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Protected Cell Companies in Guernsey

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This briefing note describes the key features of a protected cell company ("PCC") and summarises the formation, structure and the liquidation procedures particular to this type of company. Essentially, a PCC consists of a core and of separate and distinct cells. The assets and liabilities of one cell are segregated and protected from those of the other cells. Similarly, the assets and liabilities of the core are segregated and protected from those of the cells. For investment funds, the attraction of a PCC is the avoidance of any cross-class contagion if a class or portfolio within an umbrella fund becomes insolvent and if the creditors attempt to enforce judgments against assets within other classes. Insurance companies have found the PCC structure attractive for use by rent-a-captives, transformers and a wide range of other ART solutions. There has also been a number of CAT bond issues and the securitisation of life business within individual cells of a PCC.

Key features of a PCC

The principle is that where any liability arises which is attributable to a particular cell or to the core, the cellular assets attributable to that cell or the core assets attributable to the core, should be used in satisfaction of the liability. Thus, when considering a liability attributable to a cell, the core assets and the assets attributable to any cell other than the cell to which the relevant liability is attributable, are "protected assets".

A PCC must inform any person with whom it transacts that it is a PCC and must identify or specify the cell in respect of which such person is transacting. In this way, creditors are notified of the limited recourse they have to the assets of a PCC.

Who can be a PCC?

The following may be or become a PCC:

- an authorised or registered collective investment scheme under The Protection of Investors Law, 1987, as amended (the "POI Law");
- a company licensed to carry on controlled investment business within the meaning of the POI Law;
- a closed-ended investment company;
- a corporate licensee within the meaning of the Insurance Business (Bailiwick of Guernsey) Law, 2002, as amended (the "Insurance Law"); and
- a company administered by a person with a licence under the POI Law, the Insurance Law, the Banking Supervision (Bailiwick of Guernsey) Law, 1994 (as amended), the Regulation of Fiduciaries, Administration Business and Company Directors etc (Bailiwick of Guernsey) Law, 2000 (as amended) or the Insurance Managers and Insurance Intermediaries (Bailiwick of Guernsey) Law, 2002 (as amended).

Licensed Guernsey banks, insurance managers or intermediaries, licensed fiduciary companies and companies licensed to carry on controlled investment business cannot be or become PCCs.

Incorporation of a PCC

In order to incorporate a PCC it is necessary to obtain the prior written consent of the Guernsey Financial Services Commission ("GFSC"). This consent must be obtained also when converting:

- an existing company into a PCC; or
- when converting a PCC into a non-cellular company; or
- when converting the cell of a PCC into a non-cellular company

The letters "PCC" or "Protected Cell" must be included in the PCC's name. The Memorandum of Incorporation must state that the company is a PCC. Additionally, each cell must have its own distinct name and assets.

A PCC can either issue shares attributable to the cell or the core. The proceeds of issue of shares attributable to a cell are comprised in the cellular assets attributable to that cell. Proceeds of issue from shares other than cell shares are comprised in the core assets.

Separation of assets

The directors of the PCC must keep cellular assets separate and separately identifiable from the core assets and also keep cellular assets attributable to each cell separate and separately identifiable from cellular assets attributable to other cells. Nonetheless, the assets of a PCC may be collectively invested, provided that they remain separately identifiable. The assets of a PCC may also be held by a nominee or underlying company, the capital of which forms cell or core assets (as the case may be).

Attributing liability and recourse against assets

Unless excluded in writing, it is an implied term of every transaction to which a PCC is party that no party shall make or attempt to make liable any "protected assets". The Law sets out recovery mechanisms in favour of the PCC should any such party be successful in taking protected assets in satisfaction of liabilities. The principle is that, subject to the terms of any recourse agreement, the cellular assets attributable to a cell must be used in satisfaction of any liability attributable to that cell. In the same way, the assets attributable to the core are liable in respect of liabilities attributable to the core.

In the absence of a recourse agreement, creditors of a cell of a PCC only have recourse against the cellular assets attributable to that cell and those cellular assets are "absolutely protected" from the creditors of the company who are not creditors in respect of that cell. Similarly, unless a recourse agreement stipulates otherwise, the core assets of a PCC are only available to the creditors of the core and are "absolutely protected" from any creditors of the PCC who are not creditors of the core. Liabilities of a PCC not otherwise attributable to any of its cells must be discharged from the PCC's core assets.

A recourse agreement is a written agreement between a PCC and a creditor which provides that "protected assets" may be subject to a liability owed to a creditor. Prior to entering into a recourse agreement, each director of the PCC who authorised entry into the recourse agreement, must make a declaration that he believes on reasonable grounds that no creditor of the PCC will be unfairly prejudiced by the agreement. Where the assets in question are either cell or core protected assets, the declaration must also state that a resolution has been passed by the core members or the members of the relevant cell (as appropriate) approving the recourse agreement, unless the Memorandum and Articles of Incorporation provide otherwise. A director who makes a declaration without grounds is guilty of an offence.

On the application of a PCC, the Court may issue a declaration if there is a dispute as to whether a right, liability or creditor is or is not attributable to a particular cell or as to the amount to which any liability is limited.

Information obligation

A PCC must inform any person with whom it transacts that it is a PCC and identify or specify the cell in respect of which that person is transacting or specify that the transaction is in respect of the core (as appropriate). If a PCC fails to provide the transacting party with this information then the directors become personally liable to the counterparty to the contract although, unless they were fraudulent, reckless, negligent or acted in bad faith, they have a right of indemnity against the core assets of the company. Only the Court can relieve the directors from this liability for grounds set out further in the Law.

Transferring cellular assets to third parties

With the approval of the Court, the assets of a particular cell, but not of the core, can be transferred to another person wherever resident or incorporated. Note that this transfer mechanism is not intended to cover the investment or divestment by the cell of cellular assets or the payment or transfers from cellular assets in the ordinary course of the PCC's business. Such ordinary course transactions do not need Court approval.

The Court will only approve a transfer of cellular assets if it is satisfied that the creditors of the cell concerned have consented to the transfer or would not be unfairly prejudiced by the transfer. The GFSC has a right to make representations to the Court in respect of the transfer. A transfer can be approved by the Court even though the PCC is being wound up or it or any of its cells is subject to an order for receivership or administration.

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Arrangements between cells affecting cellular assets

A PCC may in the ordinary course of its business, or the business attributable to any of its cells, make an arrangement where it deals, transfers, disposes or attributes cellular or core assets between any of its cells or between the PCC and any of its cells. If necessary, the PCC must adjust its accounting records and those of the affected cells to reflect the new arrangement. The PCC itself, its liquidators or administrators, or the receiver or administrator of any cell may apply to the Court to make an order in respect of the execution, administration or enforcement of an arrangement.

Conversions

There are a range of conversions possible with PCCs. The process to effect a conversion is the same regardless of the particular transaction being considered: the consent of the GFSC is always required as well as a special resolution of the shareholders of the entity (or cell) which wishes to convert. The conversions which are possible are:

- a non-cellular company may convert into a PCC;
- a PCC may convert into an incorporated cell company; and
- a PCC may convert into a non-cellular company.

Further, a PCC cell may convert into a non-cellular company subject to the consent of the GFSC and with the authorisations of the PCC's core shareholders (excluding the cell's shareholders), the cell's shareholders (if any) and the PCC's creditors.

Liquidation of a PCC

In a winding up, the cells of a PCC remain separate and the liquidator may apply a cell's assets only to those creditors entitled to have recourse to them. The general rule that all of a company's assets must be applied in satisfaction of the company's debts and liabilities pari passu is modified in relation to PCCs.

Administration of a PCC

An administration order may be granted by the Court in respect of a PCC or any one or more of its cells if the Court is satisfied that the PCC (or cell) does not satisfy or is likely to become unable to satisfy, the solvency test set out in the Law, and if the Court considers that the making of an administration order may achieve one or more of the following:

- the survival of the PCC or cell (as the case may be) and the whole or any part of its undertaking, as a going concern; or
- a more advantageous realisation of the PCC's or cell's (as the case may be) assets than would be effected on a winding up.

Administration implements a court sanctioned moratorium against resolutions for the winding up of a company, and on the commencement or continuance of proceedings against the PCC (without the leave of the court) during the period between the application and the making of the actual administration order. The moratorium continues once the administration order has been granted but does not affect rights of set-off and secured interests.

An administrator is empowered to do all such things as may be necessary or expedient for the management of the affairs, business and property of the PCC or cell. Upon his appointment, the administrator must take into his custody or control all the property to which the PCC or cell appears entitled. The administrator must also manage the affairs, business and property of the PCC or cell in accordance with any directions given by the Court. The administrator can remove and appoint directors. Neither an application for administration, nor the consequent order for administration, results in a statutory cessation of the powers and responsibilities of the directors. However, any functions conferred on the PCC or its officers constitutionally or by Law which could be performed in a way which interferes with the administrator's functions, may not be performed unless the administrator gives his consent.

An administration order in respect of a cell of a PCC may not be made if a liquidator has been appointed to act in respect of the PCC, if an application has been made for the winding up of the PCC or if the PCC has passed a resolution for voluntary winding up. An administration order ceases to have effect when a liquidator is appointed. A resolution for the voluntary winding up of a PCC or any cell which is subject to an administration order, can only be made with the approval of the Court.

Receivership of cells in a PCC

A receivership order may be made by the Court in respect of one or more cells of a PCC where:

- taking account of any assets subject to a recourse agreement, the cellular assets attributable to a particular cell are, or are likely to be, insufficient to discharge the creditor's claims in respect of that cell;
- the making of an administration order in respect of that cell would not be appropriate, and
- the making of an order would achieve the orderly winding up of the business of that cell and the distribution of the cellular assets to those who have recourse against them.

During the continuance of a receivership order, the powers and responsibilities of the directors cease. There is a court sanctioned moratorium during the operation of the receivership order against resolutions for the winding up of the company and on the commencement or continuance of proceedings against the relevant cell of the PCC (save with the leave of the Court). The moratorium does not affect the rights of set-off Court may direct.

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Subject to rules on preferential payments, any subordination agreements and any setoff agreements, the PCC's cellular assets which are the subject of a receivership order must be realised and applied pari passu. Any surplus must be distributed to shareholders or persons so entitled. If there are no such persons, it must be distributed among the holders of the core assets in accordance with their respective rights and interests.

Tax

The Guernsey tax treatment of a PCC is intended to reflect that the PCC is a single legal entity but at the same time protect investors in and creditors of one particular cell from the tax liability attributable to the profits of other cells. Election for exempt status therefore applies to the company as a whole and not to particular cells. The fee payable by a PCC for exempt status is not dependent on the number of cells comprised within the company. A single rate of tax will apply to the PCC's taxable profits as a whole. In computing the taxable income, the taxable profits of each cell must be computed separately with the profits and losses being apportioned between the cells and the non-cellular assets in accordance with the arrangements set out in the Articles of Incorporation of the PCC and any other relevant agreements. If the PCC carries on business activities any profits attributable to individual cells, as opposed to the core, will be computed on the basis that each cell carries on a separate business. Business losses attributable to the core or to a particular cell will potentially be relievable against the profits attributable to the core or other cells under the provisions of sections 133, 133A, 134 and 135 or section 137 of the Income Tax (Guernsey) Law, 1975 as amended (the "ITL") as the case may be. An election will be required in all cases as well as a formal claim under section 137 ITL. A single assessment will be raised on the PCC. However, the liability will be apportioned between the different cells and the core according to their entitlement to the profit.

Foreign recognition

We are unaware of any case in which the mechanism by which assets are segregated through a PCC have been considered by a foreign court. Where the assets of a cell of a PCC are held outside Guernsey, and an action is brought against the PCC in the jurisdiction in which the assets are located, it is not known to what extent the foreign court will assume jurisdiction, or give primacy to Guernsey corporate law in evaluating whether or not those assets are free for the purposes of any enforcement action in that jurisdiction. As a matter of comity, it is our considered view that a foreign court would have to, first, satisfy itself that it has jurisdiction (as a matter of conflict of laws), and then if it does assume jurisdiction, recognise and uphold the manner in which assets can be segregated through Guernsey's PCC legislation by applying Guernsey law.

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