

Fund Finance Friday



A Holiday Tale - The Separation of Church (Security Agreements) and State (Laws) in CayLux Security Arrangements

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One of the common threads that runs through the granting of security over Cayman and Luxembourg property, be it capital call rights under an LPA, bank accounts or shares/interests in CayLux vehicles, is that neither jurisdiction has a central register or forum where a party is required to 'file' the security interest with a state body - either for reasons of priority or by way of placing third parties on notice.

New lenders in the market (of which there have been many in recent years!) and their internal legal counsel often find this fact slightly odd when compared to jurisdictions with public filing systems. Accordingly, the differences between what the laws of Cayman or Luxembourg provide for when compared to the security arrangements that are put in place in other jurisdictions is a common discussion topic when new entrants are getting comfortable with non-US vehicles appearing in their deals.

The absence of public or post-closing filings for security registration does not however mean that the laws of Cayman and Luxembourg have nothing to say on the interests of secured creditors. This note summarizes the most frequently seen intersections of the laws of Cayman and Luxembourg with security taken as part of fund finance deals.

Cayman - In Cayman the granting of security is primarily structured by contractual arrangements that allow a secured party to take possession of property in an enforcement scenario without the involvement or approval of the courts. There is no specific law or statute dealing with security interests and how they should or must be documented or put in place.

Each of the Companies Act and the Exempted Limited Partnership Act are crystal clear however in protecting the 'bankruptcy remote' nature of security over the assets of a Cayman company or limited partnership and provide that

where a winding up order has been made, or restructuring officers have been appointed, in respect of a company or limited partnership (as applicable) a creditor who has security over the assets of such company or limited partnership is entitled to enforce that person's security without the leave of the Court.

The only minor wrinkle that does arise in Cayman between security documentation and the general law is the so-called 'Section 99' issue. This only occurs where there is security over the shares of a Cayman company or the call rights of a Cayman company to require investors to subscribe for further shares (in the latter case, if the company is structured as a capital commitment/call private equity fund vehicle). Section 99 of the Companies Act (a section also applicable to limited partnerships) provides that when a winding up order has been made in respect of a company "*any disposition of the company's property and any transfer of shares or alteration in the status of the company's members made after the commencement of the winding up is, unless the Court otherwise orders, void*". The wrinkle that arises is that if a lender seeks to: (i) enforce share security in a NAV deal; or (ii) call on capital of investors in a subline deal, following a winding-up order being made in respect of that company and they wish to update the register of members or issue shares to reflect this action then Section 99 may, in some potential but unlikely scenarios (the best example being if the service provider that maintains the register of members is refusing to act without court direction; though even in that scenario there would be alternative options) require them to seek the approval of the Court in order to do so. There are steps commonly taken pre-closing in either case to avoid the Section 99 issue arising and it is important to note that in either scenario the worst-case result is likely additional interaction with lawyers(!) to make what would be an uncontroversial Court application for approval, with the enforceability of the security totally unaffected in the interim period.

Luxembourg - In Luxembourg security and collateral arrangements are specifically legislated for by the Financial Collateral Law (FCA). The FCA sets out a core set of requirements to be met in order for a grant of security to gain the benefits afforded to secured parties under it, but it does not require any public or post-closing filings to be made in Luxembourg.

One minor point of discussion that has arisen in recent years is the interaction of the FCA (which protects security arrangements taken in accordance with its terms from being affected by insolvency and bankruptcy proceedings so that they are 'bankruptcy remote') and the recently introduced Reorganization Law which affords parties in reorganization proceedings with certain protections from their creditors, including the suspension of payment obligations.

While there is a broad consensus that security interests taken in accordance with the FCA are unaffected by the opening of reorganization proceedings, there are certain technical points that have been raised about how an enforcement trigger in a security arrangement (if drafted to require a debt to become due and payable in order for security to be enforced) would be viewed by the Luxembourg Courts and whether it would result in a potential delay in a party being able to enforce its security. It would not, however, in any way invalidate such security. While the issue is a very technical one, it is now easily sidestepped by carve-out language which is now commonly added in Luxembourg documents 'for the avoidance of doubt' on this issue, so that there is no question of whether an enforcement could be affected by the Reorganization Law.

Conclusion - The good news underscoring any discussion on CayLux security arrangements is that, while they differ to some jurisdictions in not having public filings, in both Cayman and Luxembourg the rights of creditors are strongly protected by common law or statute and the Courts of both jurisdictions could easily be described as being very 'creditor friendly' when called upon to enforce security interests and contractual arrangements. Lenders in the fund finance market continue to be comfortable with the protections afforded to them in both Cayman and Luxembourg and while defaults in fund finance are typically remote events, strong precedent exists in each jurisdiction for the fast and effective enforcement of the types of security arrangements utilized in the fund finance market.