

FUND FINANCE FRIDAY

‘NAV’igating Cayman Share Security – Lender FAQs

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As the universe of asset-based and hybrid facilities continues to expand, fund finance lenders are increasingly encountering pledges of equity interests issued by funds or SPVs domiciled in popular jurisdictions outside of the U.S. – such as the Cayman Islands. Such pledges raise issues distinct from pledges of the capital call rights of Cayman-domiciled private equity funds, and we regularly field questions from lenders as to the best way to take and enforce such security. This article aims to answer some of the most frequent questions that lenders ask in respect of security over shares of Cayman exempted companies.

Do we need a separate security agreement for the Cayman shares?

This is by far the most common question we get when Cayman share security is in play. There is no requirement from a Cayman perspective that security over shares of a Cayman exempted company must be granted by an agreement governed by Cayman Islands law. And it is not uncommon for security over Cayman limited partnership interests or limited liability company interests to be documented under a New York law agreement that has been “Caymanized” to address certain Cayman law issues. When it comes to pledges of shares in Cayman Islands exempted companies, however, most forms of share pledge that are governed by U.S. law are more challenging to adapt in order to adequately constitute a security interest that could be easily enforced without seeking the assistance of the Cayman courts. For this reason, Cayman lawyers commonly advise that it is preferable to have a separate Cayman Islands law-governed security agreement (usually a “charge” or “equitable mortgage” over shares) which documents the security from a Cayman legal perspective and provides for the requisite protections to ensure ease of enforcement should the need arise. This Cayman security agreement is often entered into alongside a U.S. law-governed security agreement.

What type of diligence needs to be completed ahead of the grant of security?

As the key point in Cayman share security is the lender's ability to easily call for a share transfer upon the occurrence of an event of default, the constitutional documents of the Cayman exempted company (being the memorandum and articles of association) need to be carefully examined to ensure that no share transfer restrictions are present that could frustrate this process. It is common that restrictions on transfer are included in "standard" Cayman exempted company articles of association and so, in most cases, a shareholder resolution amending the articles is requested as a closing deliverable to provide, amongst other points, for the removal of transfer restrictions on shares that are subject to a security interest. The register of members of the Cayman exempted company should also be examined to check for any notes or evidence of existing security over the shares.

Is the security interest registered in the Cayman Islands?

The Cayman Islands does not have a central forum or legal framework for the granting of security over shares in a Cayman Islands exempted company or the regulation of perfection or priority of such security interests. Accordingly, Cayman Islands share security is a construction of English common law principles and contractual terms to allow ease of enforcement without the requirement for the parties to seek the input of the Courts in an event of default.

Are additional documents needed beyond the share security agreement?

Irrespective of whether the share security agreement in question is governed by U.S. or Cayman Islands law, certain ancillary documents are delivered at closing to ensure the lender is in the best position to enforce its security upon default, most notably: (i) a signed but undated share transfer form; (ii) signed and undated directors resignation letters, together with letters of authorisation to date such letters after an event of default; (iii) a signed proxy form to vote the shares in favour of the lender; (iv) notices to the exempted company and undertakings by the registered office provider to the company whose shares are subject to the security; and (v) where relevant, shareholder resolutions approving amendments to the articles of association of such company (together, the "Cayman Security Deliverables").

How would we enforce the security in an event of default?

The security agreement will commonly provide the specifics of enforcement but, assuming that the full suite of Cayman Security Deliverables has been obtained on closing, then enforcement of the security is usually a simple matter of executing the share transfer form provided on closing and delivering it to the registered office of the company, which will then update the register of members to reflect the lender (or its nominee) as owner of the shares in question. Having obtained the undertaking of the registered office provider, set out in (iv) above, becomes very helpful if a default occurs as the registered office provider will then have already undertaken to process the share transfer in such a scenario and so will be required to act on the transfer request. Obtaining the full suite of Cayman Security Deliverables on closing becomes even more important if a contentious scenario arises. For example, were the directors of the company to attempt to frustrate the lender's share transfer request, the lender could then date the director resignation letters under the authorization granted by the directors on closing (removing them from office) and use its proxy to appoint its own directors to the company, taking management control and ensuring that the share transfer can proceed. The end result of

an enforcement of the share security is that the lender (or its nominee) becomes the holder of the shares (and the corresponding economic interests) and has the ability to nominate its own directors to control and manage the company.

Is stamp duty payable and at what rate?

Unless the security document is executed in or brought within the Cayman Islands, no stamp duty (or other Cayman Islands tax) is payable on the creation of the security interest. If the security document were to be brought into the Cayman Islands (e.g., to be presented to a Cayman Court) the issue would remain immaterial as the amount of stamp duty payable on a charge over the shares of a Cayman Islands exempted company is capped at US\$600.

If the entity whose shares are charged is registered as a Cayman Islands Mutual Fund or Private Fund, are any regulatory approvals required?

No prior regulatory approval (or post-closing notification) is required in respect of the granting of security over shares of a Cayman exempted company that is registered with the Cayman Islands Monetary Authority ("CIMA") as a mutual fund or private fund. CIMA approval is not required for enforcement of the share security or any resulting change of control of the entity.