Cell companies: the segregation of assets and liabilities

The concept of cell companies was first introduced to Jersey in February 2006. In addition to the widely recognised structure of a protected cell company, Jersey also introduced a completely new concept - the incorporated cell company.

The key issue which differentiates both types of cell company from traditional (non-cellular) companies is that they provide a flexible corporate vehicle within which assets and liabilities can be ring-fenced, or segregated, so as only to be available to the creditors and shareholders of each particular cell.

Protected cell companies and incorporated cell companies
A protected cell structure involves a single legal entity (the "protected cell company" or "PCC") within which there may be established numerous protected cells. Each protected cell, despite having a separate memorandum and articles of association, shareholders and directors, as well as being treated for the purposes of the Companies (Jersey) Law 1991 (the "Companies Law") as if it were a company, does not have a separate legal identity from the PCC itself. Accordingly, where a cell wishes to contract with another party, it does so through the PCC acting on its behalf.

In contrast, an incorporated cell of an incorporated cell company (or "ICC") is a completely separate legal entity, with the ability to enter into arrangements or contracts and to hold assets and liabilities in its own name.

Segregation of assets and liabilities
The assets of a protected cell company are divided between those which are cellular and those which are non-cellular. Cellular assets are attributable to particular cells; non-cellular assets belong to, or are owned by, a PCC in its own right. The directors of a PCC are required to exercise their powers, and to discharge their duties, in order to ensure that:

(i) the cellular assets of the cells are kept separate and are separately identifiable from the non-cellular assets of the PCC; and
(ii) the cellular assets attributable to each cell are kept separate and separately identifiable from the assets attributable to the other cells of the PCC. In order to ensure that creditors and third parties are aware of this position, a director of a PCC is under a duty to notify counterparties to a transaction that the PCC is acting in respect of a particular cell. A director who fails to make this notification and to accurately reflect this in the minutes of the PCC or protected cell is guilty of an offence.

The crucial protection which the Companies Law affords to shareholders of a protected cell or PCC against creditors is that losses incurred in one cell of a PCC, or the PCC itself, do not affect profits in another cell. If a protected cell (or the PCC) is unable to satisfy the liabilities it owes to a creditor out of its own assets that creditor is not entitled to have recourse to the assets of other cells within the protected cell structure or the PCC itself.
"In order to ensure that the winding up of a protected cell does not affect the PCC or other cells within the structure, the ability of a PCC to exercise its powers whilst the winding up of a protected cell is in progress is not affected."

The Companies Law contains detailed provisions to ensure that, although protected cells are not themselves distinct legal entities, similar protection is offered and creditor recourse is limited to relevant assets only. Thus, the recourse available to a creditor of a PCC or protected cell is limited:

- to non-cellular assets if he has entered into a transaction with the PCC in its own right; and
- to the cellular assets of the cell in respect of which he has transacted, if he has entered into a transaction attributable to a particular protected cell.

Specific provisions have been included within the Companies Law to ensure that creditors of Jersey cells treat cellular and non-cellular assets in the correct manner. In particular, if a creditor recoups any assets of a PCC which are not assets of the relevant cell, such creditor is prevented from using such assets to meet its claim. Instead, the creditor must hold the assets on trust for the PCC and must pay or return them on demand to the PCC. Similarly, a creditor who succeeds in obtaining cellular or non-cellular assets to which he or she is not entitled is liable to repay to the cell or PCC (as applicable) an amount equal to the benefit improperly obtained. If the creditor fails to pay or return such assets to the PCC on demand, he or she will be guilty of an offence.

A PCC may, subject to certain conditions, agree to meet the liabilities of a particular cell. In order to do so, the articles of association of the PCC must provide for such arrangements and the directors of the PCC must make a statement of solvency at the time the assistance is given. In practical terms, such ability may not be commonly used, as it may be considered on undesirable muddying of the segregation between the PCC and cells (and in any event PCCs usually have limited paid up share capital and rarely hold any material assets over and above those required to sustain the PCC).

In the majority of cases, the ability to meet the liabilities of other cells is expressly precluded within the PCC and protected cell articles of association. In addition, measures are often taken to ensure that any contracts entered into by the PCC on behalf of a protected cell provide for the exclusion of any third party rights against the PCC or any other cells within the PCC structure.

As each cell of an ICC is a company with separate legal identity, the treatment of

segregation is straightforward, with assets and liabilities being held separately within each incorporated cell.

**Jersey insolvency**

Jersey law applies the same ‘ring-fencing’ doctrine to liquidators and receivers of PCCs and protected cells. Thus, as a result of the Companies Law (and in the absence of any special provisions in the articles of association making the non-cellular assets subject to the liabilities of an insolvent cell) creditor claims are restricted to the relevant cellular assets and creditors are denied access to non-cellular assets. The insolvency of a protected cell should not, therefore, affect the business of the PCC entity, the performance of the other protected cells within the PCC structure or lead to the insolvency of the PCC or other protected cells.

If directors are in any doubt as to whether a liability should be met by cellular or non-cellular assets of a PCC, or by a combination of both, Article 127YW of the Companies Law enables a PCC to apply to the court for determination. In certain circumstances, this may offer an attractive solution to directors who are uncertain whether they have complied with the law and/or their responsibilities to the cell or PCC.

Protected cells of a PCC can be wound up in isolation using the same procedure applicable to Jersey companies as set out in Part 21 of the Companies Law. However, in order to ensure that the winding up of a protected cell does not affect the PCC or other cells within the structure, the ability of a PCC to exercise its powers whilst the winding up of a protected cell is in progress is not affected. A PCC cannot be wound up while it continues to have one or more cells. Therefore, the only manner in which a PCC can be wound up is if all protected cells are either: (i) transferred to another PCC; (ii) wound up; (iii) "spun off" as a separate body corporate or cell under the law of another jurisdiction; (iv) incorporated independently of the PCC; or (v) merged with another company.

Due to their corporate nature and separate legal personality, Jersey ICCs and incorporated cells are treated for all purposes as separate companies. This means that the normal provisions regarding insolvency apply to each, as they would to an insolvent traditional limited company (i.e. no creditor of an incorporated cell would have recourse as a matter of law against the ICC or another cell
within the structure, just as no creditor of one company would have any claim against another, unconnected, company).

**Insolvency in foreign jurisdictions**

Although the interpretation of insolvency law in so far as it relates to protected cells in Jersey is straightforward, there is no absolute guarantee that foreign jurisdictions will treat such structures in the same way. This may be particularly true where a foreign jurisdiction does not provide for similar protected or "segregated" cell structures in its own legislation.

However, the concept of a PCC should not, in principle, be offensive to a foreign jurisdiction, on the basis that is simply a statutory arrangement limiting liability which seeks to achieve similar results to that provided by a (widely acceptable) contractual limitation of liability clause. Assuming that a foreign court would be prepared to view PCC status as an attempt to limit liability, rather than to block remedies or to deprive creditors of statutory protection, it would seem unusual that they would find such status offensive. In particular, a foreign court should not have much sympathy for a creditor where such creditor knowingly and willingly transacted with or participated in a PCC or protected cell on the basis and understanding of recourse being limited to a specific cell.

There is some legal commentary (most notably, based on the US bankruptcy court case involving a number of connected Cayman hedge funds known as the SPhinX funds) that argues that a segregated portfolio company (the Cayman equivalent to a PCC) should be treated as akin to a trust. However, this approach appears to have been rejected by the majority of commentators on the grounds that the segregated portfolio concept struggles to fit within conventional trust law notions. Accordingly, in our view, a corporate/contractual analysis is likely to be applied.

Although not providing definitive guidance on the nature of protected cell companies, the SPhinX case did provide some useful guidance on some of the potential pitfalls and practical safeguards which could be followed when managing segregated portfolio company structures, and which could equally apply to PCCs. If a portfolio or a cell is able to avoid the pitfalls identified in the SPhinX case, there seems to be a good chance the segregation principle will be upheld in the majority of overseas jurisdictions.

While the segregation principle seems relatively simple to comply with, a key problem in the SPhinX case was the intermingling of monies in non-segregated accounts. This problem appears to have been compounded by a poor system of internal controls, lack of accounting measures and records, and an inability to unwind inter-company transactions. The directors of the segregated portfolio companies had, it seems, effectively treated the portfolios as a single entity. There were common directors, board meetings and, critically, decision making (the majority of which were based, or took place outside of the Cayman Islands). Together, these factors resulted in an inability to "look through" transactions and clearly identify the assets and liabilities of particular portfolios (they also posed a further problem in determining the appropriate jurisdiction to oversee insolvency proceedings).

In addition to the above, it also appeared that little consideration had been given to funding expenses not applicable to the portfolios, as the segregated portfolio company itself did not maintain, or seek to raise, any share capital of its own. This resulted in the segregated portfolio company being unable to meet its liabilities arising in respect of general creditors, which could not be legitimately met with funds held in the portfolios. These failures together suggested that the portfolios were not ring-fenced companies at all, but rather should be regarded as one 'vehicle' where joint decisions were made for a series of connected companies.

The SPhinX case also highlights some differences between the Cayman segregated portfolio model and a Jersey PCC structure. Most notably, in a PCC structure the distinct identity (and therefore segregation) of each cell is reinforced by virtue of the fact that each separate cell has its own directors, shareholders and separate memorandum and articles of association. In contrast, Cayman segregated portfolio companies rely on internal records and accounts to make a distinction.

The majority of commentators appear to believe that most jurisdictions will, in due course, accept the principle of ring-fencing on the grounds that segregation is not contrary to public policy or so offensive to the general principles of contract to deem it unlawful. In the interim, where it is not possible to incorporate and operate a PCC solely in its home jurisdiction, to ensure that cells and
protected cell companies are treated appropriately and to mitigate against the possibility of foreign jurisdictions not recognising their existence, it is vital that clarity is achieved in all contracts entered into by a PCC. Steps which can be taken include: clearly stating that a contract is entered into in respect of a particular protected cell only; confirming (if relevant) that assets are to be treated as segregated (one of the fundamental failures of the SPX case); and, where possible, submitting to the law of Jersey and the jurisdiction of the Jersey courts. Such provisions, being a clear indication of the contracting parties' intentions, should, in our view, be persuasive in most jurisdictions, regardless of whether a form of segregated cell company exists in its legislation or not.

We also note that the English courts have shown a willingness to co-operate with a foreign insolvency jurisdiction where such foreign jurisdiction is considered more appropriate than England for the purpose of dealing with outstanding questions in a winding up. In the case of McGrath v. Riddell, the House of Lords upheld the principle that, where a principal liquidator has been appointed in the home jurisdiction of the company or cell, UK courts should ensure that assets are remitted to such liquidator in order to be distributed under a single system. Such approach should support the assertion that assets of cells held in the UK should be remitted to a Jersey appointed liquidator to be dealt with in accordance with the Companies Law.

It remains the case that, presently, not all jurisdictions will necessarily and automatically recognise and enforce provisions in relation to protected cell structures. However, the robust statutory position in Jersey is designed to bolster the concept of protected cells and should provide comfort for those using PCCs. In addition, with the number of jurisdictions adopting legislation providing for cellular companies increasing, any residual risks arising from the non-recognition of the segregation of assets and liabilities appear likely to recede.
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