OCTOBER 2020

mourant

UPDATE

Fund Finance: Take notice

Update prepared by Alexandra Woodcock (Partner, Cayman Islands) and Danielle Roman (Partner, Hong Kong)

In this update we look at law and practice in the Cayman Islands, and consider how to reconcile the law with the commercial imperative of the real world.

In the context of private equity fund finance, the customary security framework involving the assignment of the partnership's right (acting through its general partner) to call upon limited partners for payment of their uncalled capital commitments, to receive such payments when made and to apply the monies against amounts owing to the lender under the facility agreement, is well understood by borrowers and lenders. However, notice of such security can often be a source of contentious negotiation as the parties seek to blend law and practice into a commercially acceptable solution.

Due Diligence Point: check the terms of the fund's limited partnership agreement to ensure the partnership has power to borrow, and that the general partner has the ability to grant security to a lender over the right of the partnership (acting through the general partner) to make capital calls. Responsibility for checking ancillary agreements, including subscription agreements and any side letters with investors, varies by jurisdiction.

Perfection: a question of substance more than form?

Lenders are naturally concerned to preserve (and perfect) their security; in other words, to know the assignment to them of the right to call upon limited partners to pay-up uncalled capital will be enforceable, and that it will have priority over any security granted to subsequent creditors over the same collateral.

It is generally accepted capital call assignments governed by Cayman Islands law will have effect as an equitable assignment by way of security rather than as an absolute legal assignment. This is of no material consequence in terms of the value of security the lender obtains: the priority of a notified equitable assignment is the nearest equivalent to taking possession by way of legal assignment. It does, however, take such arrangements outside the scope of the Cayman Islands statutory regime for notifying limited partners (ie the debtors) of the assignment (which would apply were the assignment to be an absolute legal assignment) which require that the notice be:

(a) express (and not, therefore, implied);

(b) in writing;

(c) given by the general partner (or its agent lawfully authorised in writing); and

(d) to the limited partners.

Without a statutory framework in the Cayman Islands for form or content of notices of an equitable assignment of a chose in action, practice is to follow closely the statutory framework that applies to legal assignments, which states that notices should:

(a) be in writing;

(b) be clear and unambiguous;

(c) refer clearly to the credit agreement and describe the debt secured;

(d) refer to the assignor's right to make capital calls pursuant to the terms of the limited partnership agreement;

(e) explain clearly that the right to make capital calls has been assigned by way of security to the lender; and

(f) that the general partner may demand and receive payment of capital contributions until such time as the lender enforces its rights to call and receive capital payments.

Whose priority?

Ranking or priority of a lender's security assignment versus subsequently created security created over the same collateral is determined by the order in which notice is given to the limited partners (the so called 'rule in *Dearle v Hall*') which stipulates that a secured party's priority versus other secured party interests over the same collateral will be determined not by reference to the date of creation of the security interests but rather by reference to the order in which the security interests are notified to the third parties whose obligations are being assigned. A lender will, therefore, be concerned to ensure that limited partners are notified of the new security promptly after the general partner has entered into the capital call assignment.

General partners are often concerned to smooth the impact of investor notices being given outside of the usual investor communications cycle, and this can manifest itself as a commercial push-back on prompt delivery of the notice. Lenders are sometimes asked to relax the urgency for notice of assignment to be given until the next round of investor communications. This may be acceptable to some lenders where the time gap is short between creation of the security and notice being given, but the longer the gap the less likely it is that this will be accepted by the lender (notwithstanding the finance documents will likely contain a restriction on the grant of further security without the lender's approval (ie a negative pledge)).

Without Cayman Islands law expressly prescribing how the notice is to be given to limited partners, the correct point of reference will be the fund's limited partnership agreement, ie the agreement which:

(a) governs the relationship between the general partner and the limited partners;

(b) creates the right being assigned; and

(c) ought to prescribe how the parties give notice to one another.

Due Diligence Point: check the terms of the fund's limited partnership agreement to gauge the scope of the notices provisions, paying attention not only to the manner of giving notice but also how it is to be delivered and when delivery is deemed to occur. Side letters may be relevant in prescribing specific notice provisions on an investor by investor basis and should be considered.

There may be negotiation around the form of notice and the mechanism for its delivery. Limited partnership agreements often provide for notices to be given by email and investor portals or other electronic means, and in such circumstances it is key that notice is given in the manner outlined and that any evidence of delivery is obtained in respect of each investor. The best evidence is a written acknowledgment from the investors, but this is not market practice (except on a case-by-case basis for specified investors whose commitments are intrinsic to the credit analysis). However, it remains important to follow any agreed delivery method set out in the limited partnership agreement in order to avoid any doubts that, as a contractual matter, the notice was ineffective. Gaps in notice may be material to the integrity of the credit and security analysis (as to ranking of the security interest) and should be closed.

Lenders and general partners will usually settle upon a timeframe and mechanic for delivery of notices of assignment to limited partner. The risk to a lender of not giving notice to limited partners promptly following the creation of the security assignment is wider than just the interests of a subsequent creditor taking precedence.

English case law (which is persuasive to the Cayman Islands courts) has established an assignor may not, without the consent of the secured party (as assignee), diminish the value of the property which it has assigned to the secured party. However, by giving limited partners notice of the assignment rules of equity will be invited into the relationship which will go further and 'estop' a limited partner from benefiting from any such purported diminution. An additional benefit is that receipt of notice will extinguish (after the date of service of the notice) a limited partner's common law right to set-off any amounts owed to it by the partnership against any capital payment contribution.

Due Diligence Point: oftentimes a private equity limited partnership agreement will impose upon limited partners the requirement to pay capital calls fully, and without asserting any rights of set-off, counterclaim or defence. This is more of a common formulation in the North American market than it is in Europe (with Asia split between North American and European practice). Where this obligation is absent from the limited partnership agreement, notice of the assignment will be a helpful block to arguments of set-off. Credit agreements will also typically incorporate representations and warranties to the effect that there are no existing rights of set-off which could adversely affect or diminish a limited partners' obligation to fund their capital commitments.

Perfect timing

The timing and form of assignment notices are fundamental to the integrity of capital call security arrangements, and a lender's risk profile. Legal considerations and lender interests need not be the sole considerations: the relationship between general partner and limited partners can benefit from bolstering the notice of assignment to accommodate commercial considerations around disclosure and transparency about the fund's use of subscription credit facilities.

Global Perspective

The Guernsey View

Security over call rights in relation to a Guernsey fund is taken by way of assignment of the title to those rights pursuant to a security agreement. Notice in writing of the assignment must be given by the lender to the limited partners. The notice is a requirement for the security to be valid, not merely a means of obtaining priority, and no security will exist until the notice is given.

Beyond the requirement that the notice must be express (as opposed to implied) and in writing, there is no particular form that the notice must take, but market practice as to content is similar to the Cayman Islands. It is not essential that the notice be acknowledged, but evidence of delivery is important.

The Jersey View

The position and approach on this topic is somewhat different now in Jersey, following the introduction of the Security Interests (Jersey) Law 2012. Whereas under the previous law it was necessary to take security over call and related rights by way of assignment, this is now perfected by registration of the security interest on the SIR: the security interest register maintained in Jersey. This means it's not necessary, to perfect security, for a notice to be provided to limited partners; as such, there is less emphasis on the requirement of notice or the timing of provision of the notice, although some LPAs might nevertheless require a notification in this regard. The giving of notice and obtaining acknowledgement still has beneficial use (and remains market practice in Jersey) in eliminating concerns regarding set off, as outlined in this article.

This update does not attempt to give a full analysis of security arrangements associated with fund-level borrowing. For a complete analysis and to discuss any specific requirements you may have, please contact one of the below Partners or a member of Mourant's global fund finance team.

Contacts

Alexandra Woodcock
Partner, Mourant Ozannes
Cayman Islands
+1 345 814 9183
alexandra.woodcock@mourant.com

Alex Last
Partner, Mourant Ozannes
Cayman Islands
+1 345 814 9243
alex.last@mourant.com

Danielle Roman
Partner, Mourant Ozannes
Hong Kong
+852 3995 5705
danielle.roman@mourant.com

John Lewis
Partner, Mourant Ozannes
Guernsey
+44 1481 731 505
john.lewis@mourant.com

Helen Wyatt
Partner, Mourant Ozannes
Guernsey
+44 1481 731 408
helen.wyatt @mourant.com

Mark Chambers
Partner, Mourant Ozannes
Jersey
+44 1534 676 080
mark.chambers@mourant.com

2021934/78956863/1