LEGAL INSIGHT

Payment of dividends by a Cayman Islands company and what constitutes "profits".

Introduction

Cayman Islands holding companies, operating companies, and investment funds structured as companies pay dividends and make other distributions to shareholders and investors all the time, but what are the Cayman Islands' rules governing the payment of dividends and making of distributions? In the first of our series of legal insights on the payment of dividends and other distributions[1] by Cayman companies, we explore the concept of "*profits*" and how "*profits*" are calculated under Cayman Islands law.

Legal position as it relates to payment of dividends and making distributions generally

Under Cayman Islands law, even though the shareholders are the owners of a Cayman company the property of that company belongs to the company and not to its shareholders. For this reason a company cannot simply pay or distribute its property to its shareholders. There are legal requirements to be followed in order to ensure, among other things, that the Directors of the company do not, for example, find themselves personally liable for authorising an unlawful dividend or distribution[2].

The legal position is that dividends and other distributions of a Cayman company may be paid out of profits or from the company's share premium account. However where dividends or other distributions are to be paid from the company's share premium account, there is a solvency test which must be passed (i.e. immediately following the date on which the distribution or dividend is proposed to be paid, the company must be able to pay its debts as they fall due in the ordinary course of business)[3].

Distributions of capital are also permitted by means of the redemption of redeemable shares or the company purchasing its own shares. Under section 37(3)(f) of the Companies Law[4], shares may be redeemed or purchased (A) out of profits of the company, (B) out of the share premium account, or (C) out of the proceeds of a fresh issue of shares made for the purposes of the redemption or purchase, or (D) out of capital if (i) it is authorised by the company's articles of association and (ii) provided that it passes the solvency test (i.e. immediately following the date on which the payment out of capital is proposed to be made the company must be able to pay its debts as they fall due in the ordinary course of business).

Payment out of "profits"

Cayman Islands law as it relates to the payment of dividends out of profits is largely judge-made law. There is no statutory definition of "*profits*" in the Companies Law and no authority of the Cayman Islands courts which may be looked to for guidance as the meaning of "*profits*".

In determining what constitutes "*profits*" of a Cayman company for the purposes of paying dividends and making other distributions to shareholders and investors[5] it is necessary to look at the rules laid down by English case-law authorities based on the English Companies Act 1948 and also earlier English Companies law statutes which are of persuasive authority in the Cayman Islands. Subsequent statutes in England (e.g. the Companies Act 1985 which has been superseded by the Companies Act 2006) and the case-law authority based on such subsequent enactments would not necessarily be regarded as persuasive authority in the Cayman Islands since the Cayman Islands Companies Law is based, in the material part, upon the Companies Act 1948 (and its predecessors) and has not been amended subsequently in a manner analogous to the legislative amendments introduced in England.

How to calculate "Profits"?

In practice, "*profits*" is normally taken to mean the accumulated retained earnings or profit of previous years which have not been capitalised by a bonus issue or transferred to the capital redemption reserve, shown on the company's balance sheet, plus all net trading profits shown in the profit and loss account for the current financial year[6].

In light of the rulings in the English case-law authorities based on the English Companies Act 1948 and also earlier English Companies law statutes, it would appear that the following rules can be applied as a guide with regard to how the Cayman Islands' courts would determine the question of how profits in a Cayman company are to be calculated for the purposes of making lawful dividend payments and other distributions:

1.1 A loss made on fixed assets does not have to be recovered before treating a revenue or income profit as available for distribution to shareholders and it is not legally essential to make any provision for depreciation. Sums written off out of past profits as depreciation of fixed capital may be applied as profit available for distribution if on a revaluation of the fixed assets no depreciation has in fact taken place.

1.2 Losses of circulating assets (i.e. trading stock) in the current accounting period must be made good however for otherwise there is no profit.

1.3 A realised capital profit on the sale of fixed assets may be treated as a profit available for distribution at any rate if there is an overall surplus of fixed and circulating assets over liabilities. However best practice is probably to revalue all fixed assets before making this assessment.

1.4 An unrealised capital profit on a revaluation of assets may also be used to fund a distribution to shareholders. However caution must be exercised by the Directors in this situation because an unrealised capital profit may well involve speculative matters of valuation and in the event that a lesser amount is achieved on actual sale a question may always arise as to whether or not the Directors acted properly in arriving at the valuation.

1.5 Losses, even revenue losses on circulating assets (i.e. trading stock/assets being used up in the business) made in a previous accounting period need not be recovered, if there were no profits carried forward into that period to make them good, since such losses are then categorised as losses of capital.

1.6 A distribution to shareholders can be made provided there is a profit on the current financial year of the company regardless of capital losses of a prior financial year. In other words, for the purposes of this rule each accounting period is treated in isolation[7].

1.7 However, in contrast to the above mentioned rule, past profits (retained earnings) from a previous financial period may be carried forward and used to fund a distribution in the current financial year.

For specific advice on payment of dividends or making other distributions by a Cayman Islands company and how to calculate profits available for distribution, please contact either of:

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[1] "distribution" would refer to any payment, transfer or other disposal by a company of its property to its shareholder(s) as shareholders whether in cash or otherwise (i.e. the payment, transfer or other disposal is being made to them in their capacity as shareholders and not because, for example, they are suppliers, creditors, or employees).

[2] See Re Exchange Banking Co (1882) 21 Ch. D. 519, CA, also known as Flitcroft's Case, an English case (and therefore is of persuasive authority to the Cayman Islands' courts) which covered the issue of the directors' personal liability for improper distributions.

[3] Section 34(2) of the Companies Law (2016 Revision) of the Cayman Islands.

[4] Companies Law (2016 Revision) of the Cayman Islands (the "**Companies Law**").

[5] In determining whether there are profits from which dividends and other distributions can be made in accordance with the rules set out by case-law, the starting point will be to review the relevant figures in the company's accounts.

[6] The Cayman Islands does not have its own separate accounting standard such as UK GAAP or US GAAP. Each company has the ability to determine whether it follows US GAAP, UK GAAP, IFRS or some other standard for its accounts.

[7] This position, arising out of the general English common law, is different from statutory provisions enacted in a number of onshore jurisdictions.