

The strongest link



The successful process of amalgamating two Guernsey PCCs gives an indication of how valuable the PCC vehicle may prove following a significant regulatory change such as Solvency II

by **Martin Le Pelley**

In March of this year, Friary Court Insurance PCC (Friary Court), the ex-Heath Lambert-owned cell captive facility which was acquired by Heritage Group as part of the acquisition of Heath Lambert's captive management operations, was amalgamated with Heritage's Harlequin Insurance PCC (Harlequin). This was the first time two protected cell companies (PCCs) have merged.

PCCs versus ICCs

The fundamental difference between a PCC and an incorporated cell company (ICC) is that a PCC, including its cells, is a single legal entity, whilst an ICC and its cells are separate legal entities. An insurance PCC has a single board of directors which take responsibility for the transactions within the core and each of the cells and for the statutory and regulatory compliance and corporate governance requirements of the company as a whole.

The cells are created by the issuance of non-voting redeemable shares which means that the cell shareholders have very limited 'control' over the transactions within the cell. The cell shares are non-voting because the cell shareholders have no statutory right to appoint directors or manage the affairs of the cell, and therefore the shares simply determine ownership of the cellular assets.

In contrast, because ICC cells are separate legal entities, the cell shares might be non-voting, but the cell owner does 'control' the cell because the directors of the ICC have no power to enter into transactions on behalf of the cell.

Ironically, the directors of an incorporated cell of an ICC must, in normal circumstances under Guernsey Law, be the same individuals as the directors of the ICC core. However, they hold two

directorships – one for the ICC core, and one for the incorporated cell. Furthermore, as a result of the cell being a separate company, the cell is a controlled foreign company (CFC) for tax purposes. As a result, there is very little difference between the statutory and tax position of an incorporated cell versus a non-cellular company.

Some people believe that the ICC cell structure may offer a more secure environment for the segregation of assets and liabilities than the PCC cell structure, by virtue of it being a separate legal entity. In practice, most PCC cells are managed in isolation from the other cells with separate bank accounts, ledgers and agreements such that there is very little additional risk posed by the lack of separate legal personality.

Economies of scale

As a PCC is a single legal entity there are benefits to be gained from growing the company through the addition of cells, especially where the PCC is used to host third-party captive business. The tax advantages to PCCs are already well known: a cell within a PCC can avoid CFC status where the cell's participation in the profits of the company as a whole are below 25%, and there is no other 'control' over the activities of the cell. This is one key advantage for cell owners as tax on cell profits can be deferred until distributed as a dividend and therefore the lack of control is a benefit. As CFC rules change and the profit participation percentage reduces the larger the PCC, the more likely that any one individual cell will not exceed the threshold, as compared to a smaller PCC.

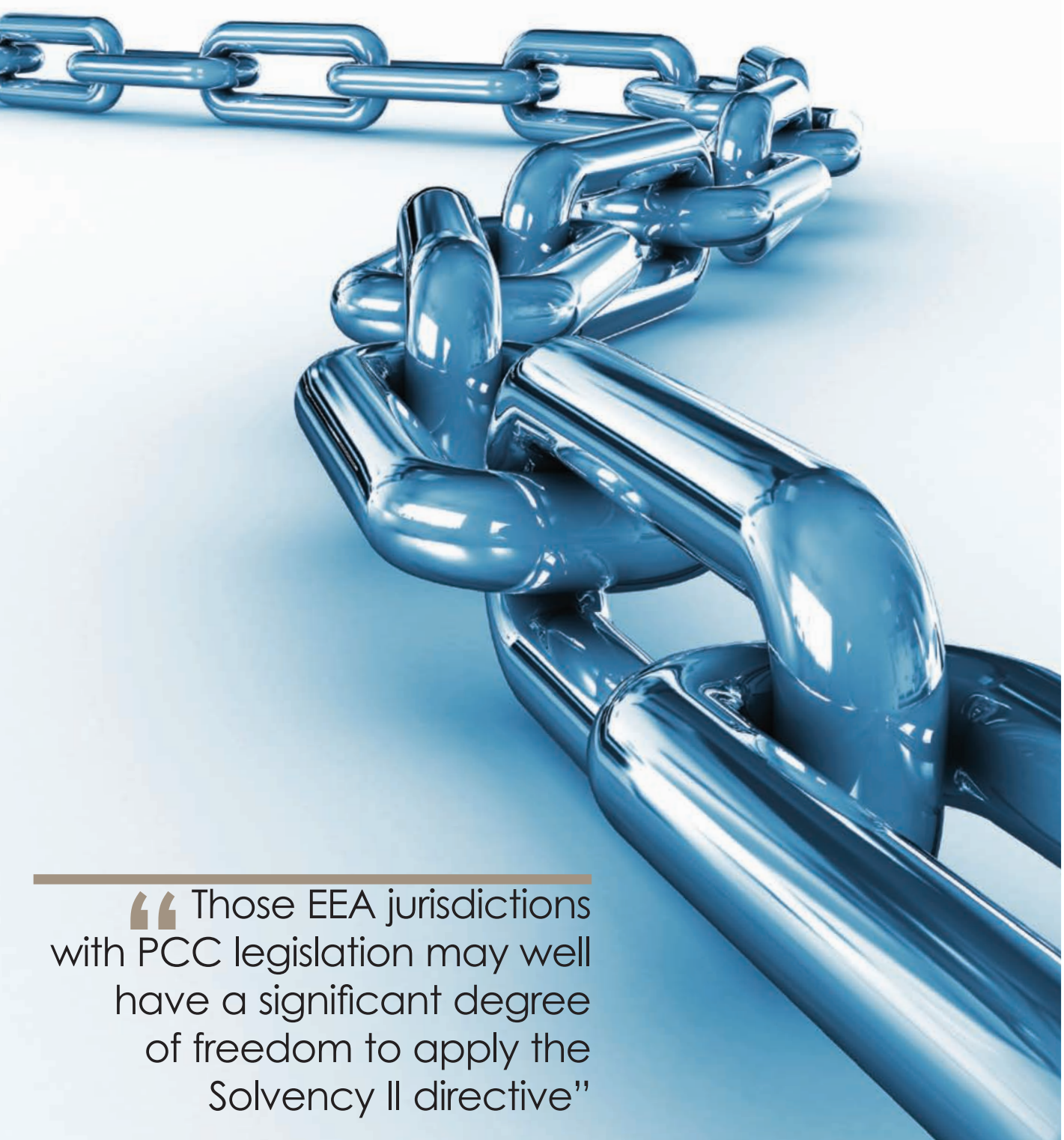
The economies of scale and reduced administrative burden per cell associ-

ated with a large PCC are derived from the PCC structure itself. Because it is a single legal entity the PCC requires only one board meeting for the company as a whole and the directors of the PCC have a corporate governance responsibility for the transactions relating to the PCC as a whole (as compared to an ICC and its cells, where the corporate governance is at a cellular level as each cell is a separate legal entity).

Amalgamation

The amalgamation of Friary Court and Harlequin was carried out in accordance with the provisions in Guernsey's 2008 Company Law, which is a modern piece of legislation. This helped to ensure that the process was, to some extent, smoother than might have been the case under older legislation. However, each company's Articles of Association, which were drafted under the previous Company Law, carried equal weight and could not be avoided.

Both Articles of Association carried a somewhat standard 'variation of rights' clause for cellular shareholders such that an amalgamation would be deemed to be a variation of cellular shareholder rights. Normally cellular shares are non-voting preference shares, but under the Articles (which were drafted under the provisions of the 1994 Company Law), if the cell shareholder's rights are varied, the cell shareholders become entitled to approve or vote down the variation. In the case of the above amalgamation, it could be argued that the cellular shareholder rights were varied to their benefit. However, this does not remove the necessity to allow the cell shareholders the right to approve the variation.



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Consequently for the purposes of this amalgamation, we required approval by each class of cell share (in other words, each cell owner) in order for the amalgamation to proceed. Under the new Company Law, the variation of cell shareholder rights need not be included in the Articles of Incorporation (as opposed to Association), thus avoiding this rather onerous requirement. For an ICC amalgamation, the cells would still need to approve such a move, regardless of each cell's Articles, as each cell is a separate legal entity.

Of course, obtaining cellular shareholder approval was not the only obstacle. There are legal obligations to produce statutory documentation (such as the Amalgamation Proposal), certify solvency, notify creditors, obtain approval of the regulator (in this case the GFSC) and to meet the requirements of the Company Registry. However, these provisions are all appropriate for the protection of creditors and cell owners and none of these should be problematic in a well-run PCC.

Safeguarding assets

If cell shareholders no longer have the right to vote at all (as a result of the removal of the variation of rights clause from the Articles and no similar provision being included in the law) this could give greater power to the voting shareholders and the directors to carry out such amalgamations or restructuring in the future. This prompts the question as to whether the lack of cell shareholder rights in a PCC causes a risk in relation to the safeguarding of cell assets and, if so, does this mean that an ICC structure is more appropriate?

It is fair to say that an ICC cell, being a separate company, has a very clear separation of assets and liabilities between itself and any other cell of the same or another ICC. However, the safeguarding of assets in a PCC is not compromised by any restructuring or amalgamation that may take place, as the cellular assets are legally ring-fenced and continue to be so before and after any such restructuring.

The biggest issue faced by PCCs in terms of the safeguarding of assets is the risk that any cellular assets held outside of the PCC's home jurisdiction, such as a bank account in an overseas territory, may not be recognised by a foreign court as being a cellular asset because the foreign court does not recognise PCC legislation.

This is a weakness not of the PCC legislation itself, but of the ability of foreign jurisdictions to recognise how the legislation works. The solution to this problem is to ensure that PCC cellular assets are only located in jurisdictions which do rec-

ognise PCC legislation. Luckily the list of such jurisdictions is growing all the time.

This 'weakness' in respect of the application of PCC legislation could equally apply to ICCs, although the likelihood is much reduced as almost all countries recognise the legal separation of companies as separate legal personalities.

But how are PCC cell owners protected from, for instance, a restructuring which reduces their cell's economic or fiscal effectiveness? The answer is that the cell owners remain a creditor of the company (by virtue of their shareholding) and would continue to have the right to be notified, and object to, any changes in the structure of the PCC, such that while they may not vote on a change, their views will still be taken into consideration.

It is currently not possible for cells to 'move' from one PCC to another (unlike ICC cells) without Royal Court approval, and this is, in itself, a significant protection for cell owners against being trapped in an uneconomic PCC structure.

In Guernsey, as insurance PCCs are regulated at a cellular level, the regulator will not permit any restructuring which would have a detrimental impact on the solvency or prudent management of the cells within a PCC. Therefore the requirement to seek regulatory approval for any such restructuring brings with it an additional level of protection for cell owners who may be concerned about the proposals.

While the regulations provide significant protection for cell owners' business within the cell, there are also notable advantages for PCC companies in terms of the regulatory approach adopted for PCCs in most domiciles.

As PCCs are single legal entities, the cells are treated as part of the whole PCC for statutory solvency purposes. This is because of the lack of control which cell owners have over the transactions in the cell. From a corporate governance perspective the board of the PCC has responsibility to ensure that the company as a whole meets minimum capital and regulatory requirements.

The cell owners may, however, have some ability to influence the activities within the cell through the management agreement entered into between the cell owners, the PCC and the insurance manager – consequently each PCC's and cell's tax and regulatory status must be considered on a case-by-case basis.

Nevertheless, if the cell is structured such that the level of influence is minimal and the board of the PCC have transparent responsibility for the activities of the company and cells as a whole, then this could have significant implications for the application of regulations such as the forthcoming Solvency II

Directive – and could mean that cell captives are able to achieve a level of capital efficiency and regulatory compliance which standalone captives or ICC cells will struggle to achieve.

Better things to come?

It is interesting to note that neither CEIOPS nor the European Commission have mentioned PCCs once within their deliberations on the application of Solvency II. This means that those EEA jurisdictions with PCC legislation may well have a significant degree of freedom to apply the directive and the binding technical standards coming out of CEIOPS Level 2 implementing measures in such a way as to make the PCC a very attractive vehicle for captive insurance business in Europe.

Even if the standard formula is applied at a cellular level within a PCC (due to the ring-fencing of assets and liabilities) such that there isn't a diversification benefit, it may be that an internal model for the PCC as a whole would seem to be more cost-efficient than applying separate models for each cell, and finally, the corporate governance requirements of Solvency II for a PCC, having a single board of directors, may be more easily achieved than would be the case if applied at a cellular level.

Given the concerns that ECIROA, FERMA and others have expressed over the very limited proportionality being afforded to standalone captive insurance companies under Solvency II, it is surprising that these organisations appear to have overlooked the potential benefits which may be achieved by using PCC cells as captive insurers rather than standalone companies or ICCs.

The test of time

ICCs, although a more recent innovation, lack some of the unique benefits which PCCs can bring, such as the ability to manage tax liabilities in an efficient way and to benefit from reduced administrative and corporate governance overhead costs. Whilst some might question the robustness of PCCs in terms of segregation of assets and the cell owner's ability to control the activities in the cell, these risks are more due to a lack of understanding of the legislation as opposed to any weakness in the legislation itself.

PCCs have stood the test of time and are more popular than ever. As the EU introduces a radical new regulatory regime in the form of Solvency II, there are indications that the PCC may be best-placed for captive owners to manage their self-insurance needs in a more cost effective way within Europe. ☺