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Cayman Islands: Fund Financing and Taking Security over Capital Call Rights

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In recent years, the subscription facility market has increased significantly in size as more private equity funds use these lines of credit attracted by the flexibility and liquidity that such facilities can offer. Lenders are also moving into the space attracted by the product's strong credit profile and historically low delinquency rates.

The key feature of a subscription facility is the security package. It will typically include security over the unfunded capital commitments of the fund's investors including: (i) the right to make capital calls on investors in respect of their unfunded capital commitments together with rights to enforce payments thereof, and (ii) the right to receive the proceeds of such capital calls. It will generally also include security over the bank account into which investors are required to deposit their capital contributions. The Cayman Islands exempted limited partnership ("ELP") is a common vehicle used for structuring private equity funds and therefore, where so structured, the security package will include an assignment of these rights as provided for in the fund's Cayman Islands law governed limited partnership agreement ("LPA") and related investor subscription agreements.

Subscription line facilities were traditionally used for short term bridging purposes, namely to provide the fund with access to credit pending the receipt of capital contributions from investors. This enables a fund to finance investments quickly – a drawdown on a subscription credit facility can take only a matter of a few days, whereas a fund's LPA will often allow limited partners' 10-15 business days to make payment after a capital call has been made. A subscription credit facility can also be used as an effective cash management tool to pay costs and expenses of the fund and thereby reduce the frequency of capital calls and the corresponding administrative burden.

The popularity of subscription credit lines and the development of the market can be demonstrated by looking at how fund documentation has changed over the years. It is now very common for the fund's LPA to include provisions tailored to address the requirements of subscription facility lenders. We have also seen examples of fund documents that specifically

prohibit a fund from obtaining subscription facilities, which demonstrates how increasingly aware investors are of the popularity of these facilities.

This article looks at the various legal considerations (from a Cayman Islands perspective) for lenders and borrowers where subscription facilities are being made available to private equity funds structured as ELPs.

Cayman ELP Law

The Exempted Limited Partnership Law (the "ELP Law") makes clear that the right to make capital calls and the right to receive the proceeds of such calls constitutes partnership property which is held by the general partner on trust for the partners in accordance with the terms of the LPA. Therefore, it is the exempted limited partnerships rather than the general partner in its own capacity that grants the security over the unfunded capital commitments and the rights to make capital calls. That said, the general partner will still typically be required to enter into the security assignment agreement in its own right to give certain representations, undertakings, covenants and a power of attorney.

It is worth noting that an ELP is not required to maintain a register of security interests over partnership property. However, as a practical matter, it is common for the general partner to record security interests over partnership property in its own register (if applicable) as discussed below.

Key Points to Note when Acting for a Lender

The structure of the fund is clearly going to impact how the facility documentation is drafted. Whilst most Cayman domiciled private equity funds are structured as ELPs, the structure (i.e. type of entity and domicile) of the general partner can vary. This will need to be considered at the outset.

Documentation and Due Diligence

The fund documentation will need to be reviewed. Although it is now typical to find that LPAs include provisions for the fund to enter into subscription facilities, the LPA may contain restrictions around incurring debt, including as to the amount of any indebtedness (which is often expressed as a percentage of the aggregate capital commitments) and the term of that debt.

It will be important to examine the terms surrounding the ability to make capital calls, for example when the commitment period expires and the right to make capital calls ceases. There should clearly be no restrictions on the rights of the general partner to assign its rights to make capital contributions. In fact, it is now typical to see an express right in the LPA allowing for the assignment of such rights by way of security in favour of a finance party under a subscription facility.

Lenders will look at other provisions in the LPA that might undermine the value of the security package such as the general partner's right to set up parallel funds and alternative investment vehicles. These provisions allow the fund to re-direct capital commitments from its investors to another vehicle outside the fund. Lenders will also generally insist on restrictions around the fund's ability to amend its fund documentation without lender consent. Lenders will also want to determine if a fund's investors have agreed to fund commitments without setoff, counterclaim or defence (thereby not potentially reducing the amount of an investor's commitment).

The finance parties will be concerned with the credit quality of the fund's investors and situations that might remove such investors from the borrowing base. So for example the facility might require mandatory repayments if "exclusion events" are triggered absolving one or more limited partners from being required to make a capital contribution. The LPA's transfer provisions will also naturally have an impact and so lenders may seek a veto right in respect of transfers by limited partners (or a certain group of limited partners).

A lender should also review any side letters that have been entered into with investors to determine whether these contain any provisions that might affect the security package.

In addition, the general partner may have delegated powers to make capital calls to an investment manager and so the terms of any such delegation and the investment management agreement should also be reviewed.

Following the implementation of the Private Funds Law 2020 (the "PF Law") in the Cayman Islands, a lender lending to a fund that is a 'private fund' under the PF Law will want to see evidence of the fund's registration under the PF Law and an affirmative covenant in the finance documents that the fund will maintain its registration under the PF Law.

Notice to Investors

Priority of the security over unfunded capital contributions is achieved by giving written notice of the creation of the security interest to the investors (this is the so-called rule in *Dearle v Hall*).

Sending the notice to investors can be a sensitive issue and something that is often subject to negotiation. General partners may be reluctant to send specific notices to the fund's investors, the fund will likely be concerned about maintaining good relations with its investors and may not want to concern them with such details.

How the notice requirement is dealt with will often be determined by the relationship and bargaining power of the lender and the fund, as well as practicalities (such as the number and sophistication of the limited partners in the fund).

The notice should include: (i) the description of the security document; (ii) its date; (iii) the parties to the security document; and (iv) that the security comprises security over capital

contributions and rights to call capital from investors.

It is very common for the entire charging clause to be included within the notice, but this is not strictly required.

Notices should be delivered in accordance with the section of the LPA governing service of notices on the limited partners.

Ideally notice should be given immediately upon execution of the security documents, or within a few days, to avoid a situation in which a secured party's priority may be compromised, however the timing of delivery is often subject to negotiation. The notice is only effective upon receipt of the notice by the investor (not upon it being sent by the fund).

Lenders may ask that investors provide acknowledgements of the security notice but these are not a requirement for the purpose of obtaining perfection or priority. What is key is that notice has been given and so lenders will commonly require some sort of evidence that the notices have been sent.

Updating the Register of Mortgages and Charges

Where the general partner granting the security over unfunded capital contributions and rights to make capital calls is a Cayman Islands exempted company, it is common for it to enter the details of the security into its register of mortgages and charges in accordance with the Companies Law (Revised). However failure to make an entry in the register of mortgages and charges does not affect the validity or priority of the lender's security.

Key Points to Note when Acting for the Fund

At the time of the establishment of the fund, general partners should consider their potential need for a subscription credit facility and whether the fund documentation should be drafted in a way that supports such facilities. The intention being that the general partner is not required to go back to investors at a later date to amend the fund documentation for the purpose of entering into a subscription facility and the associated security package.

When considering the undertaking by the general partner to make capital calls, it may be asserted that the general partner cannot agree to make calls when required to do so by the lender on the basis that it would be an unlawful fetter by the general partner on its discretion. Here we would draw the distinction between the situation where the general partner has agreed to make calls when necessary to meet liabilities to a lender and a situation where it has agreed to make capital calls if and when directed by the lender. In the latter situation it would most likely be fettering its discretion and so the borrower should insist on drafting the undertaking as per the former example.

The fund will be concerned to ensure that the undertakings and restrictions contained in the

facility agreement do not go further than is necessary to protect the lender. General partners will also need to be mindful that the effect of such undertakings and restrictions will not interfere with the day-to-day operation and administration of the fund. For example, borrowers would typically insist that any consent right granted to a lender in respect of the fund's ability to amend its fund documentation only extends to amendments that could have an adverse effect on the lender or its security.

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