



Cayman Islands Unit Trusts and their use as an Investment Fund Vehicle

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Cayman Islands unit trusts have become an increasingly popular vehicle for structuring hedge funds. These structures have traditionally been most popular among Japanese fund managers and investors given the similarity to the Japanese domestic investment trust and the associated historical tax benefits. However, we are now seeing increasing enquiries from China-based managers. The similarity with the domestic trust vehicle may again be a contributor to this trend, but the perceived benefits associated with having an independent professional trustee responsible for the oversight of the fund is also likely to be a key driver. Investors may take comfort from the fact that an independent fiduciary will hold the legal title to the fund's assets (rather than a newly incorporated company) and be responsible for controlling the governance of the fund (rather than a board of directors whose appointment is usually under the control of the investment manager or one of its affiliates).

Given the generally passive nature of investments in hedge funds, with such investments typically carrying limited or no voting rights, funds structured as a trust can be an attractive option to investors. We consider the benefits in more detail below.

What is a unit trust?

A unit trust is a form of express trust whereby the interest in the underlying assets is unitised under the terms of the trust instrument. The concept of a unit trust is not one set out in Cayman Islands statute. To understand the nature of a unit trust, one has to look back to the mid-nineteenth century and the origins of the English management trust. This was established pursuant to a deed of settlement providing for the assets of a company to be held by a trustee for the benefit of investors.

Units issued to investors in a unit trust confer a proprietary interest in all the underlying investments, which are subject to the trust. However, the trust instrument will usually include a provision to the effect that a unit does not entitle the holder to any particular asset comprised in the trust fund. Therefore, ownership of a unit entitles an investor a right not to a specific investment comprising the trust fund, but simply a right to redeem its share of the pool of assets, represented as a unit, in return for cash based on the underlying value of the trust assets.

A Cayman Islands unit trust will typically be registered as an exempted trust under the Cayman Islands Trusts Law (Revised) on the basis that its beneficiaries are not and will not include any person at any time resident or domiciled in the Cayman Islands. The purpose of such registration is that the trust is then entitled to obtain an undertaking from the Governor that the trust will pay no Cayman Islands taxes for a fixed period of up to 50 years from the date of the creation of the unit trust. In any case, there are currently no corporation, capital gains, income, profits or withholdings taxes in the Cayman Islands.

How does a unit trust compare to a corporate structure?

A trust is an equitable obligation binding a person, the trustee, to deal with property which is owned and held by him as a separate fund from his own personal property for the benefit of persons, being the beneficiaries of the trust.

Unlike a company, a unit trust has no separate legal personality, rather it is a relationship which relies on the trustee enforcing contractual obligations entered into by the trustee on behalf of the trust. The trustee is responsible for the overall business and affairs of the unit trust and has a duty to act in the best interests of the beneficiaries.

Given the evolution of equitable principals arising out of the fact that trustees hold legal title to the trust property, trustees are therefore generally seen as owing a higher standard of prudence in protecting the interests of the beneficiaries than would be reasonable to impose on a director of a commercial company. The two positions are however comparable and directors are subject to similar obligations derived from the relationship of trust and confidence as those that are imposed on trustees. Directors are required to act in good faith in the best interests of the person that they represent (ie, the company), and must not abuse the trust and confidence placed on them. The trustee's responsibility is, in contrast, directly owed to the beneficiaries collectively.

Beneficiaries can enforce the trustee's fiduciary duties directly against the trustee, whereas in a corporate structure equivalent fiduciary duties owed by directors will generally only be enforceable by the company and not the shareholders (although there are some limited exceptions to this).

The manager or sponsor of a corporate fund will typically hold the voting shares of the fund and therefore be in a position to change the fund's board of directors at any time in their sole discretion. However, in a unit trust structure, removal of the trustee usually requires the vote of

the unitholders under the terms of the trust instrument.

The trustee of a Cayman Islands unit trust will commonly be a corporate trustee in the Cayman Islands and will therefore be required to be licensed as a trust company under the Banks and Trust Companies Law (Revised) or as a mutual fund administrator under the Mutual Funds Law, irrespective of whether or not the unit trust is regulated under the Mutual Funds Law. The Cayman Islands trustee will thus be regulated and supervised by the Cayman Islands Monetary Authority (“CIMA”). Directors sitting on the boards of hedge funds registered under the Mutual Funds Law are generally required to be registered with CIMA, regulated by CIMA (if they are a professional director) or licensed (if they are a corporate director); however, this requirement does not apply in the case of non-regulated Cayman Islands mutual funds.

At common law, unitholders are personally liable to indemnify the trustee, although this personal liability is usually excluded by the trust instrument. This compares to corporate structures where the liability of shareholders is limited as a matter of law. Investors should ensure that the trust instrument specifically states that their liability is limited (ie, with no requirement to indemnify the trustee).

Unit trusts offer a certain amount of additional flexibility when compared to corporate structures. For example, distributions to unitholders are unrestricted whereas distributions to shareholders are subject to certain restrictions as set out in the Cayman Islands Companies Law. However, unit trusts cannot be set up for unlimited duration as is the case for companies. The expiration of the trust period cannot exceed the perpetuity period. Apart from certain types of trusts (including STAR Trusts), the Perpetuities Law (Revised) provides that Cayman trusts must have a perpetuity period not exceeding 150 years. As unit trusts are rarely drafted as STAR trusts, they invariably have a perpetuity period of up to 150 years.

Dual Party Trust Deeds

It is possible to establish a unit trust with the manager as a party to the trust instrument, namely a two party trust deed. Managers may have been wary of adopting this approach in case they be deemed to be a co-trustee (although this is unlikely given that the manager would not hold legal title to the fund assets) or be subject to the same fiduciary duties as trustees.

However, recent case law has demonstrated that, depending on the precise nature and scope of its role, the manager may owe fiduciary duties to a unitholder regardless of whether or not they are a party to the trust instrument. In the Jersey law case, *Barclays v Equity* [2014] JRC102D, (which could be persuasive but would not be binding on a Cayman court) the court found that a unit trust can generally be expected to establish a triangular relationship between the manager, the trustee and the unitholders. The court found that the trustee and the manager owe trustee-like or fiduciary duties and obligations to the unitholders for a number of reasons including that they have control of properties belonging to the unitholders and that unitholders are in a vulnerable position,

for they have no right to interfere with the management of their own money. In this particular case, it was noted that virtually all trustee-like functions were allocated to the manager.

A manager may be inclined to prefer a two-party trust deed on the basis that under this arrangement the manager may limit the trustee's powers and responsibilities. The manager is no longer a delegate of the trustee, appointed under the management agreement, rather the manager's powers and duties are set forth in the trust instrument itself.

Before deciding whether to opt for a one or two party trust deed, managers should consult with their legal counsel to discuss the legal and practical implications of each approach. There may also be regulatory requirements to consider. For example, unit trusts which are publically offered in Japan will be structured as a two party trust deed.

Stand-Alone vs Umbrella Trusts

A standalone unit trust is, as the name implies, a single trust established under a single trust instrument and is most appropriate where the trust fund is used to pursue a single investment strategy. An "umbrella" unit trust is, on the other hand, a structure whereby the trustee holds different pools of investments which are each allocated to separate "sub-trusts".

An umbrella structure is typically used where the manager intends to pursue multiple investment strategies. It may also be used to establish a platform with different investment managers and/or other service providers appointed to each sub-trust.

A master trust instrument is entered into to establish the master trust and this is supplemented from time-to-time to establish one or more sub-trusts by way of a supplemental trust deed. The master trust instrument will provide that each sub-trust is a separate and distinct trust; this is intended to segregate the assets of each sub-trust into separate funds. Therefore, the investors in one sub-trust will only have an interest in the property held by the trustee in respect of that sub-trust and the trustee, as trustee of that sub-trust, will only be entitled to an indemnity out of the assets of that sub-trust.

This contractual segregation under the trust instrument goes to the relationship between the unitholders and the trustee and should be extended to dealings with third parties. Therefore, when the trustee enters into contracts with third parties it must be sure to include limited recourse language so as to limit any third party's claim to the assets of the relevant sub-trust on whose behalf it is contracting. This is because the trustee is personally liable to the full extent of his personal wealth for liabilities incurred in respect of the trust. Without including this language (to the extent that the assets attributable to the sub-trust in respect of which the liability was incurred are insufficient to meet that liability), the third party would have a claim against the trustee. The claim would extend only to the trustee's personal assets. The trustee would not be able to use the assets attributable to the other sub-trusts to meet the liability, as it is prohibited from doing so under terms of the trust instrument.

Summary

While traditionally associated with the Japanese hedge fund market, Cayman Islands unit trusts are now increasingly being used to attract other Asian investors. As the trust deed is a private agreement it can be tailored to meet specific client demands and therein lies its flexibility. There is also an opportunity to provide heightened governance (although capable of being mirrored to a large extent in a corporate structure) on the basis that a professional independent body will hold legal title to the fund's assets and control the operation of the fund. To take advantage of this potential benefit, the experience and professionalism, as well as the location of the trustee will be critical.

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Key Contacts



Kate Hodson 凱特·赫臣

Partner and Head of ESG (Legal) 合伙人

Hong Kong

E: kate.hodson@ogier.com

T: +852 3656 6049



Sabina Jerrybandan

Trust Director

Cayman Islands

E: sabina.jerrybandan@ogier.com

T: +1 345 815 1741



Adam Fox

Associate Director

Cayman Islands

E: adam.fox@ogier.com

T: +1 345 815 1735



Skip Hashimoto

Managing Director

Tokyo

E: skip.hashimoto@ogier.com

T: + 81 3 6402 5635

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