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A Time for Cayman Common Sense?: The Future of the Cayman Islands as an Offshore Funds Jurisdiction

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As a funds lawyer who has been practicing for decades, I have always liked the Cayman Islands as a jurisdiction for offshore fund formation. The quality of offshore counsel is hard to beat. The statutes are easy to understand, and the common law approach reinforces practical principles over formalities.

Over the past few years there has been an increased migration away from the Cayman Islands to other jurisdictions, partly as the result of interactions that the Cayman government has had with the European Union.

Some of the comparative advantages of the Cayman Islands versus other jurisdictions are beyond its control as it has no control over what other jurisdictions are doing. However, there is some low hanging fruit that the Caymans could harvest on its own to make its jurisdiction more appealing to international commerce. A number of these potential actions are focused on common sense updates and the elimination of burdensome items that present very little, if any benefit.

It may be time for the Cayman Islands to no longer take its position as a well-liked offshore jurisdiction for granted, especially considering rising competition from EU jurisdictions, and instead be

proactive in seizing the initiative. Discussed below are good first steps that merit consideration.

Adoption of a Merger Statute

The use of Cayman Islands limited partnerships is currently hobbled by the absence of an effective merger statute. For context, a merger statute, commonly seen for limited partnerships in US jurisdictions, commonly allows for two things: (1) a limited partnership to merge with and into another entity; and conversely (2) another entity to merge with and into the partnership itself.

In the first scenario a merger statute allows a partnership to effectively merge into another entity with that other entity being the surviving entity. These types of provisions can help improve liquidity for partnerships as they make them easier to sell or consolidate with other entities, while increasing potential tax efficiencies for the limited partners under the laws of their respective jurisdictions. For example, the laws of a number of foreign jurisdictions allow for tax free reorganization treatment in connection with mergers.

The second scenario is one where another entity could be merged with and into a Cayman limited partnership. This would present the same liquidity

and tax flexibility as the first scenario but also would allow non-Cayman funds to merge into Cayman funds, with the Caymans being the surviving entity.

A merger statute would help the Caymans in maintaining its presence in the Special Purpose Acquisition Company (SPAC), reinsurance and fund management entity sectors, where M&A is robust and considered desirable by investors.

Conversion Statute for Cayman Limited Partnerships

In other jurisdictions it is not uncommon for an entity to change its form or jurisdiction after obtaining appropriate investor and other government consents. In other jurisdictions, a Delaware limited partnership might elect to convert to a Texas limited partnership, for example. Alternatively, a limited partnership might wish to change its form to a limited liability company or a company/corporation. A conversion statute, common in a number of other jurisdictions, allows this by a simple filing with a government office.

Absent a conversion statute, entities wishing to change their form or jurisdiction often have to set up a parallel entity with the desired form or jurisdiction and then transfer all the assets of the first entity to the second entity, with accompanying efforts to mirror ownership in a tax efficient manner. The process is cumbersome as the transfer of assets often involves third-party consents and the mirroring of ownership often involves complicated and expensive tax planning.

A conversion statute would make it easier for fund managers from other jurisdictions to convert their fund entities to Cayman Islands entities should the Caymans become more competitive as a funds venue.

Segregation of Liabilities

Cayman companies offer these for segregated portfolio companies. However, they currently do not exist for Cayman Islands limited partnerships. The absence of the ability to create segregated cells

undermines the competitiveness of the Caymans at a time when fund managers and fund investors have come to find the cost savings aspects of segregated cells to be appealing.

Legal Personality

The absence of “legal personality” for Cayman limited partnerships creates confusion, particularly for US lawyers and business counterparties who are not familiar with the concept. At times Cayman lawyers will put provisions in limited partnership agreements saying that assets of the partnership actually are held by the general partner in trust for the Cayman limited partnership.

The result is a mess of confusion that seems to have no relevance other than to pay homage to an archaic legal nuance. In addition, from the United States regulatory standpoint it is highly undesirable for partnership fund assets to be titled in any name other than the name of the fund partnership under the US Securities and Exchange Commission (SEC) custody rule.

Consideration should be given to providing clarity regarding the treatment of Cayman limited partnerships or perhaps even eliminating the “no legal personality” concept.

Notice of Pledges

Cayman Islands law currently contains a provision whereby limited partners need to receive notice within a tight time frame if the partnership pledges its right to call capital from limited partners—a situation that usually arises in the context of subscription line credit facilities. The requirement seems to provide very legal investor protection as limited partners agree often at the front end when they enter into an applicable fund that the partnership can pledge its right to call capital from the limited partners.

However, the provision creates unnecessary legal expense as legal counsel to the borrower needs to check with Cayman counsel to the borrower on the form of notice and then coordinate with the borrower and then legal counsel to the lender to agree

on the form and then to provide evidence of the notice being provided. The provision also interjects uncertainty into financing transactions as the lender can only find out after the post-closing notice was actually made after the loan already has closed.

Consideration should be given to revising the notice to provide that it can be provided in advance of closing along with the other closing documents or to whether the requirement of notice could even be forgone in situations where limited partners already have agreed that a Cayman limited partnership can pledge its right to call capital.

Enforcement Provisions

Some concern exists among fund managers that the new regulatory environment adopted in the Cayman Islands will result in more Cayman Islands Monetary Authority (CIMA) enforcement actions.

The concern is particularly acute as a number of managers are already facing heightened regulation from domestic regulators. At the same time, CIMA may be under pressure to make sure it takes compliance seriously.

One approach may be to allow parties that have unintentional infractions to have the option of having their enforcement orders suspended if they undergo periodically offered CIMA compliance training. The situation would serve both enforcement and education at the same time.

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