IN THE GRAND COURT OF THE CAYMAN ISLANDS

FINANCIAL SERVICES DIVISION

The Honourable Mr Justice Andrew J. Jones QC
In Open Court, 11th and 17th December 2012

CAUSE NO: FSD 153 OF 2012 (AJJ)

IN THE MATTER OF THE COMPANIES LAW (2012 REVISION)

AND IN THE MATTER OF SANTIAGO PIPELINES COMPANY

CAUSE NO: FSD 154 OF 2012 (AJJ)

IN THE MATTER OF THE COMPANIES LAW (2012 REVISION)

AND IN THE MATTER OF NEW SANTIAGO PIPELINES COMPANY

Appearances: Mr Anthony Heaver-Wren and Mr Benjamin Woolf of Appleby for the Petitioners

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JUDGMENT

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1. Santiago Pipelines Company ("SP") and New Santiago Pipelines Company ("New SP") (collectively "the Companies") have petitioned the Court, pursuant to sections 15 and 16 of the Companies Law (2012 Revision), for orders confirming special resolutions passed by their parent company to reduce their share capital by

US$10,000 in each case. The Companies are wholly owned subsidiaries of Talisman Equion (Cayman) Inc, an intermediate holding company which is itself a wholly owned indirect subsidiary of Talisman Energy Inc, a global upstream oil and gas company headquartered in Canada, whose shares are listed on the Toronto and New York stock exchanges. The two petitions have been dealt with together because both capital reductions have taken place as part of identical asset restructuring transactions and the evidence relating to them is essentially the same.

2. The evidence consists of affidavits sworn by Mr David Boyd ("Mr Boyd"). I was told by counsel that he is an employee of Appleby Trust (Cayman) Limited which carries on business locally as a trust corporation and corporate service provider. The Companies' boards of directors each comprise two corporate directors, namely Integra Limited and Verita Limited, whose sole function is to provide directorship services to the clients of Appleby Trust (Cayman) Limited. Mr Boyd has sworn two affidavits in support of each petition in his capacity as a director of Integra Limited, which was appointed as a director of each Company on 5th November 2012, just four days before the presentation of these petitions. He says in paragraph 1 of each of his affidavits sworn on 9th November 2012 that he is "acquainted with the affairs of the Compan[ies]". He does not explain how or to what extent he has become acquainted with their affairs. Nor does he say to what extent (if at all) he was involved in this matter prior to the appointment of Integra Limited on 5th November 2012. On any view, it is unsatisfactory for the evidence in support of these petitions to be given by an employee of a local corporate service provider who has no first hand knowledge of the matter and whose formal involvement commenced only four days before the petitions were presented.

3. SP was incorporated under the Companies Law on 3rd November 1994 as an exempted company limited by shares.[1] Its business is described by Mr Boyd in a single sentence. He says in paragraph 18 of his first affidavit that "The principal activities of [SP] and its affiliates are investment in oil and gas exploration and

[1] It was originally incorporated under the name BP Santiago Pipelines Company Limited. Its name was changed to Santiago Pipelines Company on 11th February 2011.

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development projects and companies". However, he has produced SP's audited financial statements for the year ended December 31, 2011 which reflect that its assets then comprised (a) an investment (representing 9.6% of the equity) in Oleoductor Centra S.A, a Columbian company engaged in the pipeline business, having a recorded value of US$15,086,000, (b) receivables of US$76,493,000 due from other Talisman Group companies and (c) cash of US$3,000. It had no liabilities or contingent liabilities except for an account payable of just US$8,000. Its balance sheet reflected an NAV of US$91,574,000. I draw the inference that SP's only business is that of an investment holding company. In addition, an unsigned unaudited balance sheet as of 2nd November 2012 is exhibited to Mr Boyd's first affidavit. This reflects that SP's assets now comprise only (a) an unidentified "Asset Held for Distribution" having a recorded value of US$11,239,000 and (b) a receivable of US$10,000. SP now has no liabilities. Its "Equity Share Capital and Share Premium" is recorded as US$11,249,000. It follows that SP's NAV has been reduced from US$91,574,000 as at December 31, 2011 to US$11,249,000 as at November 2, 2012. How this reduction came about is not explained in Mr Boyd's first affidavit.

4. New SP was incorporated under the Companies Law on 15th May 2012 as an exempted company limited by shares. In paragraph 17 of his first affidavit Mr Boyd says that "The principal activities of [New SP] and its affiliates are investment in oil and gas exploration and development projects and companies". This is a reiteration of the satement made in respect of SP. At the time Mr Boyd swore his first affidavit the only accounts prepared for New SP is a document entitled "Statement of Financial Position as of November 2nd 2012" which reflects that its assets comprise (a) an unidentified "Asset Held for Distribution" with a recorded value of US$7,857,000 and (b) a receivable of US$10,000. Its share capital is recorded as US$7,867,000. It has no liabilities.

5. Prior to the initial hearing for directions, the Petitioners' attorneys were asked to prepare a written submission (or additional evidence) which explains the

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commercial rationale for these capital reductions. A written submission was prepared but I did not find it particularly helpful. In spite of having sought further clarification from counsel during the course of the application for directions, I still felt that I lacked a proper understanding of the Companies' financial condition and the commercial purpose of the overall transaction, of which the capital reductions are an integral part. I considered Mr Boyd's first affidavits to be superficial, but there was little point in asking him to attend the hearing because he is not an empoloyee of the Talisman Group and has had no personal involvement in the transactions at all. In response to my observations, Mr Boyd has sworn a second affidavit in support of each petition, to which is exhibited unsigned financial statements for each of the Companies as at 2nd November 2012; pro forma financial statements for each of the Companies reflecting their financial position after the capital reductions; and an explanatory letter dated 3rd December 2012 written by the London office of Deloitte LLP and addressed to Talisman Energy UK Limited.[2] Taken together, these new financial statements and Deloitte's letter do explain the Companies' current financial condition in a meaningful way, which the management accounts exhibited to Mr Boyd's first affidavit did not.

6. SP's balance sheet as at 2nd November reflects that its share capital is US$11,248,701[3] which is represented by two assets, namely (1) a 7.152% shareholding in Oleoducto Cantral SA which is valued at $11,238,701 [4] and characterised as "assets held for distribution" and (2) cash at bank of US$10,000. It has no actual or contingent liabilitities. It follows that the amounts of its assets,

[2] Apart from being a member of the Talisman Group, Talisman Energy UK limited does not appear to have had any part in the transactions giving rise to these applications.

[3] SP's share capital of US$11,248,701 comprises 2,503,253,159.11 ordinary shares of US$0.004493633 each. This is materially different from the share capital as at 31st December 2011. Deloitte's letter explains how this difference came about but I do not think that it has any bearing on the matter in issue before the Court.

[4] The valuation of Oleoducto shares has remained the same since 31st December 2011, but SP's shareholding has been reduced from 9.6% of the equity having a book value of US$15,086,000 to 7.152% having a book value of US$11,239,000. Whether the book value is the historic cost or current market value is not stated in the financial statements.

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its share capital and its NAV match exactly. The structure of New SP's balance sheet as at 2nd November 2012 is the same. It reflects share capital of US$7,867,034[5] represented by (1) a 5% shareholding in Oleoducto Central SA which is valued at US$7,857,034 and characterised as "assets held for sale"[6] and (2) an inter-company receivable of US$10,000. It has no actual or contingent liabilities. As in the case of SP, it follows that the amounts of New SP's share capital, assets and NAV match exactly. The pro forma balance sheets reflecting the Companies' projected financial position after the capital reductions have now been produced. These simply reflect that US$10,000 (cash at bank in the case of SP and an inter-company receivable in the case of New SP) has been given away and the amount of the share capital reduced by the same amount. The Companies' balance sheets will each then reflect a single asset, the book value of which exactly matches the amount of the share capital. They will still have no creditors.

7. In addition to the two assets reflected in their financial statements as at 2nd November 2012, Mr Boyd says (in paragraph 15 of his first affidavits) that both Companies also own a percentage economic interest in a contract made on 31st March 1995 between Oleoducto Central SA and Santiago Oil Company[7] which I shall refer to as the "Transportation Agreement". It has not been put in evidence and its terms have not been explained save to say that it provides Santiago Oil Company with the right to transport crude petroleum through pipeline facilities owned by Oleoducto Central SA. SP has acquired a 2.15% interest and New SP has acquired a 5% interest in the Transportation Agreement. Deloitte's letter says that the book value attributable these interests is zero, which explains why it is not

[5] New SP's share capital of US$7,867,034 comprises 92,438,983,648 ordinary shares of $0.00000072105104543 each (which is $66,653.23) and 1 residual share of US$7,800,380.77 each. Why New SP has two classes of shares, whereas SP has only one class, has not been explained. In the absence of any explanation, I assume that this distinction has no bearing on the matters in issue before the Court

[6] SP's Oleoducto shares are described as assets held for "distribution" whereas New SP's Oleoducto shares are described as assets held for "sale". In the absence of any explanation for this distinction, I assume that it has no bearing on the matter in issue before the Court.

[7] Santiago Oil Company is not reflected on the corporate structure chart exhibited to Mr Boyd's affidavits, but I was told that it is also a wholly owned indirect subsidiary of Talisman Energy Inc. It is incorporated under the Companies Law and also has its registered office at the offices of Appleby Trust (Cayman) Limited.

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reflected as an asset in their financial statements. However, Deloitte also say that the "estimated value" of these interests (which I think must mean the estimated market value) is US$18,124,500 and US$42,150,000 respectively. Deloitte's letter does not explain the basis for this valuation and counsel was unable to shed any light upon what must be a key aspect of the overall restructuring transaction. As I understand it, SP and New SP acquired their rights in the Transportation Agreement from Santiago Oil Company for nil consideration pursuant to "spin-off agreements" (the nature of which is explained below). Why property having an economic value (presumably market value) of US$18,124,500 for SP and US$42,150,000 for New SP is not reflected as an asset in their respective financial statements led me to raise questions which have not been answered, or at least not convincingly. Deloitte's letter deals with the point in the following way –

> "The [Transportation Agreement] rights are derived from an agreement which was originally entered into by Santiago Oil Company ("SO"), a subsidiary of Equion Energis Limited ("Equion"). When SO entered into the agreement, no accounting entries were recorded and therefore the [Transportation Agreement] rights were held at zero in the accounts of SO.
>
> Under a reorganisation effected by Equion and SO in 2012, some of the rights under the Transportation Agreement] were transferred to SP and New SP.[8]
>
> In accordance with the relevant accounting standards (which for SP and New SP are International Accounting Standards), the steps taken under the reorganisation were effected at book value[9], so that for accounting purpoases there was no requirement to revalue the [Transportation Agreement] rights at market value. For this reason, the [Transportation Agreement] rights remain at zero in the accounts of SP and New SP."

I find this explanation unconvincing, but I suspect that this accounting treatment is actually a very important aspect of the whole reorganisation plan.

[8] As I understand this statement, it means that SP and New SP acquired their interests in the Transportation Agreement from Santiago Oil Company for nil consideration as "beneficiaries" pursuant to the terms of "spin-off agreements".

[9] As I understand this statement, it means SO's book value.

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8. On 9th November 2012 both SP and New SP entered into tripartite contracts described as "the Spin-Off Agreements". The agreement to which SP is a party is made between (1) Talisman Santiago (Cayman) Inc as "beneficiary", (2) SP as the "spin-off company" and (3) Talisman Equion (Cayman) Inc as the "shareholder". The agreement to which New SP is a party is made between (1) Talisman SO (Cayman) Inc as "beneficiary", (2) New SP as the "spin-off company" and (3) Talisman Equion (Cayman) Inc as the "shareholder". These are not arms length contracts. All the parties are wholly owned Talisman Group companies. They all have the same corporate directors and Mr Boyd has signed both of the Spin-Off Agreements on behalf of all the parties. They are expressed to be governed by Cayman Islands law although the language and legal concepts reflected in these agreements are in fact derived from the corporate and tax laws of Colombia. As a matter of Colombian law, a spin-off agreement is a tripartite contract between a parent company and two or more of its wholly owned subsidiaries, whereby one subsidiary (referred to as the "spin-off company") transfers an asset to the other subsidiary (referred to as "the beneficiary") for no consideration. In lieu of consideration passing from the beneficiary to the spin off company, the beneficiary issues new shares to the parent company. The spin off company then reduces its share capital by an amount equal to the book value of the assets transferred between the two subsidiaries. These transactions are treated as having taken place simultaneously. The overall economic result is that an asset is transferred (or spun-off) from one subsidiary to another for no consideration but, from the shareholder's perspective, the economic result is neutral and its consolidated financial statements will remain exactly the same, both before and after completion of the spin-off transactions.

9. It is now apparent that the commercial rationale for the Spin-Off Agreements, which is not adequately explained in counsel's written submission, derives from two particular aspects of the Colombian tax law as explained in a letter dated 3rd December 2012 and written by Lewin & Wills, the Talisman Group's Colomian tax lawyers. First, under the current Colombian tax regime, the sale or exchange

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of the outstanding shares of a foreign company by a foreign seller to a foreign buyer is not a taxable event for the purposes of income or capital gains taxes. For this reason it is potentially advantageous to the Talisman Group to sell the shares of group companies rather than sell their underlying assets. It follows that it is advantageous to reorganise assets intended for sale so that they are owned by special purpose vehicles which hold only one asset and have no liabilities. Second, assets can be transferred pursuant to spin-off agreements between Talisman Group companies at book value (provided that it is a positive book value) without any requirement that the assets be re-valued to market value for Colombian tax purposes. As I understand it, the actual purpose of the Spin-Off Agreements is to make a tax free transfer of the Companies' interests in the Transportation Agreement to two newly incorporated SPVs (namely Talisman Santiago (Cayman) Inc and Talisman SO (Cayman) Inc) at a positive book value of US$10,000. The balance sheets of these two companies will then reflect a single asset (cash at bank of US$10,000 in one case and an inter-company receivable of US$10,000 in the other case) which will exactly match its share capital, but they will also own rights under the Transportation Agreement having a book value of zero but a market value of US$18,124,000 and US$42,150,000 respectively. The shares of these SPVs can then be sold at their market value, thereby potentially realising a total tax free gain of about US$60 million.

10. In summary, Clause 3.1 of the Spin-Off Agreements provides that the "Spin-Off Companies (SP and New SP) will "transfer in bulk" the "Spun-Off Patrimony" to the "Beneficiaries" (the new SPVs) for no consideration. The "Spun-Off Patrimony" is the interest in the Transportation Agreement plus US$10,000 (either in cash or receivables) at the combined book value of US$10,000. The Beneficiaries issue new shares of US$10,000 to the Shareholders and the Spin-Off Companies cancel US$10,000 of their share caital. For present purposes, I assume (without expressing any view) that these Spin-Off Agreements are binding and enforceable in accordance with their terms and that the intended results will be achieved.

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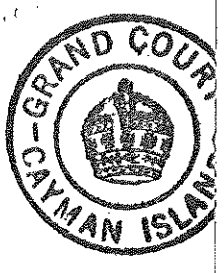
11. Having understood the purpose and effect of the Spin-Off Agreements, it becomes apparent that the amount of the capital reductions, which corresponds with the book value attributed to the Spun-Off Patrimony, is in fact an arbitrary sum. Deloitte's letter explains the point in this way. "A fundamental principle of the "spin off" is that the transfer takes place at book value and, in addition, that it must take place at a positive book value, ie it cannot take place at zero book value". This requirement is met by adding some cash into the Spun-Off Patrimony. Deloitte say that "The amount of $10,000 was chosen as representing an asset which is not so small that it could be effectively ignored (eg. $1 or perhaps $100), but is also not sufficiently large that it materially alters the commercial effects of the transaction."

12. On the basis of this factual background, I now turn to ask myself whether I can properly exercise the Court's discretion under section 16 of the Companies Law by confirming the special resolutions passed by Talisman Equion (Cayman) Inc to reduce the share capital of its two subsidiaries, by US$10,000 in each case, in accordance with the terms of the Spin-Off Agreements. The statutory purpose of sections 15 and 16 of the Companies Law (which is based upon sections 66 and 67 of the English Companies Act 1948) is creditor and shareholder protection. It was well established that the English Court should exercise its discretion in favour of confirming a special resolution for a reduction of share capital if the following three criteria were satisfied. First, the shareholders (or different classes of shareholders) must be treated equitably, although equitable treatment does not necessarily mean equal treatment. Second, in circumstances where the company must convene an extraordinary general meeting of its shareholders, the purpose and effect of the proposed capital reduction must be properly explained to them in a circular letter or explanatory memorandum delivered with notice of the meeting, such that they are able to make an informed decision about the merits of the proposal. Third, the Court must be satisfied that the interests of creditors are unaffected or properly safeguarded. In the circumstances of thise cases the question of shareholder and creditor protection does not arise. There are no



dissenting shareholders. The capital reduction resolutions are unanimous written resolutions signed by the parent company. There are no actual or contingent creditors. To the extent that the Companies must necessarily incur some operating expenses, these expenses (including the professional fees incurred in connection with the petitions) are being bourne by some other Talisman Group company. However, I must go one step further.

13. Based upon two judgments of Harman J. in *Re Ratners Group Plc* [1988] BCLC 685 and *Re Thorn EMI Plc* [1989] BCLC 612, it is now accepted, both as a matter of English law and Cayman Islands law, that there is a fourth criteria. I have to be satisfied that the capital reduction is being done for a "discernable purpose" but this Court has never explained exactly what this means. Both *Ratners* and *Thorn* concerned the reduction of the share premium account for the purpose of creating a reserve against which differences arising on consolidation of their financial statements with those of their subsidiaries (referred to as "goodwill" in the applicable accounding standards) can be written off. In *Ratners* the evidence was that the company had no need to write off any goodwill and so it could be said that the creation of the capital reserve by means of a reduction of the share premium account, and the consequential application to the court, served no purpose or at least no immediate purpose. The Court sanctioned the reduction on the basis that the company was likely to use the reserve for this purpose at some stage in the future. Harman J. said (at page 688b-c) –

> "Counsel wholly accepted that the court will not do anything in vain and that, if a reduction was applied for, approved by shareholders but on the evidence was not for any discernable purpose at all but simply an act in a vacuum, the court might well say that it was not in its discretion sanction it. The refusal by the court would not be because the reduction was not within the powers of the shareholders and the jurisdiction of the court, but as a matter of discretion: the court will not act in vain; the matter had not be shown to have any real purpose, and should not be troubling the court or wasting everybody's time; and for that reason the court might exercise its discretion against sanctioning the proposed reduction."

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Clearly, the court never acts in vain, but I do not find this statement particularly helpful, even in the context of the facts of the *Ratners* case, and it is perhaps unsurprising that the law reporter makes no mention of it in his headnote. However, Harman J. returned to the same theme six months later when faced with exactly the same factual scenario in *Thorn.* On this occasion the judge arranged for Mr Peter Curry QC, who was a leading practitioner in this field and an editor of *Palmers Companies Law*, to appear as amicus curiae. The judge said (at page 616) that –

> "The requirements are that shareholders are treated equitably, that the reduction proposal is properly explained (that means in the circular summoning the meeting), that the creditors are safeguarded and that the reduction is for a discernable purpose. 'Discernable' means, in my view, something which is demonstrated by evidence to the court and is something sufficiently solid and near in expectation to be a real prospect."

When read in the factual context, it is clear that the only point which concerned Harman J. was that there was no immediate need in either case to reduce the share premium account in order to create a reserve against which goodwill (as defined) would actually be written off in the current year's consolidated financial statements. Nor was there any means of knowing whether the need would arise in the next year or the year after. The companies were seeking to create a reserve in this way so that the matter could be dealt with easily, if and when it arose (as it probably would) at some stage in the future. Harman J. confirmed the resolutions in both cases because there was a legitimate commercial reason for passing the resolutions and it was not regarded as a speculative or useless exercise.

14. It is now said, as a matter of general principle, that the Court must be satisfied in every case that a special resolution to reduce share capital has been passed for a "discernable purpose". (See: *Re ING Securities (Japan) Limited* [2004-5] CILR 308 and *China.Com Incorporated* [2009] CILR 384.). In the Cayman Islands context, this means more than merely satisfying the Court that the Petitioner has some actual objective in mind and that the capital reductionis not merely an academic exericse which might or might not serve some useful purpose in the

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future. It means that the Court must have a proper understanding of the commercial rationale for the overall transaction of which the capital reduction forms part. Clearly, it is no part of the Court's role to second guess the commercial judgment of a company's directors and shareholders but the evidence must demonstrate that they are seeking to achive some legitimate commercial purpose. This appears to be the approach adopted by the English Court of Appeal in *Re Ransomes Plc* [1999] 2 BCLC 591 in which Walker LJ (as he then was) simply said at page 603f-g that "in every case the court needs to know at least the general purpose of what is proposed". *Palmer's Company Law* explains the need for a "discernable purpose" in a single sentence by stating that "In *Re Ransome Plc* the Court of Appeal emphasised that in every case the court needs to know at least the general purpose of what is proposed and that the applicant company has a duty of full and frank disclosure to the court". The fact that the special resolution is passed unanimously and there are no creditors is not the end of the Court's enquiry. The Court will not lend its assistance by confirming a capital reduction unless it appears to have been done for some legitimate business purpose which is fully explained in affidavit evidence sworn by someone who has direct knowledge of and responsibility for the relevant transaction.

15. My concern in this case arose because these petitions were initially supported by opaque affidavit evidence sworn by an employee of a local service provider who cannot have had any personal involvement in or responsibility for the decisions made on behalf of the Companies. Having now considered the supplementary affidavits and the advice of the Companies' accountants and Colombian tax advisers, the commercial rationale for this asset restructuring exercise has become apparent. It is no part of the Court's function to express any view about the efficacy of the transactions or second guess the commercial judgments made by the Companies' management. It is sufficient that the Court has a proper understanding of the overall exercise and accepts, as I do, that it is intended to achieve a legitimate business purpose.

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16. For these reasons, I am satisfied that all the relevant criteria are satisfied and that I can properly confirm these capital reduction resolutions.

DATED this 17th day of December 2012

The Honourable Mr Justice Andrew J. Jones QC
JUDGE OF THE GRAND COURT