

FUND FINANCE FRIDAY

The Corporate Collateral Package in Subscription Facilities: A Share Peg in a Round Hole

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Those in the subscription credit market will likely be familiar with traditional collateral arrangements over the capital call rights of Cayman funds formed as exempted limited partnerships (ELPs). Recently, however, we have seen a resurgence in the use of funds formed as Cayman exempted companies (CayCos), rather than ELPs, which gives rise to some additional considerations for a lender.

ELP vs. CayCo

There are both structural and practical differences between ELPs and CayCos in terms of contributing capital to the fund which can impact how the collateral package is structured.

In terms of the structural differences: while the governing agreement of an ELP is the limited partnership agreement (LPA) (which is a contract between the parties thereto with rights capable of assignment by the ELP), the governing agreements of a CayCo are its memorandum and articles of association (M&As), which are not of themselves capable of assignment by the CayCo. This results in one of the fundamental differences in a corporate subscription facility, as a lender will essentially receive security over the subscription documents (which are then subject to the M&As), rather than over the actual governing document of the CayCo.

In terms of the practical differences: for a CayCo, typically capital contributions are linked to the obligation of the CayCo (acting through its directors or investment managers) to issue shares. The creation of an obligation on the investors in the CayCo to purchase shares “to-be-issued” is different from the obligation of an investor in an ELP to fund the remainder of its capital

commitment to the ELP as part of its existing interest. This difference results in both enforcement concerns and additional insolvency risks – the biggest potential issues for a lender (each discussed further below).

Due to these fundamental differences, security over a CayCo's right to draw down outstanding capital commitments from its investors differs from the arrangements which have become common practice in relation to securing capital call rights of ELPs.

Further share issuances: enforcement considerations

Of utmost concern to a lender is its ability to enforce an investor's obligations to contribute to the CayCo, irrespective of the CayCo's ability to issue shares to the investor on payment. Following a capital call, the investor might expect to be issued additional shares for the capital contribution which has been made, and such issue will only then give rise to the payment obligation to the CayCo (proceeds of which are subject to claim by the lender pursuant to its security entitlements). This then leads to a practical issue for a lender on enforcement: how to issue the shares and have the register of members of the CayCo updated in order to receive payment.

Further share issuances: insolvency risk

If a winding up petition is issued before a capital call is made, there is a question as to whether section 99 of the Cayman Islands Companies Act (dealing with the avoidance of dispositions) would require a validation application to be made to the Court, because the issue of shares post-petition would be considered "an alteration of the status of the company's members." Without Court approval of the share issue, the capital call would be void and the money would be recovered for the benefit of the liquidation estate of the CayCo.

The solution

To address enforcement and insolvency concerns, we suggest that capital contributions be structured such that no further shares are required to be issued or that the CayCo has the option, but not the obligation, to issue further shares in exchange for capital contributions. Like most other concepts, this is ideally baked in from inception of the fund and should be included in the subscription documents, the M&As and any offering document. It is worth noting that we do often see this approach where subscription facilities have been contemplated when the CayCo was formed. If the fund is already in existence, this can also be achieved by way of amendment of these documents.

If the requirement to issue shares cannot be avoided, there are some innovative solutions that can be adopted. We have seen various approaches, including (i) investors being issued shares at a nominal par value on closing, coupled with a remaining obligation to fund their outstanding commitment with respect to those shares when called to do so by the CayCo (the lender was then granted a security interest over its right to enforce the investors' obligations to fund their remaining commitments), or (ii) investors waiving their right to receive shares on an insolvency pursuant to an investor letter, coupled with preapproval of any share issuance on enforcement. We note, however, that these workarounds are deal-specific and generally not as neat or straightforward for a lender as where the capital contributions are not tied to a share issuance.

Additional considerations

Of course, the ideal LPA for a lender also includes a suite of protections in addition to just the ability to make capital calls (*e.g.*, the ability to call on non-defaulting investors, the requirement to fund without setoff, counterclaim or defense, etc.), so lender's counsel will need to closely review the M&As, in conjunction with the applicable subscription documents, to ensure that the lender is also sufficiently covered in relation to the wider suite of lender protection provisions. The separate elements of the standard subscription security package (*i.e.*, security over the collateral account and the power of attorney) should not be impacted by the fund being a CayCo, rather than an ELP.

Conclusion

Given the array of unique issues and concerns around CayCo subscription financings, in our experience it is critical to engage counsel at the early stages of the transaction. As with all fund finance structures, the smoothest transactions occur where the investors are aware that subscription financing will be utilised by the fund, with the fund's documents set up at the outset to anticipate the applicable financing structures and pre-empt creditor concerns. Although not without its challenges, with careful review and relevant amendments, a robust corporate fund security package can certainly be achieved.