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Capital call security perfection in the Cayman Islands – who, how, what, when and why

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Although long recognised as integral to protecting a lender's position, recent market events have re-emphasised the importance for lenders of successfully navigating the idiosyncrasies of the law regarding the perfection of security interests over capital call rights in the Cayman Islands. Indeed, despite being a well-trodden path, we are regularly asked to explain some of the more granular aspects and pitfalls of the regime and comment on the practical impact of variations in market practice. This note thus aims to provide a brief overview for lenders and onshore practitioners on the who, how, what, when, and why of the topic as well as some (hopefully) useful practical considerations.

The rule in Dearle v Hall

Named after a Nineteenth Century English case, the rule can be summarised as follows: as between competing equities in, or security interests over, a legal interest in a contractual right or receivable, priority is afforded to the first person to give notice, regardless of the order in which competing interests have been created[1].

To whom must notice be given and who must give it?

With respect to a right to make a capital call / drawdown on a commitment, notice of the security must be given to each counterparty that owes such commitment (i.e. the relevant limited partners, shareholders, or members (the "**Investors**")).

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1 This is subject to certain limited exceptions. For example, a subsequent security holder cannot generally take priority by giving notice first if it knew of the prior interest at the time its interest was created.

As a legal matter, it should be of no consequence who provides notice of the security interest. However, as a practical matter, notice is often best given by the general partner or such other party that usually communicates with Investors, if for no other reason than to heighten the chance of such notice being received and read.

How should notice be given?

What must be shown is *"proof that the mind of the [Investor] has ... been brought to an intelligent apprehension of the nature of the incumbrance which has come upon the property, so that a reasonable man, or an ordinary man of business, would act upon the information and would regulate his conduct by it"*[2].

As such, while any number of methods of notice may suffice, the prudent view is that constructive notice will be insufficient. The test is thus partially a factual one: has notice actually been received? Some practical ramifications of this include the following:

- Any method of delivery that heightens the chance that an Investor will not read a notice, also heightens the chance that perfection will not have occurred. For example, the increasingly popular use of investor portals (which some Investors may not regularly access) is arguably less preferable for a lender than, say, sending notices by recorded delivery.
- Although not legally required (and admittedly not universal market practice), obtaining acknowledgement of the notice from each Investor provides helpful evidential support that perfection has indeed occurred.

What should a notice contain?

Although invariably given in writing, there is no prescribed form that a notice must take. Practically however, particularly in light of the above, while a notice need not set out every detail of the security, it should include:

- the nature of the document granting the security interest;
- a reasonable description of the property subject to the security interest;
- confirmation of the identity of the security holder (and the capacity in which it is acting), and
- the nature of the obligations secured.

Lenders and counsel should thus be wary of overly simplistic or opaque wording, and it is incumbent on Cayman Islands counsel to ensure that the proposed form includes all relevant detail. Equally, it is arguably prudent to ensure that any change in the material substance of the arrangements (e.g. the nature of the sums secured) is also notified to the Investors.

When should notice be given?

The longer the period between sums being drawn under the facility and notice being given to Investors, the greater the risk that some intervening and prior-ranking security (or other interest) over the collateral will arise. Further, as highlighted below, there are a number of other benefits to providing notice to Investors beyond mere perfection none of which will apply during such time.

With that said, lenders regularly take a view and accept various periods of delay, for example, until the next monthly or quarterly reporting packs are circulated. The level of comfort a lender may have will of course depend on the specifics of the transaction and in particular, the identity of the sponsor.

One important point of note is that there is support[3] for the view that notice can only be effectively given once the commitments in question have come into existence (and not thus in relation to future assets). As such it is prudent for a lender to avoid notice of a security interest being given prior to the relevant Investor's commitment being accepted and becoming legally enforceable.

Why should notice be given?

As above, notice functions to perfect the security and help ensure that subsequent security interests cannot rank ahead of the relevant lender's claim. In addition however, other benefits include:

- *Set off* – while many fund documents expressly exclude rights of set off with respect to Investor commitments, in the absence of such language, notice of security over such commitments should also help negate the mutuality required for future rights of set off to arise between an Investor and the fund[4].
- *Waiver of commitments* – as highlighted in a previous Carey Olsen note[5], giving Investors notice of the grant of security, and any contractual restrictions on the unilateral release or waiver of Investor commitments, may help provide a lender with recourse in the event that such restrictions are breached.
- *Satisfaction of obligations* – notice may prevent any Investor from obtaining good discharge of its funding obligations in circumstances in which it pays such sums contrary to the terms of the notice.

2 Lloyd v Banks (1867-68) LR 3 Ch App 488.
3 Johnstone v Cox (1880) 16 Ch D 571 and Re Dallas.
4 Noting here that insolvency set off is not mandatory in the Cayman Islands.
5 Fund Finance and releases of investor commitments: How can lenders protect themselves?

Continued

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