where a company encounters financial difficulties and is insolvent or is bordering on insolvency, the directors must consider the creditors' interests as part of their duty to act in the best interests of the company – and depending on the severity of the situation, that can require the directors to put the interests of ordinary creditors ahead of the interests of both shareholders and / or former shareholders who have redeemed their shares.

Separately, the Companies Act of the Cayman Islands also provides that a payment out of capital by a company for the redemption of its shares is not lawful unless immediately following the payment, the company is able to pay its debts as they fall due in the ordinary course of business. As the financial position of the company deteriorates, the investors will often be surprised to find that the company will not be able to satisfy its redemption requests, pay dividends or make any distributions to its investors (which is consistent with the exercise by the directors of their fiduciary duties and the requirements of Cayman Islands law), despite the carefully negotiated dividend preference and redemption provisions in the preference share financing contractual documentation and M&AA.

### Redemption Issues and Considerations

#### *Procedural compliance*

The first step for a redemption is the submission by the shareholder of a valid redemption request. Whether the redemption request is valid can be a pivotal issue as it will determine the shareholder's status as either a creditor or shareholder and therefore whether it is entitled to be paid by the company, and where any such payments may rank in the waterfall with other shareholders and creditors if the company goes into liquidation.

Often just the act of submitting a redemption request may not be straightforward because the company's articles or the shareholders' agreement may require the shareholder to comply with complicated procedural steps including the submission of documents within a stipulated timeframe. As a result, there can be ample scope for a company to challenge a shareholder's redemption request on procedural grounds and, in effect, delay the redemption. Further, it is reasonably common for the articles or shareholders' agreement to require the company to acknowledge the request, which raises issues as to the status of the request if the company fails to comply with its own procedural obligations.

It is therefore important for shareholders to study the redemption provisions carefully and, if necessary, take legal advice before submitting the request.

### Non-Payment and Lack of Engagement

#### *Legal options*

Where there has been a valid redemption and the investor has not been paid, such that the investor has become a subordinated unsecured creditor (referred to below as a redemption creditor) rather than a shareholder, there are two common legal options. While each case will turn on its facts, the following general guidance should be borne in mind.

The redemption creditor may be able to start legal proceedings (and commonly the contractual documentation governing the investor's investment will provide that disputes must be resolved through arbitration). Commencing such proceedings may cause the company to pay the redemption sum or, if the proceedings are successful, result in a judgment or arbitral award that can be enforced against the company. However, even then, the above considerations regarding payment of subordinated debts where the company is insolvent may still be an issue when it comes to paying this debt.

Another potential option is to commence winding up proceedings against the company. These are proceedings in which, if successful, the assets of the companies are realised and distributed among its creditors (and if any sums are remaining after the payment of creditors, its shareholders) in accordance with a prescribed payment waterfall.

A common first step is to issue a statutory demand to the company requiring it to satisfy the sums due under the redemption request. The company then has 21 days from the date of service of the statutory demand on it to either satisfy the demand or dispute the debt. If the company fails to satisfy a statutory demand within the 21-day period or does nothing in respect of it, this provides rebuttable evidence that it is unable to pay its debts. That evidence can then be used as the basis for the winding up of the company. In short, if the company does not pay the demand, it exposes it to the real risk of being placed into liquidation. This puts pressure on the company to pay to avoid such an outcome.

The redemption creditor can then take the next step, which is to petition the Cayman Islands court to wind up the company. The petition will be advertised and a hearing before the court will be scheduled to determine whether the company ought to be placed into liquidation. Unlike the statutory demand this will be a public step and other interested parties (including other investors that have redeemed their shares but have not been paid and potentially non-redeemed shareholders) are entitled to join the proceedings and put forward their own positions (or even be substituted as the petitioner). This means that the original petitioning party may not be able to control the proceedings. If the company does not pay the debt, reach a settlement with its creditors or raise a genuine and substantive defence for why the debt is not due, the company will usually be placed into liquidation.

It is also important to bear in mind that a liquidation may not (indeed, almost invariably will not) result in immediate payment. If

liquidators are appointed, their role essentially is to take control of the company, realise the company's assets, and distribute them in order of priority. That will mean paying ordinary creditors first, ahead of payments to (subordinated) redeemed shareholders. Whether a liquidation is likely to be the best result in the circumstances will be fact-sensitive.

### *First mover advantages*

Submitting a redemption request and commencing proceedings against the company at an early stage has some advantages:

- (a) It could lead to payment or, at least, a level of engagement from the company that may be more difficult where there are numerous other competing redeeming shareholders.
- (b) A first-mover may benefit from a degree of control over the process and timing of enforcement proceedings.
- (c) If the company is ultimately placed into liquidation, the claim of a redemption creditor can rank ahead of any claims by investors that have not submitted a redemption request (or have not validly redeemed). The uncertainty in this regard is because there is currently an ongoing matter before the Court of Appeal in the Cayman Islands, the decision in which could affect the priority ranking of the above claims. Where the claims of investors that have not submitted a redemption request (or have not validly redeemed) are treated as a claim by a shareholder (rather than as a subordinated unsecured creditor) they are highly likely to recover nothing in a liquidation.

There are a number of strategic considerations which factor into the most appropriate course of action to take in order to maximise the chance of recovery. Maples Group has highly experienced experts who can assist in navigating these waters to chart the appropriate course.

## Applying to Commence Winding Up Proceedings – Three Likely Considerations

There are three common issues that can arise when an investor seeks to commence winding up proceedings where a redemption creditor is unpaid.

*Payment of the redemption sum out of "legally available funds" – a potential defense?*

It is not unusual for redemption provisions in a company's articles to provide that the payment of the redemption price may only be made from "funds legally available to the company" (or similar wording).

Much will depend on the interpretation of the redemption provisions, but in general, the Cayman Islands courts have found that where payment of the redemption price is to be made out of "legally available funds" and the company does not have sufficient legally available funds to meet the redemption requests, those debts would not become payable until the company had legally available funds. In other words, the company's obligation to pay the redemption price is conditional on it having sufficient "legally available funds" do so. The courts have found that this constitutes a genuine and substantive dispute of the debt and have struck out a winding up petition on that basis.

The position is however likely to be different where the company is in a financial situation where its cash flow position is inevitably terminal, such that the company will never have legally available funds with which to pay the deferred debt. If it is clear that payment will need to be deferred indefinitely (or payments suspended indefinitely) then a redemption creditor may be able to argue that the company is effectively hopelessly insolvent and will never be able to satisfy the redemption request such that it ought to be wound up.

*Arbitration clause in investment documents*

Often, the relevant shareholders' agreement or investment agreement will contain redemption provisions that are identical to those found in the articles, and may provide for any dispute arising out of those agreements to first be referred to arbitration in another jurisdiction (e.g., arbitration under the HKIAC or SIAC<sup>1</sup> rules).

Where winding up proceedings have been commenced against the company, there is a risk of those proceedings being stayed or dismissed on the basis that the dispute regarding the redemption request would need to be resolved by arbitration in view of the agreement to arbitrate in the relevant preference share financing contractual documents.

Such referral to arbitration is not, however, automatic. The Cayman Islands court has established that before staying or dismissing winding up proceedings in favour of arbitration, it should, when exercising its discretion, first be satisfied that there is a *bona fide* dispute on substantial grounds. This approach has recently been endorsed by the most senior court of the Cayman Islands. The court will therefore examine the evidence to establish whether there is such a *bona fide* genuine dispute, or if the company is simply seeking to deploy delaying tactics to stave off winding up proceedings.

*A holistic solution*

If a company has insufficient funds to pay all its creditors (including redemption creditors), there may be scope for the company and the investors to agree a consensual restructuring. Where a consensual deal cannot be struck with all relevant stakeholders this could include using a court process such as a scheme of

<sup>1</sup> Hong Kong International Arbitration Centre ("HKIAC") and Singapore International Arbitration Centre ("SIAC").

arrangement to implement the restructuring (either with or without the appointment by the court of restructuring officers).<sup>2</sup> This may have the potential for a better return to investors than a liquidation of the company.

There may also be real advantages for a company to take the initiative and try to agree a holistic solution with its redeeming shareholders. By actively engaging with its stakeholders, a company may find a way forward instead of attempting to deal with individual claims on a piecemeal basis – this may become impossible when it is inundated with potential claims, arbitration notices and winding up threats. In such circumstances an overall solution will be required at some point to resolve matters and to avoid further threats of legal proceedings.

## Concluding Thoughts

For many investors, the road to exiting an investment and effecting a redemption is not an easy one given the complexities and issues involved in what can be multi-jurisdictional disputes or insolvency/restructuring proceedings. It will be important to coordinate the enforcement strategy between Cayman Islands counsel and onshore counsel, including ensuring that steps are taken to oversee or potentially directly enforce over where the assets are located.

When assessing their options in respect of an insolvent or potentially insolvent company, investors should seek advice on the risks, opportunities and potential rate of recovery in respect of each option.

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<sup>2</sup> This was introduced in 2022 following recent reforms to the restructuring regime in the Cayman Islands. For more information, please refer to our client updates on this topic. <https://maples.com/en/knowledge-centre/2024/1/cayman->

## Contacts

Maples Group is well-positioned to advise on companies, shareholders and creditors on issues pertaining to the redemption provisions in the M&AAs and investment documents, potential remedies and strategies to pursue or defend winding up proceedings, and debt restructuring. Our experts in these fields are consistently recognised as the best in the industry.

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