CHANGES IN OFFSHORE M&A
BUYER BE AWARE

George Weston, Philip Graham and Matt Taber of Harneys discuss the practical impact of recent legislation in the British Virgin Islands and the Cayman Islands on offshore M&A transactions.

On 1 January 2019, new legislation came into force in the British Virgin Islands (BVI) and the Cayman Islands requiring companies that undertake certain activities to actively demonstrate and report that they have economic substance within the relevant jurisdiction. Similar requirements were introduced simultaneously across the other major offshore financial centres.

The new requirements are relevant to any mergers and acquisitions (M&A) transaction where a BVI or Cayman Islands company is a target or a subsidiary of a target, or where the buyer is considering using a BVI or Cayman Islands company as an acquisition vehicle. Given that companies incorporated in the BVI alone were recently estimated to hold $1.5 trillion of assets around the world, and BVI companies were the ninth largest recipients of foreign direct investment and the seventh largest source of outward investment in 2015, the new laws are likely to have an impact on a large number of cross-border M&A transactions (*www.bviglobalimpact.com/media-centre/creating-value-the-bvis-global-contribution*).

The good news is that the fact that a BVI or Cayman Islands target company may be required to have adequate economic substance in the jurisdiction is unlikely to prevent a transaction from going ahead (*see "Substance requirements" below*). It is largely a due diligence issue and any risks can be addressed, and properly apportioned between buyer and seller, through the use of appropriate contractual protections.

It will, however, be all the more important to take advice from lawyers in the relevant jurisdiction.

This article sets out the key requirements of the new legislation, and considers how it will affect M&A transactions and what steps should be taken by practitioners in due diligence and disclosure.

OUTLINE OF THE NEW LEGISLATION

The primary new legislation in the BVI is the Economic Substance (Companies and Limited Partnerships) Act 2018 (BVI Act). The BVI Act is supplemented by an Economic Substance Code (the Code) published by the BVI International Tax Authority (ITA), which is the regulator responsible for enforcing the Code.

In the Cayman Islands, the primary new legislation is the International Tax Co-operation (Economic Substance) Law 2018 (Cayman Act), which is supplemented by guidance issued by the Tax Information Authority of the Cayman Islands (TIA).

Affected companies

The BVI Act applies to any BVI company or BVI limited partnership as well as to any foreign company or limited partnership that is registered in the BVI as a foreign entity. The BVI Act does not, however, apply to BVI limited partnerships without legal personality (which is optional under BVI law for partnerships registered under the Limited Partnership Act 2017). Entities that are tax resident in a jurisdiction outside of the BVI, unless that jurisdiction is on the EU taxation blacklist, are also not subject to the economic substance requirements but still need to determine whether they carry on any relevant activities (*see "Relevant activities" below*).

The Cayman Act applies to most Cayman Islands exempted companies, Cayman Islands limited liability companies (LLCs) and foreign companies registered in the Cayman Islands except for:

- Investment funds or entities through which investment funds directly or indirectly invest or operate.
- Entities that are tax resident outside the Cayman Islands.
- Domestic companies.
- Cayman Islands exempted limited partnerships and trusts.

Given the dominance of the investment funds sector in the Cayman Islands, the express exemption for investment funds will mean that the Cayman Act catches significantly fewer entities than the BVI Act.

Relevant activities

Although there are some nuances in how they are defined, particularly where certain definitions refer to local legislation, the categories of relevant activity are the same in both the BVI and the Cayman Islands (*see box "Categories of relevant activity"*).

Not all entities caught by the BVI Act and the Cayman Act (together, the 2018 Acts) will be carrying on a relevant activity. For example, companies whose only assets and income derive from holding real property, or dormant entities with no assets or income, will not be carrying on a relevant activity.

Categories of relevant activity

The nine categories of relevant activity are the same in both the British Virgin Islands, under the Economic Substance (Companies and Limited Partnerships) Act 2018, and the Cayman Islands, under the International Tax Co-operation (Economic Substance) Law 2018. They are:

- Banking business.
- Insurance business.
- Fund management business.
- Finance and leasing business.
- Headquarters business.
- Distribution and service centre business.
- Shipping business.
- Holding business. This is narrowly defined as a "pure equity holding entity", which is a legal entity that exists only to hold equity shares in other entities and earns only dividends and capital gains.
- Intellectual property business.

Other companies may be carrying on more than one relevant activity.

For entities that are conducting banking, insurance or fund management business, these activities are already subject to regulatory requirements and so these entities are likely to already have licences or registrations in the relevant jurisdiction. If one of these entities is found to be failing to comply with the 2018 Acts, it is likely that it is also in breach of its licence or registration.

Substance requirements

The economic substance requirements differ depending on the type of relevant activity in question. For example, that a company operates a holding business has a reduced substance requirement meaning that the company will comply with its economic substance obligations if, broadly, it complies with its general obligations under company law in the BVI or the Cayman Islands and, if it actively manages those equity participations, it has adequate employees and premises in the relevant jurisdiction of that management. It is therefore feasible that a "passive" pure equity holding company may be able simply to continue engaging its registered office service provider in order to be in compliance. Pure equity holding entities do not have to hold board meetings in the relevant jurisdiction in order to comply.

For all the other relevant activities, a different set of rules apply:

- The relevant activity must be directed and managed in the relevant jurisdiction, which means that a quorum for an adequate number of board meetings must be present in the relevant jurisdiction.
- Having regard to the nature and scale of the relevant activity:
  - there must be an adequate number of suitably qualified employees or other personnel physically present in the relevant jurisdiction, whether employed directly or employed by another entity;
  - there must be adequate expenditure incurred in the relevant jurisdiction;
  - there must be adequate physical premises as may be appropriate for the core income-generating activities associated with the relevant activity. Guidance provided by the ITA and the TIA (together, the tax authorities) sets out examples of the core income-generating activity for each relevant activity; and
  - the entity must conduct a core income-generating activity in the relevant jurisdiction.

Additional requirements and more detailed rules apply to intellectual holding business, and there are presumptions of non-compliance that arise for certain types of intellectual property holding entity which are perceived as high risk (*see "IP holding business" below*).

The tax authorities have both made clear in their guidance that "adequacy" is a question of fact in all the circumstances and there are no blanket confirmations as to what constitutes adequacy for any particular activity.

Financial periods and reporting

Compliance is generally assessed over a 12-month financial period. The ways in which financial periods apply are slightly different between the BVI and the Cayman Islands, but while the Cayman Islands uses a company's own financial period to assess compliance, in the BVI there is not necessarily any correlation between the financial period used for assessing substance and any other financial year that the company uses for its general accounting purposes.

Penalties

	British Virgin Islands	Cayman Islands
A person fails to provide information without reasonable excuse, or provides false information.	On summary conviction, a fine not exceeding $40,000 or imprisonment for a term not exceeding two years, or both. Higher fines and more significant jail terms are possible if convicted on indictment.	A fine of CI$10,000 or up to five years' imprisonment.
A company fails to meet the economic substance requirements.	A fine of between $5,000 and $20,000 for a first offence. For a second offence, a fine of between $10,000 and $200,000, and the BVI International Tax Authority may strike off the company.	A fine of CI$10,000 for non-compliance in the first year, rising to CI$100,000 if the Tax Information Authority is still not satisfied in the subsequent financial year after a notice of failure was served. Failure for two consecutive years may result in a court order that it is a "defunct company" or, in the case of a Cayman Islands limited liability partnership, being struck off.

In both jurisdictions, significantly higher penalties apply to entities carrying out certain types of intellectual property business which are not in compliance.

The relevant information must be filed with the relevant tax authority within six months of the end of the financial period in the BVI or 12 months in the Cayman Islands.

Enforcement and sanctions

There are two broad circumstances where there could be a risk of sanctions or enforcement action: where there has been a failure to provide information without excuse or inaccurate or misleading information has been provided; or where the substance requirements are deemed by the relevant tax authority to not have been met. Different penalties will apply depending on the jurisdiction and whether it is a first or continuing offence (*see box "Penalties"*).

DUE DILIGENCE

Approaching an economic substance due diligence exercise on a BVI or Cayman Islands company should be fairly simple. It will be very similar to the process that all BVI and Cayman Islands companies are, or should be, currently going through in order to identify how the 2018 Acts apply to them.

Due diligence questions

If the seller is sophisticated or has already engaged lawyers in the BVI or the Cayman Islands, the due diligence approach may be as straightforward as seeking confirmation that they have already considered the application of the 2018 Acts to each offshore entity and asking for details of the analysis and the basis of their conclusions. If the target has taken written advice from legal or tax advisers, the buyer might seek to get a copy of that advice. The buyer may then want its own lawyers to test and backstop the analysis, depending on whether the buyer is able to get reliance on the advice previously given to the target, the size of the transaction, and the relative materiality of the BVI or Cayman Islands companies to the overall transaction.

In other cases, for various reasons, the buyer will need to ask due diligence questions that allow it and its lawyers to determine compliance for themselves. The seller's own lawyers, if asked to provide a seller due diligence report, would need to conduct a similar exercise.

Due diligence is always an iterative process and trying to ask all the questions that would enable a full analysis in an initial due diligence request list is likely to be impractical and potentially frustrate the seller with questions that they may not see as relevant to their business. Therefore, it is recommended that in an initial request list, the buyer's lawyers focus only on the most important questions, many of which a prudent buyer would have already been asking in some form (*see box "Initial due diligence request list"*).

IP holding business

One particular point to be aware of in the due diligence exercise is that companies which carry on the relevant activity of IP holding business in the BVI or the Cayman Islands, and in particular those that meet the definition of a high-risk IP legal entity, face the most daunting requirements and potentially the highest penalties for non-compliance. Accordingly, where the due diligence identifies that IP is being held through the BVI or the Cayman Islands, it is strongly recommended that buyers seek advice at an early stage and proceed with due caution.

The good news, however, is that not all companies that hold IP property will be carrying on the relevant activity of IP holding business. If they are not exploiting the IP to generate income, they may not be carrying on a business. In addition, the guidance from the tax authorities has made clear that merely holding IP which is incidental to the company's other activities will not usually be caught; for example, a company that operates as a trading, retail business, whose only IP is a trademark on their store name. In addition, many BVI and Cayman Islands companies

Initial due diligence request list

An initial due diligence request list might include the following questions:

What does the company actually do? What are its assets and sources of income? An alternative, more targeted, version of this question might quote the legislative definitions of the relevant activities and ask the seller to confirm whether the target companies undertake any of these activities. The risk with this approach is that many of the definitions are more nuanced than they first appear and therefore an actual reference to the legislation might be the clearest approach. In general, the best approach is to obtain a summary of the offshore company's actual activities and then determine with further questions whether they fall within the statutory definitions.

Is the company tax resident in a jurisdiction other than the British Virgin Islands (BVI) or the Cayman islands and, if so, where? If the answer to this question is in the affirmative, further questions would be needed to determine what evidence there is of tax residence, and whether it would qualify to take the company out of scope of the legislation.

Does the company have any employees? If not, do employees for other group companies work for the company?

Does the company have directors in the BVI or the Cayman Islands? If not, where are the directors located?

Does the company have any employees or premises in the BVI or the Cayman Islands?

Has the company had any correspondence with the relevant tax authority? Has the company filed any returns or documents under the substance legislation? If nothing has been filed yet, when do they intend to file? At the time of writing, most companies will be just beginning their first financial periods under the new legislation, so are unlikely to have had much, if any, correspondence with the tax authorities. Accordingly, this question will assume greater importance in the future. In the BVI, it is possible that companies might have filed to shorten their statutory financial period to align it with their financial period for other accounting purposes or have sought to file a compliance plan with the BVI International Tax Authority, so the question is still potentially relevant. In the Cayman Islands, the first filings will be required in January 2020 when all entities will be required to confirm whether or not they are a relevant entity and, if so, whether they are conducting a relevant activity.

that hold IP are tax resident in an onshore jurisdiction and so are largely exempt from the 2018 Acts.

Evidence of compliance

It is perhaps both unfortunate and inevitable that there is no current plan by the tax authorities in the BVI or the Cayman Islands to issue certificates of compliance or similar official confirmation that companies have complied with the 2018 Acts. Hopefully, it will at least be possible to generate and print a return which will show what information has been submitted. This would be very helpful for due diligence once a target company has already completed a financial period and made its first filing. In those circumstances, the due diligence may be limited to asking for a copy of the filing, a confirmation that the factual information is correct (potentially backed by a warranty) and that the activities of the company have not changed since the filing was made (*see "Warranties and indemnities" below*).

As the fines and penalties in both the BVI and the Cayman Islands escalate significantly after the first offence, the importance of getting the due diligence right will only increase as time passes.

WARRANTIES AND INDEMNITIES

A well-drafted "compliance with applicable law" warranty is likely to already cover compliance with the economic substance legislation. If so, there will be no need to add a specific warranty; after all, the very purpose of this warranty is to avoid the need to state every single piece of legislation to which the target is, or could be, subject. One point to watch in both jurisdictions is that the scope of the definition of "law" will need to be checked to ensure that it is wide enough to catch subsidiary regulations and regulatory guidance, as these guidance and regulations are fundamental to understanding and applying the relatively short 2018 Acts.

However, if the company has provided responses to due diligence enquiries that underpin the buyer's analysis, and assuming that responses to enquiries are not generally being warranted, the buyer may want those statements specifically warranted in the sale and purchase agreement (SPA). For example, a warranty that the company's only activity is to act as a property holding company, or that it has at all times been tax resident in the UK.

Insufficient protection

There are obviously a number of reasons why a warranty may be insufficient protection, given the usual contractual and legal limitations on recovery. It is likely that some buyers will seek specific indemnification for any losses arising out of the target company's compliance, or lack thereof, with the 2018 Acts. The BVI does not have a firm market practice as to whether warranties are given on an indemnity basis, and the approach is usually driven by market practice in the jurisdiction where the transaction is being run or the governing law of the SPA.

If the warranties are not generally being given on an indemnity basis there does not seem to be a very compelling reason why the 2018 Acts should be treated any differently to any other piece of legislation or legal risk. That being said, if due diligence or disclosure identifies an issue or if sufficient due diligence information is not provided and the risk is material in the context of the transaction as a whole, then an indemnity will be justified.

Disclosure letters

Where there is a disclosure letter, it will be interesting to see whether there are attempts to specifically disclose non-compliance with the substance legislation. Where the seller or target has identified an issue and sets out the nature of the issue and the steps being taking to remedy it, it would be hard for a buyer to reject it. For example, the seller might disclose that it has identified that the company is carrying out a relevant activity but has inadequate substance and is working on relocating an employee to the BVI. However, buyers should strongly resist generic disclosures that merely seek to disclose against the warranties that a new law has come in and that the company has not taken steps to comply, or even to identify whether the legislation applies.

PROTECTION BEFORE CLOSING

If a target company is carrying on a relevant activity under the 2018 Acts and there will be a delay between signing and closing, there are several risks for the buyer to consider and which may need to be addressed contractually in the purchase documents.

Key undertakings

Even if the target company is not carrying on a relevant activity at the start of a due diligence process, or is exempt for another reason, such as being tax resident in a non-blacklisted jurisdiction, it will be important to ensure that this position does not change between signing and closing. The pre-closing undertakings in the purchase documents should be reviewed to ensure that they are wide enough to catch this and, if not, specific undertakings should be added. Commonly, this will include an undertaking that the target will continue to carry on its business in the ordinary course and in the same manner as carried out before signing the purchase documents, which may be wide enough, although the buyer may push for more specific language depending on the facts.

If the target company is carrying out a relevant activity and has satisfied both itself and the buyer that it has adequate substance in the relevant jurisdiction, the main risk is that the position changes between signing and closing. A buyer would be well advised to seek either a general undertaking that the company will maintain adequate substance for the purposes of the 2018 Acts, or undertakings that the seller will maintain the activities that underpin its economic substance; for example, keep its employees, premises and expenditure in the BVI at the same level, continue to hold its board meetings in the BVI or have a majority of BVI resident directors.

Remedial measures

A trickier situation may arise where the target company is carrying out a relevant activity but the diligence or disclosure process has revealed that it does not have, or is at risk of not having, adequate economic substance in the jurisdiction. Even if the buyer has negotiated complete indemnification for the risk, it is not in either party's interest to allow non-compliance to continue for longer than necessary. This is particularly true if there is, or is likely to be, a long delay between signing and closing; for example, because competition or regulatory clearances are needed. Ideally, in this situation, the buyer and seller would jointly agree on what remedial measures are to be taken and when and the seller would undertake in the SPA to take those steps in consultation with the buyer within an agreed timeframe. The ITA has indicated that it is open to, and will look more favourably on, non-compliant entities filing a compliance plan setting out how and when they will come into compliance and this may also be a route to explore.

Filing deadlines

The closing of the transaction is unlikely to be perfectly aligned with the target company's financial period or filing deadlines under the 2018 Acts. If the target company is to make a filing during the period between signing and closing, the buyer may want to ensure that the seller will make that filing on the same basis as previous filings, if there are any, and that the seller will consult with it on the filing generally.

A related issue, which will arise after closing, is that the buyer is likely to be required to make a filing that covers a period where the company was not owned or controlled by it. The buyer should seek an undertaking from the seller that it will provide any information or assistance that the buyer reasonably requires for this. If the seller has assumed some or part of the risk arising out of a post-closing filing relating to a period of time when the company was under the seller's ownership, for example because it has given an indemnity, the seller may want some degree of control or consultation in relation to that filing. However, the buyer is likely to resist giving the seller complete control, given that the primary obligation and risks will rest on the company it then owns.

ACQUISITION VEHICLES

There are several reasons why BVI and Cayman Islands companies have typically been popular acquisition vehicles. These include that the BVI and the Cayman Islands have stable and well-known legal regimes, flexible corporate law, a range of acquisition tools, quick and easy company set-up procedures and tax neutrality. It is unlikely that the 2018 Acts will deter businesses from using a BVI or Cayman Islands company as an acquisition vehicle.

Share purchase

In a share purchase, a typical structure might see a new company incorporated simply for the purpose of buying and holding the shares in the target company, in order to segregate the risk from the other assets of the buying group. The buying vehicle might be, but is not always, incorporated in the same jurisdiction as the target company. Assuming that the acquisition vehicle is set up purely for the purposes of the transaction and has no other activity, it will not be carrying on a relevant activity until the transaction takes place, and at that point will be a pure equity holding company, which, as noted above, will mean that it is subject to the very basic substance requirements.

As an aside, there is no prohibition on financial assistance in either the BVI or the Cayman Islands. Particular care will need to be taken where, as part of the post-acquisition planning, the acquisition vehicle will provide some element of a credit facility into the target group, as this will potentially take the company into "finance and leasing" business, which is a relevant authority. If this is the case, there will need to be an analysis of what employees or premises are required to perform this function and, assuming it is extremely limited, if any at all, it need not be too difficult or prohibitively expensive to ensure that the economic substance requirements are met. There are also a number of other structuring options that could be explored as well.

Statutory mergers

Where the target is being acquired by way of a statutory merger, which is very popular for offshore M&A transactions with US or Canadian buyers and sellers, it is usual to establish a new company that will act as one of the parties to the merger. A true merger between two substantive companies is possible, although relatively rare, not least because it risks contaminating the buyer with any and all liabilities in the target. In a statutory merger, the new vehicle is commonly referred to as the merger sub.

There are sensible logistical reasons to establish the merger sub in the same jurisdiction as the target company, although both the BVI and the Cayman Islands allow mergers with foreign companies, the merger process is easier with a domestic company as there are no issues with the mismatch between corporate laws, or a need to satisfy the corporate authorities as to the existence or good standing of the foreign company. It also usually results in the most cost-effective legal fees. The merger sub will not usually be the surviving entity of the merger; in other words, its existence will cease on completion.

Therefore, the economic substance analysis on the merger sub should be straightforward: it will not carry on a relevant activity during its lifetime and, unless something goes drastically wrong, it is also unlikely to survive a full financial period.

LISTED COMPANIES AND SPACS

Under the 2018 Acts, BVI or Cayman Islands companies that have been listed are treated in the same way as any other company. This article will apply in the same way to public takeovers as to private transactions, with the caveat that it is unlikely that the buyer will get the same level of contractual protection or opportunity to run a formal due diligence process in the same level of detail. The buyer's lawyers are therefore likely to have to come to their own conclusion as to whether the target company is undertaking a relevant activity and whether it has adequate economic substance based on information filed publicly.

Fortunately, listed companies typically take seriously their statutory and legal obligations, and it would be surprising if there were many significant BVI or Cayman Islands incorporated companies listed on a major stock exchange which have not already sought advice on their position under the 2018 Acts and taken steps to comply if necessary.

Offshore vehicles, and BVI companies in particular, have been a popular choice of special purpose acquisition company (SPAC) in the US market in recent years. While SPACs are not exempt from the 2018 Acts, the same considerations as for other acquisition vehicles will apply. Most SPACs will not be carrying on a relevant activity until a transaction completes, and thereafter are likely to be pure equity holding companies with only minimal substance requirements.

DEVELOPING AREA OF LAW

This is a new and developing area of law. While there is an emerging consensus on how certain provisions should be interpreted and dealt with, it is inevitable that there will also be some scenarios that arise but have not yet been anticipated by lawyers or, indeed, by the tax authorities. It is likely that the tax authorities will provide updates to the guidance on a regular basis. In addition, any analysis will need to evolve in time to match the practical approaches that each tax authority begins to take once the reporting process in both jurisdictions commences.

However, all entities are now within their first financial reporting period under the 2018 Acts and it is likely that quite a number do not currently fully comply. To avoid unpleasant surprises, it is vital to identify any issues in transactions that are happening right now and ensure that these are adequately caught and addressed.

Although it has always been important to seek and obtain advice from appropriately qualified local lawyers when a transaction involves a BVI or Cayman Islands company, these legislative changes make this even more important. By taking a proactive approach to due diligence and making relatively minor modifications to standard contractual terms, the risks can be addressed in a way which is straightforward and balances them fairly between both the buyer and the seller.

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