

HAS THE CELL COMPANY COME OF AGE?

Mark Helyar of Bedell Cristin in Guernsey outlines why the Protected Cell Company concept born in Guernsey in 1996 has become a worldwide success story

The protected cell company was first created in Guernsey in 1996, as a significant refinement and development of a type of segregated portfolio company then utilised in Bermuda. Its first and primary use was in the risk management sector, to enable liabilities relating to insurance or reinsurance policies to be segregated from assets which did not derive from or relate to the premiums and reserves relating to those specific policies and underlying risks by separating them into different individual 'cells'.

This ability to segregate, protect or ring-fence assets and liabilities enabled much simplified risk management and improved confidence and security, and reduced a significant risk for insurance companies with multiple lines who were at risk of contagion of assets as a result of a catastrophic event affecting one risk but eating up all of the assets of a company. In some cases the type of event which could cause such contagion were entirely unexpected, such as the major revisions in the 1990s to the mortality rates of persons exposed to asbestos where increased liabilities caused insolvencies worldwide.

It is a basic precept of company governance that assets and liabilities should be matched, but with increased complexity can come a dangerous lack of transparency and unintended consequences or synergism which is not anticipated. The Equitable Life saga aptly demonstrated to the financial

community how difficult managing a wide group of risks from one fund could be in the event of a significant failure of one risk class. Had Equitable been structured as a PCC with its funds separated into cells then its liabilities to certain types of risk would have been far more transparent and therefore easier for its board to manage.

It soon became evident that the protected cell company or PCC could be utilised to segregate investment assets too, and they began to be used very quickly for umbrella funds, enabling simplification of governance and reduction of complexity and cost whilst at the same time providing protection from insolvency of other cells. This enabled a single investment fund to run a range of different investment opportunities and to separate them according to the risk profiles of investors, or by asset type or currency and to ring-fence profits (or losses) whilst having the economy of scale of a single company with a single board of directors.

Developments since 1996

The concept has become so successful that more than 40 jurisdictions worldwide now have PCC-style legislation. In many places that legislation is very closely based on Guernsey's original 1996 legislation and Guernsey lawyers are often called upon to assist and advise with the development of legislation. Many people are often surprised to find that the US has a number of states with similar legislation, although

the companies and legislation are often called by different names such as segregated asset companies or 'SACs'. In common with many other countries, this type of company is often restricted to use in the insurance, investment or other regulated sectors where there is a higher level of regulatory supervision.

So what was wrong with the original PCC legislation which needed to be changed? Various problems arose quite early on in the life of PCC's, the first being the general presumption in the original law that a creditor could, having used up all the assets of the cell with which he had a debt, go against assets of the core of the PCC. This meant that often cumbersome arrangements in writing needed to be made between the PCC and every creditor to ensure that they had no recourse to core assets (or in other words only to the assets of the cell with which they had a contract). To correct this problem the law was amended to limit liability only to cells, unless it was specifically agreed that recourse could be had to core assets, or in other words reversing the presumption.

An early problem was also the tendency for mistakes to be made by administrators in drafting contracts and particularly in attempting to make contracts between cells or between cells and the core of a PCC. There was a tendency to think of the PCC as a group of small companies rather than groups of segregated assets. In some



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cases quite elaborate contractual relationships were attempted. As the PCC is a single legal entity, it was thought by practitioners not to be possible to create a contractual relationship because a breach of contract could never be enforced.

This issue was further compounded when practitioners in the investment fund industry wanted to be more flexible in the way in which investors could exchange shares in one cell for the shares in another. Eventually the law was amended to allow for what are classified as 'arrangements' whereby directors have more flexibility in determining whether a liability should be a mixed one of a number of cells, or otherwise. This enables arrangements to be made which are similar in operation to contracts but provide protections for creditors by having a statutory right to apply to the courts to reverse an arrangement if prejudice is caused. Arrangements therefore allow for apportionment of variable costs (such as audit fees) between cells, for example.

Recent times and the future for the investment PCC

In practical terms, a PCC fund will usually have a main prospectus which deals with the issues common to the PCC, its directors, the provisions of the articles and other generic issues such as regulatory status and generic risk warnings applicable to all cells. Each cell will then have its own (usually much thinner) bespoke supplement which will deal with the investment profile and any asset-specific risk warnings.

This flexibility means that the creation and licensing of new cells is relatively straightforward and cheaper than creation of a new standalone fund. In the case of open-ended funds the costs can be significantly lower. This

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is particularly appealing to promoters looking to achieve economies of scale, or to launch smaller investment vehicles with lower initial costs. For many years in the insurance industry there has been the familiar concept of a PCC which is owned and controlled at its centre by an administration firm, but which 'rents' or allows its cells to be used by third parties.

Interestingly, there are now some PCC funds which will entertain enquiries from third-party promoters to create new cells within an existing PCC fund platform. As the PCC cell is really a separate class of shares and can be formed by simple resolution, it is fast and flexible. The development of the use of PCC funds in this way could provide a cost-effective platform for new investment funds, particularly in the current market where start-up costs and a more heavily regulated market are potential barriers to new initiatives. A 'rent-a-fund' PCC could provide a number of benefits already seen in the insurance industry:

- Already licensed therefore quick to market
- Board and administrator already known to regulator
- No need for extensive legal work or structuring, tax advice or finding non-executive directors
- Simple 'standard' core documentation leaving only bespoke supplemental prospectus
- Independence of control from pro-

motors/managers

- Transparency by not mixing multiple strategies/portfolios
- Ability to use company legislation to turn a successful cell into a stand-alone fund if it reaches sufficient critical mass (for example an 'incubator' for new investment funds)

This type of investment fund platform could be a useful tool in the future for the incubation of smaller, bespoke investment funds, whether open or closed ended.

Good assets versus bad assets

Two key issues arising from the financial crisis have been how to manage the transparency of financial instruments in the future and crucially how to prevent high-risk assets circulating in an opaque market from causing paralysis and contagion. One way in which to do that at a fundamental level is to conduct effective risk management through identification, separation and protection of good quality assets from poor quality, high-risk ones. There are many good reasons why the increased use of segregated cell companies like the PCC could be good for protecting assets and managing risks better in the future. Perhaps it is time that the PCC as a major offshore risk management innovation was taken onshore and mainstream to allow better risk management by a progressive regulator or government?