BRIEFING NOTE

May 2023

Key issues and trends in series financing transactions from a BVI and a Cayman Islands law perspective

Overall, 2022 was a disappointing year for series financing transactions across China, Hong Kong, Macao and Taiwan (together, "**Greater China**") as the region grappled with macroeconomic challenges and geopolitical issues. The "zero-COVID" policy which led to multiple lockdowns throughout the year also negatively impacted dealmaking activity. For example, according to Pitchbook data[1], deal value in the venture market dropped from a record US$136.2 billion in 2021 to US$69.5 billion in 2022, landing at its lowest level since 2017. Deal count in the venture market also fell by 17.4% over the same period.

Nevertheless, British Virgin Islands ("**BVI**") and Cayman Islands companies have continued to play a significant role in series financing transactions in Asia and beyond as they offer a flexible, cost-competitive and well-tested means of deal structuring. The absence of exchange controls, tax neutrality and the ability to close transactions electronically, among other things, have continued to drive the popularity of the BVI and the Cayman Islands as jurisdictions of choice in these types of transactions.

In this article, we examine some of the recent trends and key issues that impact series financing transactions from a BVI law and a Cayman Islands law perspective. Importantly, with Greater China reopening its borders in 2023, we expect investment activity to improve significantly across the region.

1. What is a series financing transaction?

A series financing transaction is a type of equity investment deal where an investor injects cash into a business in exchange for preferred shares. Irrespective of whether the investor is a venture capitalist, an angel investor or a private equity house, the issuance of preferred shares to the investor by the relevant company is typically documented by a share subscription agreement between the investor and the company. A shareholders' agreement ("**SHA**") is also entered into among the investor(s) and the relevant company to govern the rights and responsibilities of the parties, and the memorandum of association and articles of association of that company (collectively, the "**M&AA**") is typically amended and restated to incorporate relevant provisions of the SHA to ensure that there are no inconsistencies between the contractual provisions of the SHA and the constitution of the company.

[1] Pitchbook: https://files.pitchbook.com/website/files/pdf/H2_2022_Greater_China_Venture_Report.pdf

2. Are there different types of series financing transactions?

A distinction is often drawn between different rounds of series financing transactions. For example, a series A financing refers to the first round of venture capital funding for a startup which typically follows a company's seed round. A series B financing usually follows thereafter if the company is successful. In general terms, while a series A investment usually provides a startup with sufficient capital to develop its products and team and to commence the execution of a go-to-market-strategy, a series B investment is designed to accelerate a company's growth. Series C financing transactions and other "late-stage" investments generally occur at a subsequent stage to support an initial public offering or in anticipation of an acquisition.

Although an investor's key commercial drivers will vary between different rounds of series financings, many of the local law issues that arise from a BVI and a Cayman Islands law perspective are materially the same. However, there may be differences, such as in relation to board and observer appointment rights, the payment of dividends and the rights in a winding-up, that BVI or Cayman Islands legal counsel (as appropriate) will be able to advise upon.

3. What specific features of BVI and Cayman Islands law makes these jurisdictions attractive to startups and other early-stage companies?

There are various features of BVI and Cayman Islands law which makes these jurisdictions attractive to startups and other early-stage companies.

i. Cost-effective and quick to incorporate. BVI and Cayman Islands companies are inexpensive to incorporate and to maintain in comparison with companies in other premium offshore jurisdictions. BVI companies are typically incorporated within two business days of submitting an incorporation application and Cayman Islands companies may be incorporated on a same day basis for an additional fee.

ii. Corporate governance is efficient. Non-regulated entities may have a sole shareholder and a sole director (which may be the same) and there are no nationality and/or residency requirements with respect to them. Corporate director(s) and shareholder(s) may also be appointed. There is no requirement to appoint a company secretary and/or to prepare audited financial statements.

iii. Flexibility. There is significant flexibility in tailoring the M&AA of the relevant company to accommodate the issuance of different classes of shares and the rights and restrictions attaching to them, board and shareholder reserved matters and other provisions pertaining to corporate governance issues.

iv. Tax neutrality. There is no corporation tax, capital gains tax, income tax, profits tax and/or share transfer tax as a matter of BVI and Cayman Islands law. Additionally, there is no withholding tax from a local law perspective.

v. Investor familiarity. Private equity houses and venture capital investors are familiar with the BVI and the Cayman Islands as jurisdictions which is helpful in facilitating investment decisions.

vi. Secured creditor friendly. The BVI and the Cayman Islands are widely recognized as creditor friendly jurisdictions, which is helpful in the context of facilitating any debt financing that an early-stage company may require. The BVI also has a straightforward system of registering security interests which is attractive to secured creditors.

4. What due diligence is typically undertaken on behalf of a key investor in a series financing transaction?

In our experience, most key investors opt to undertake local law due diligence on a company into which an investment is proposed to be made.

From a BVI and a Cayman Islands law standpoint, the due diligence exercise typically encompasses the following matters.

i. Basic corporate information, M&AA, directors and shareholders

Whilst certain basic corporate information and the names of the current directors of a Cayman Islands company are a matter of public record, its constitutional documents and statutory registers are a matter of private record and can only be obtained with the consent of the relevant company authorizing its registered office service provider to disclose it. This consent will invariably be provided as it is market practice for an investor's Cayman Islands legal counsel to review these documents.

In contrast, a broader range of corporate information is publicly available in relation to a BVI company. Its certificate of incorporation and M&AA may be obtained from a company search, its register of members is publicly searchable to the extent that it has been filed with the BVI Registrar of Corporate Affairs (the "**BVI Registrar**") and, following certain changes to the BVI Business Companies Act, 2004 (As Amended) (the "**BVI Act**") that came into effect on 1 January 2023, the names of the current directors of a BVI company are a matter of public record. All of the other statutory registers of a BVI company (such as its register of directors and register of charges) are a matter of private record and can only be obtained with the consent of the relevant company authorizing its registered agent to disclose it. This consent will invariably be provided as it is market practice for an investor's BVI legal counsel to review these documents.

The M&AA of a BVI company and a Cayman Islands company may reveal important information in the context of a series financing transaction. For example, it could assist in determining whether:

a. any third-party consents are required to implement a series financing, or whether certain conditions need to be complied with prior to its consummation;

b. there is an existing SHA in relation to the company (which could impose certain consent requirements on the parties with respect to the series financing);

c. a series financing falls within the scope of any existing board and/or shareholder reserved matters;

d. there are any most-favored nation provisions in favor of an existing investor;

e. there are certain procedures on the issuance of preferred shares, such as with respect to pre-emption rights; and/or

f. the directors of the company may resolve to refuse or delay the registration of an issuance of shares in the company at their discretion.

ii. Outstanding charges

Although the register of charges (if maintained) of a BVI company and the register of mortgages and charges of a Cayman Islands company are matters of private record, the register of registered charges of a BVI company is publicly searchable. The primary purpose of filing particulars of a charge in a BVI company's register of registered charges is to protect the priority of the underlying security interests and to put third parties on constructive notice of them. An investor's offshore legal counsel will invariably review the register of registered charges of a BVI company and request a copy of the register of charges or register of mortgages and charges (as applicable) to be provided to ascertain whether a company's assets are subject to existing security interests.

iii. Good standing

In the BVI, "good standing" means that the relevant company is on the Register of Companies, has paid all fees, annual fees and penalties due and payable, has filed with the BVI Registrar a copy of its register of directors which is complete, and has filed its annual return in accordance with the BVI Act. Any BVI law firm can order a certificate of good standing from the BVI Registrar with respect to a BVI company which confirms that the relevant company is in good standing as a matter of BVI law.

A Cayman Islands company is deemed to be in good standing if all fees and penalties under the Cayman Companies Act (As Revised) (the "**Cayman Act**") have been paid and the Registrar of Companies of the Cayman Islands has no knowledge that the company is in default under the Cayman Act. Only the registered office service provider of a Cayman Islands company can order a certificate of good standing from the Cayman Registrar which confirms that the relevant company is in good standing as a matter of Cayman Islands law.

An offshore law firm that is conducting due diligence on a BVI company or a Cayman Islands company will order or request to be provided (as applicable) a certificate of good standing to ascertain whether the relevant company is in good standing.

iv. Litigation

In the BVI, a search may be conducted to verify whether there are any actions or petitions against a company in the Eastern Caribbean Supreme Court, the Court of Appeal (Virgin Islands) and the High Court (Civil and Commercial Divisions) at the time of the search.

In the Cayman Islands, a search may be conducted to verify whether there are any actions or petitions against a company in the Grand Court of the Cayman Islands at the time of the search.

These searches will invariably be completed by an investor's offshore legal counsel.

v. Certificate of incumbency

An investor's offshore legal counsel will usually review an up-to-date certificate of incumbency issued by the registered office service provider or registered agent (as applicable) of the relevant company. Most certificates of incumbency typically confirm that the applicable company is in good standing, as well as its name and company number, registered office address, the identities of the director(s) and shareholder(s) and share capital (if applicable). It is usually also possible to request a confirmation from the registered office service provider or the registered agent (as applicable) that it is not aware of any proceedings which are pending or which have been threatened against the relevant company, and that no receiver has been appointed over the assets of the company to its knowledge.

vi. Books and records

Every BVI and Cayman Islands company must maintain books and records that are sufficient to show and explain that company's transactions, as well as enable the financial position of the company to be determined with reasonable accuracy. This includes keeping copies of invoices, contracts and similar documents. A BVI and a Cayman Islands company must also keep copies of all resolutions of its directors and shareholders and minutes of any meetings.

Whether a review of a BVI or a Cayman Islands company's books and records is necessary will depend on a variety of factors, including the risk appetite of the investor and the activities of the relevant BVI or the Cayman Islands company. To the extent that any commercial agreements have been entered into by the company, an investor may request these to be reviewed to identify any consent requirements in relation to a proposed series financing and any termination provisions

which could be triggered by an issuance of preferred shares and/or a change of control. We have generally seen an increase in these types of requests which is reflective of the more cautious approach that is currently being adopted by many investors.

5. What are some of the key local law issues that typically arise in the context of a series financing transaction?

The following is an indicative list of local law issues that we frequently encounter in series financing transactions.

i. Inconsistencies between the SHA and the M&AA

As noted above, it is important to ensure that there are no inconsistencies between the contractual provisions of the SHA and the M&AA of a BVI or a Cayman Islands company. Although there is no prescriptive approach as to the incorporation process as a matter of BVI and Cayman Islands law, certain types of provisions in the SHA will invariably be included in the M&AA for legal, commercial and other reasons. Examples of such provisions include rights and restrictions with respect to the shares (such as provisions with respect to pre-emption, drag-along and tag-along rights), matters which are reserved to the board of directors and/or the shareholders and other matters that impact the corporate governance of the company (such as provisions with respect to board and shareholder meetings). While the approach that is taken will vary as between BVI and Cayman Islands companies because, as noted above, the M&AA of a BVI company is a matter of public record, whereas the M&AA of a Cayman Islands company is a matter of private record, there may be advantages of incorporating commercially important provisions into the M&AA for the following reasons:

a. new shareholders are automatically bound by the M&AA, whereas only shareholders that execute the SHA or a deed of adherence to it are bound by the SHA;

b. there are statutory remedies available for a breach of the M&AA, whereas only contractual remedies will be available for a breach of the SHA;

c. the relevant company is automatically a party to the M&AA as a matter of law, while it may not be a party to the SHA; and

d. an amendment to the SHA typically requires the consent of all of the parties, whereas the M&AA of a BVI company may usually be amended by a majority of the directors or shareholders (depending on the nature of the amendment) and the M&AA of a Cayman Islands company may be amended by a special resolution (which requires at least two thirds of the votes cast by shareholders).

To address any potential conflict between the provisions of the SHA and the M&AA of a company, the SHA typically provides that its provisions will prevail in the event there is any conflict with the M&AA. This provision is potentially unenforceable against a

BVI or a Cayman Islands company which, in the first hand, is bound by its constitutional document, the M&AA. For that reason, the conflicts provision in the SHA should be amended to limit its application to the shareholders and to impose a covenant upon them to amend the M&AA to resolve any conflict(s). In practice, the circumstances of the conflict and the interpretation of the documents may determine which document takes precedence over the other. For example, in *Dear and another v Jackson*[2], where an SHA obliged the parties to ensure that a shareholder would be periodically re-appointed as a director but the M&AA permitted the other directors to remove him, the Court of Appeal of England and Wales ruled that there was no conflict: the SHA was to be read as if it did not purport to affect the removal provisions in the M&AA, especially because some of the directors had no knowledge of the terms of the SHA and were entitled to take the M&AA at face value and to assume that the removal article would work. This underscores the importance of appointing local law counsel in a series financing to ensure that the terms of the SHA are consistent with the M&AA.

ii. Covenants with respect to group companies

Given that BVI and Cayman Islands companies typically serve as holding vehicles, it is relatively usual to see covenants imposed upon them in the SHA with respect to the activities and conduct of their operating subsidiaries. Such covenants usually prescribe that the relevant BVI or Cayman Islands company must procure that its subsidiaries do not take specified corporate actions without meeting the same consent requirements that are applicable to the company. Whether the relevant company is in a position to comply with such procurement obligations is ultimately a matter of fact that will depend on all of the circumstances, but in practice the company may be unable to do so with respect to any indirect subsidiaries over which it does not exercise direct control. There are different approaches to drafting which may be taken in the SHA to address this issue that local law counsel can advise upon.

iii. Directors that are appointed by key investors

It is relatively common for key investors to be given the right to appoint directors to the board of the relevant company. An SHA typically states that such directors need to comply with the instructions that are given by the appointing shareholder(s).

Under BVI and Cayman Islands law, the directors of a company generally owe their common law and fiduciary duties to the company and not to other parties, such as any individual appointing shareholder(s).[3] There are certain exceptions to this. For example, where a company is insolvent or potentially insolvent, the duties of a company's directors may extend to the company's creditors.[4] A BVI company that is carrying out a joint venture may also act in a manner which is in the best interests of a shareholder or shareholders, even if it is not in the best interests of the company, so long as this is expressly permitted by that company's M&AA.[5]

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[2] [2013] EWCA Civ 89

[3] *Percival v Wright* [1902] 2 Ch 421

[4] *Walker v Wimborne* (1976) 50 ALJR 446 (High Court of Australia)

[5] Section 120(4) of the BVI Business Companies Act, 2004 (As Amended)

Absent any exceptions of the above nature, any provisions which seek to curtail the discretion of the directors should be carefully reviewed as they may render the directors unable to comply with their fiduciary duties and may therefore be unenforceable as a matter of local law. Depending on the circumstances, it may be possible to include drafting in the relevant M&AA and SHA to clarify that the directors shall only comply with instructions provided by the appointing shareholder(s) to the extent that they are compatible with BVI or Cayman Islands law (as applicable), including the fiduciary duties of the directors.

iv. Statutory fetters

A statutory fetter is a restriction that is imposed on the ability of a company or its shareholder(s) to exercise certain rights or powers granted under common law or statute. This is relevant in the context of a series financing transaction because it is relatively common for an SHA and, in turn, the M&AA, to prescribe a list of matters in relation to the company that are reserved to the directors and/or the shareholders. Typical examples of such matters include the alteration of a company's share capital, the issuance of shares, a change to the name of the company, and amendments to the M&AA. While shareholders may enter into such contractual agreements in the SHA among themselves as they please, any provisions which constitute a statutory fetter that purport to bind the company will be potentially invalid and unenforceable. Offshore legal advice should be sought to identify the most effective solutions with respect to these types of issues.

v. Definitions and concepts that are incompatible with BVI and Cayman Islands law

As most SHAs are based on precedents that are governed by English or Hong Kong law, it is important to remain alert to any drafting that is incompatible with BVI and Cayman Islands law. Common examples include:

a. share issuance and transfer provisions which purport to pass title to shares upon delivery of share certificates, as opposed to when the register of members of the relevant company is updated;

b. conditions precedent and/or conditions subsequent to closing that include items which are not necessary from a local law perspective (such as bought and sold notes) and/or which have no particular meaning from a BVI or Cayman Islands point of view (such as endorsing share certificates);

c. references to "share capital" with respect to BVI companies, despite the fact that this concept is no longer applicable to most BVI companies; and

d. definitions that do not meet the minimum requirements of BVI or Cayman Islands law (such as in relation to the thresholds for passing resolutions at a meeting or in writing, or the declaration of a dividend).

These types of issues highlight the importance of seeking local law advice in series financing transactions.

6. What documents are typically provided to a key investor at closing in connection with a series financing transaction from a local law perspective?

The following items are typically provided to a key investor at closing from a BVI and a Cayman Islands law perspective in connection with a series financing transaction:

i. a copy of the constitutional documents and statutory registers of the relevant company;

ii. an up-to-date certificate of good standing of the relevant company;

iii. an up-to-date certificate of incumbency of the relevant company;

iv. duly executed resolutions of the board of directors and shareholders of the relevant company approving, as applicable and among other customary matters, the issuance of the preferred shares, the updates to the company's register of members, the issuance of share certificates (to the extent that share certificates are to be issued), the appointment of any new director(s), any updates to the company's register of directors or register of directors and officers (as applicable), and the amendments to the company's M&AA;

v. a certified, updated copy of the relevant company's register of members showing the investor as the holder of the applicable preferred shares;

vi. a certified, updated copy of the relevant company's register of directors or register of directors and officers (as applicable) showing the appointment of any new director(s) by the investor;

vii. new share certificates (to the extent that share certificates are to be issued); and

viii. a stamped copy of the amended and restated M&AA in relation to a BVI company (noting that delivery of a stamped copy of the amended and restated M&AA in relation to a Cayman Islands company is usually a post-closing obligation).

Additional documentation may also be necessary if the parties undertake to complete other key actions as part of the closing process, such as changing the registered office service provider or registered agent (as applicable) of the relevant company. Furthermore, to the extent that the relevant company's M&AA (or any agreements to which the relevant company is a party) impose additional requirements in relation to an issuance of shares, additional deliverables may need to be provided to the relevant investor.

7. What trends have we observed with respect to series financing transactions in 2022?

As noted above, 2022 was a disappointing year for series financing transactions

across Greater China. For example:[6]

i. deal value for angel and seed deal activity fell from US$1.4 billion in 2021 to US$1.3 billion in 2022, with a drop in deal count from 719 to 554 over the same period;

ii. deal value for early-stage VC deal activity fell from US$43.6 billion in 2021 to US$28 billion in 2022, with a drop in deal count from 3,774 to 3,100 over the same period;

iii. deal value for late-stage VC deal activity fell from US$72.7 billion in 2021 to US$35.8 billion in 2022, with a drop in deal count from 2,697 to 2,297 in the same period; and

iv. deals conducted in US dollars in 2022 fell drastically to US$18 billion, representing a 67.6% yearly decrease, while RMB deal value dropped by 36.3% to US$51.3 billion.

8. What trends are we expecting to see with respect to series financing transactions in 2023?

Unsurprisingly, according Pitchbook data, cumulative dry powder in Greater China has continued to decrease from the record high of US$239.7 billion in 2018 to just US$132.4 billion at the end of 2022.[7] While this has resulted in a more competitive dealmaking environment with less capital available for startups and other early-stage businesses, we anticipate that the need to deploy capital in 2023 due to their lifespan limits will reduce the decline in deal activity compared to 2022.

This publication is not intended to be a substitute for specific legal advice or a legal opinion. For specific advice, please contact:

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Peter is recognized as a leading offshore lawyer in the Asia Business Law Journal A List 2022 and the Asian Legal Business Offshore Client Choice List 2022. He is also recognized as a Rising Star in the Asian Legal Business 2023.

[6] Pitchbook: https://files.pitchbook.com/website/files/pdf/H2_2022_Greater_China_Venture_Report.pdf

[7] Pitchbook: https://files.pitchbook.com/website/files/pdf/H2_2022_Greater_China_Venture_Report.pdf