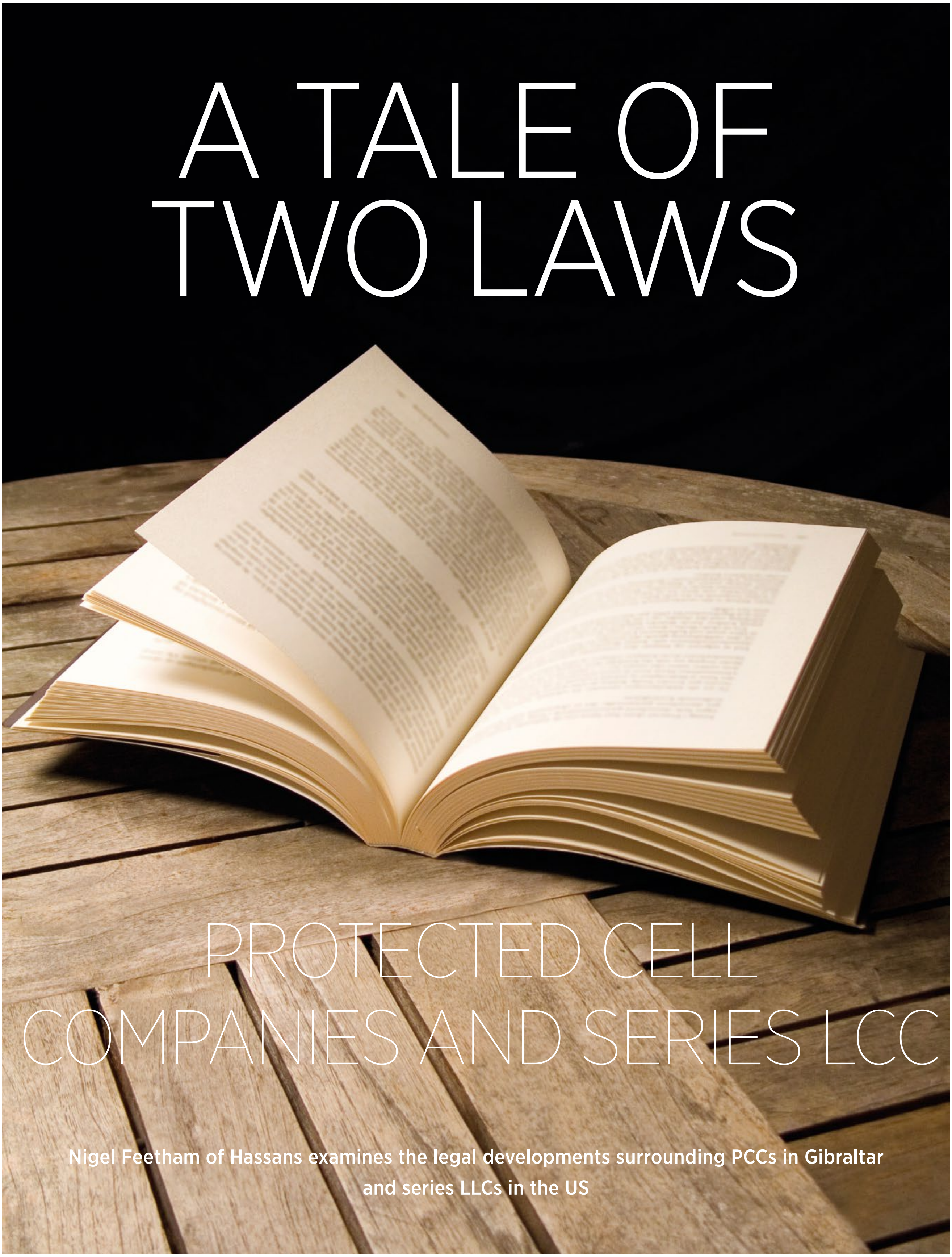

A TALE OF TWO LAWS

PROTECTED CELL COMPANIES AND SERIES LCC

Nigel Feetham of Hassans examines the legal developments surrounding PCCs in Gibraltar and series LLCs in the US

Segregated business forms operate across many jurisdictions around the world including the US and Europe. They are intended to segregate assets and liabilities for specific business transactions. The most familiar is the protected cell company (PCC) but other types of firms in many jurisdictions perform a similar function such as the US series LLC, the Italian regime ('dedicated assets to a specified activity' and 'financing allocated to a specific business activity'), the Luxembourg SICAV and securitisation regimes, the Irish investment fund, the French FCC, and more recently, the UK open-ended investment company (among others). But whereas in Europe the expansion and development of the concept (supported by the powerful insurance and investment sectors and endorsed by local regulators) appears to have gathered momentum, in the US it has yet to achieve the same level of official recognition, and more recently, in respect of the series LLC, the US Fifth Circuit Court of Appeals appeared to be reluctant to rule on the issue.

Insurance portfolio transfers and the PCC

Gibraltar implemented protected cell company legislation in 2001 and was the first European jurisdiction to do so. Since then Malta has implemented a PCC Act and the UK itself has introduced its own regime for open-ended investment funds. Whilst the exact number of companies operating as protected cells across the European Union is not known, it is likely to be over 100 in all jurisdictions and sectors. It is also of note that in Europe a PCC insurance company has the distinct advantage that the EU Insurance Insolvency Directive requires mutual recognition of a local insolvency process (which in the case of the PCC must include a PCC insolvency). The same applies to cross-frontier insolvencies under the European Insolvency Regulations. Therefore as a general rule an EU PCC insolvency should be respected across the EU and this augurs well for PCCs.

The Supreme Court of Gibraltar recently heard two applications; one application for the transfer of the insurance business of a Gibraltar PCC to an EEA insurer under Part I of Schedule 10 of the Financial Services (Insurance Companies) Act, and a separate but consequential application for the transfer of the cellular assets under the Protected Cell Companies Act. The proceedings were held in open court.

The case appears to be the first cross-border portfolio transfer application in respect of the insurance business of an EU PCC to a non-PCC.

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Under Gibraltar law a transfer of insurance business from a Gibraltar life insurance company to another insurer requires Gibraltar Supreme Court approval. It should be noted, however, that no court approval is required for portfolio transfers by general insurance companies; only the approval of the local regulator, the Financial Services Commission (FSC), is required in that case and several such transfers have previously been approved by the FSC. The equivalent regime in the UK is the Part VII transfer provisions.

As would be expected, the Gibraltar legislation transposes all the requirements of the relevant EU insurance directives, including in respect of publicity of the application, policyholder notifications, and 'home state' consultation with the relevant EEA regulators. Applications are therefore matters of public record.

Under the court process, the judge is taken through the affidavit evidence by counsel for the applicant, especially the independent actuary's report and each statutory requirement that the applicant has to comply with in order to obtain the order sought.

Policyholders can object to the proposed transfer by contacting the applicant or the regulator, and also, they have a right to object directly to the court. It should be noted, however, that the question of approval of the scheme is one for the court alone.

In this case, the court also had to consider the consequential application for a cell transfer order under the Protected Cell Companies Act. These provisions apply to every PCC regardless whether business is being transferred from an insurance company or not. The PCC would be obliged to obtain the approval of the court before the transfer of the business can be made (save for transfers from cellular assets in the ordinary course of the company's business).

The case is interesting for several reasons. It is the first court application in Gibraltar under Part I of Schedule 10 of the Financial Services (Insurance Companies) Act and under the Protected Cell Companies Act. This should be helpful for the further expansion and development of local portfolio transfers. In some jurisdictions insurers may push back from court approved portfolio transfers in the absence of a local precedent.

Further, the case is important because of the very limited history of cross-border transfers of a PCC to a non-PCC anywhere in the world. What we may now see as a result are portfolio transfers from ordinary companies to PCC insurers in the insurance run-off space where promoters are looking to segregate different portfolios using a PCC. This is where the cellular structure comes into its own.

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The other side of the Atlantic – a cautionary tale

Meanwhile, on the other side of the Atlantic, the US Court of Appeals for the Fifth Circuit has recently been given (and missed) the opportunity to provide judicial clarity to another type of segregated business form in the US, known as the series LLC. (When looking at this business form for 'series' read 'cell' and note that a series LLC can have many series just like a PCC can have many cells). The case is Glenn E. Alphonse, Jr. v. Arch Bay Holdings, L.L.C.; Specialized Loan Servicing, L.L.C. (filed 11 December 2013, although the court has determined that this opinion should not be published and is not precedent except for limited circumstances).

I am particularly interested in the series LLC because I discussed US legal developments for this type of firm in the book *Protected Cell*

Companies: a Guide to their Implementation and Use (2nd edition). I noted the lack of judicial authorities in the US, especially regarding the enforcement of the internal firewalls (also known as the statutory ring-fence) in other states, but given the wide spread use of the series LLC I considered it likely that judicial clarification was inevitable.

As an academic I therefore cannot hide my disappointment with the Fifth Circuit opinion. It is not necessary to restate the facts of the case or the court's legal analysis (or lack thereof). It seems clear (and not just to me) that the court appeared to have difficulty in finding an appropriate legal classification for a Delaware Series LLC: "…Series 2010B is a Series LLC, and Series LLCs only exist to represent the interest of the parent LLC, which in this case is Arch Bay." As other commentators have observed, the court's description of Arch Bay Holdings, LLC as the "parent" of "Series 2010B" must be legally wrong, even if it is open to the courts to conclude that the Series 2010B is "a distinct juridical entity". Admittedly, recognition that a series has separate juridical status (at least for certain legal purposes) should aid recognition of series separation by foreign states and countries, and therefore, its internal firewall more likely to be enforced across jurisdictions. Still, that does not make the legal relationship between an LLC and a series that of a parent and subsidiary. The court also described a series LLC as "basically a business entity within a business entity" (which, loosely, is not incorrect).

One could be forgiven for saying that the US court should have grasped the opportunity to provide a much needed judicial precedent. Instead, the question for consideration was remanded back to the US District Court to decide. Essentially, it dodged the question.

Judging the wind

The concept of segregated business structures is indeed very complex. Despite the fact that I have written extensively about the subject matter, I can say unashamedly that I still find it difficult to articulate clearly in oral discussion how they work. And if I find it difficult, it cannot be easy even for lawyers who practice in this business area, and less still for judges who may lack the experience of them at a commercial level. But as I attempted to discuss in my book, similar structures have already attracted multi-jurisdictional recognition through local laws and we are now at the stage of the evolutionary process where the cross-border recognition is the next step. In the US, unlike in Europe where European legislation has come to the aid of cross-border PCC transactions, only judicial authorities can provide the necessary certainty and predictability. It is therefore most unfortunate that the US Court did not do so in the above mentioned case.

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My natural apprehension for the series LLC is that they can be used as a cheap alternative to establishing a new corporate entity whereas legislatures around the world have tended to restrict the PCC for more sophisticated uses (especially insurance and investment funds). But, at the same time, US interstate series LLC transactions have become a fact of commercial reality which a court should not ignore, and absent any considerations of fraud or bad faith, they should take a realistic view of the position. This is even more so given the fact that many US States also have PCC legislation and accordingly should recognise a cell type structure.

Squaring the circle over liability

Over the years I have spent a lot of time thinking about cell structures, in particular consideration of the enforcement of the internal firewalls in foreign court proceedings. While judicial clarification would be extremely helpful, the fact that they have been endorsed by regulators and used throughout the world has become a more important factor in the quest for global recognition. Indeed, the absence of judicial decisions has not stopped the concept's expansion or development. But I am increasingly convinced that, notwithstanding cells (of a protected cell company) are not separate legal entities as such, it would help the process of judicial acceptance if a cell was treated, for certain legal purposes at least, as if it was. This is not the same thing as saying that a cell must be a legal person separate from the company (i.e. have 'incorporated' status as in the case of the incorporated cell company). In my view this is neither necessary nor desirable. Rather, it can be treated by the applicable legislation for certain legal purposes as a separate entity.

It should then follow that a foreign court would be more likely to respect the internal firewalls by reference to the greater separation it offers; most importantly, the ring-fence protection in liquidation of its individual cells. This is because if a cell can be legally liquidated as if it was a separate legal entity, the liability of the cell (of a protected cell company) itself would not, in liquidation, be limited in any way; the liability of the cell (like of a limited company) would be unlimited but such liability would be discharged only from its assets. It would be the liability of its members which would be limited, in accordance with the universally accepted insolvency principle, and in liquidation the non-liability of other cells follows from the liability shield as separate legal entities. In my view, the important legal distinction is not the incorporation of a cell, but that the cell could be wound-up as if it was a company in liquidation under the insolvency legislation and that, therefore, for the purposes of the cell liquidation, each cell is endowed with a corporate shield.

Interestingly, this is where the US District Court (which will now have to consider the case again) may have been heading with its legal analysis that a series LLC was (per Judge Helen Berrigan) a "separate juridical entity": according to the court, the correct defendant in this claim should have been "Arch Bay Holdings LLC, Series 2010B" (not Arch Bay Holdings LLC).

If a 'cell', 'series', 'segregated portfolio' (or whatever term is used), as a creation of local statute is treated for certain important legal purposes as a separate juridical entity (despite the fact that for other purposes it is not), that does seem to square the liability circle. In this regard, it is of note that in the case of PCCs, some jurisdictions have introduced ad hoc amendments to the original legislation to provide for cells to be treated as if they were separate companies in relation to certain matters (usually, liquidation and taxation e.g. Gibraltar) despite the fact that it is the PCC that still carries on business as a single legal person. In this sense, one could say a cell has 'quasi corporate status' even if it is not a company in its own right (which should offer a PCC more protection in a foreign court). Indeed, the clear direction of the local legislatures to courts in a foreign state is that a cell of a PCC should be treated as a separate entity for liability purposes.

"Future growth areas for European cell companies is likely to be the portfolio transfer opportunities and insurance run-off market"

Whatever the uncertainties in the US might be for a series LLC, back in Europe a PCC established in the EU should also enjoy the protection of the EU insolvency regime. In my view, one of the future growth areas for European cell companies is likely to be in the portfolio transfer opportunities and the insurance run-off market. I also expect to see the expansion of the concept in the Asian region where its uptake has not been noticeable.

"The quest stands upon the edge of a knife. Stray but a little and it will fail. Yet hope remains while the company is true." (*The Lord of the Rings*).

It is usually the case in jurisdictions with financial centre aspirations that local lawyers pioneer ideas to promote a jurisdiction's competitiveness and the local legislature then implements them by statute. This is often done with a degree of flexibility in the expectation that in the development of local case-law the judiciary will be as flexible as possible within what was originally intended by the legislature. Sometimes the evidence of intention is not always apparent and the legislature has to step in to amend the existing law as courts begin to interpret it beyond the gaps left open by the legislation. If the statute finds favour it is soon adopted by foreign jurisdictions seeking the same competitive advantage for their own financial sector. Others may take longer to persuade as they wait for regulators and courts around the world to resolve any open questions. Whilst a local court can clearly only apply local laws and develop local jurisprudence, in a world where law reports are easily accessible over the internet (especially to the probing mind of the academic who writes about them in equally accessible local journals) this can often influence the development of similar legal concepts by foreign courts. Unfortunately, in the case of segregated business forms (whether PCC, series LLC or other), judicial guidance of any sort has not been there. That spurred the publication of the PCC book but the elusive quest for judicial acceptance of the cellular structure has not yet come to an end. Yet hope remains.