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GUIDE

Protected Cell Companies

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Introduction

Guernsey was the first jurisdiction to introduce the concept of a protected cell company (**PCC**) through the enactment of the Protected Cell Companies Ordinance, 1997. The 1997 Ordinance was repealed and replaced by the Companies (Guernsey) Law, 2008 (the **Companies Law**) which effectively modernised Guernsey company law with effect from 1 July 2008.

What is a PCC and what is it used for?

A PCC is an entity which has legislative protection for the segregation of its assets. A PCC is a single legal person. A cell within a PCC is not a separate legal person although each cell must have its own name or designation and its own distinct assets and liabilities. Assets in a PCC are either **cellular** (in that they are attributable to a specific cell) or **non-cellular** (in which case they are considered **core assets**). Subject to certain exceptions, the assets of one cell are not available to shareholders or creditors of another cell or to shareholders or creditors of the core.

PCCs were initially used primarily by the captive insurance industry in Guernsey. However, and whilst there are certain restrictions on the use of PCCs, the funds industry, both open and closed-ended, consistently use PCC structures and PCCs have been used by most parts of the offshore finance world including for securitisations, as special purpose vehicles and for discrete, bespoke transactions. In addition, since the enactment of the Companies Law, PCCs can be used for purposes other than as above mentioned regulated products including, as a licensee under Guernsey's protection of investors legislation. This development permits the use of a PCC as a fund manager, including a general partner, managing multiple funds. Using a PCC allows the manager to undertake regulated activities at a cell level and to segregate liability as between the cells thereby avoiding cross contamination risks.

Advantages and disadvantages of a PCC

One of the advantages of a PCC includes the additional flexibility. For instance, for a multi-class fund or asset holding entity, individual cells can have differing investment objectives and cater to different investors or hold different types of assets. Further, the insolvency of one cell will not lead to liabilities for other cells and, except in unusual circumstances, the winding-up of the whole vehicle. This type of protection would only otherwise be available from an umbrella structure which is typically more cumbersome and more expensive to administer.

Other advantages include a reduction in administrative costs and the creation of one or more cells by resolution of the board (normally without reference to any regulatory body).

In addition, the regulatory process for a PCC can often be streamlined where a transaction is to be replicated by more than one cell.

PCCs do have certain drawbacks. Whilst most of the finance world is familiar with the concept of a PCC, this is not true for everyone. Various jurisdictions have however now introduced similar products and the awareness of PCCs is growing.

Previously, a PCC was required to prepare consolidated accounts of both the core and its cells which are often neither practicable nor desirable where, for example, each cell is a separate sub-fund. In such cases, it would be usual to limit the rights of cell shareholders to the accounts of the relevant cell and not the consolidated accounts. However, following an amendment to the Companies Law in September 2015, PCCs no longer have such an obligation and may now prepare separate accounts for each cell and the core. This is of particular interest to multi-fund PCCs, incubation vehicles and the like which may have different shareholders across the cells.

Finally, there are restrictions in respect of cells of a PCC transacting with each other although, again, there are usually ways around this.

Formation of a PCC

A company can be incorporated as a PCC or an existing company can be converted into a PCC (and vice versa) with the prior consent of the Guernsey Financial Services Commission (**GFSC**).

A cell of a PCC may also convert into a standalone company, again with the prior consent of the GFSC. Some of the likely uses for such include:

- where an asset holding PCC seeks to sell an asset, it will now be able to convert the relevant cell into a standalone company in anticipation of a sale or for an initial public offering;
- PCC fund or incubator platform or managed account structures which wish to launch an existing cell into a standalone vehicle; and
- captive insurance, investment management, technology or other incubation PCCs being able to 'release' the relevant cell once the product or technology no longer needs the cost saving benefits of the PCC.

The procedure for incorporation of a PCC is almost the same as for an ordinary company. The name of a PCC must include the expression either Protected Cell Company or PCC and each cell must have its own distinct name or designation. In addition, the memorandum of incorporation of a PCC must state that the PCC is a protected cell company.

Application for consent under the Companies Law is made to the GFSC in writing and, if granted, the GFSC has the power to vary or revoke its consent or impose any new term or condition in relation to its consent.

Although the Companies Law is drafted restrictively to state that a company may not be incorporated as a PCC unless it falls within certain specified categories, in reality, those categories are relatively broad. Essentially, provided that a PCC is administered by an administrator licensed in Guernsey (under various regulatory laws) it will be granted approval. However, the GFSC will expect a satisfactory explanation of the business to be carried out by the PCC prior to providing the consent.

Where a PCC is a regulated entity (ie a fund or a licensed captive insurer), it may also be necessary to obtain the GFSC's consent or to give the GFSC prior notification in respect of the formation of additional cells however, in practice the consent/notification process is not overly cumbersome.

What are cellular assets?

Cellular assets are all the assets of a PCC attributable to its cells. Initially this will be the proceeds of the issue of the cell shares. However, in due course, cellular assets can include any assets which might be held by a company, both tangible and intangible, such as shares, securities and property as well as contracts, causes of actions, licences and other rights. Cell shares can carry dividend rights, but any dividends are calculated by reference to the profits of the cell declaring the dividend and not by reference to profits of the PCC as a whole or of any other cell.

It is the duty of the directors of a PCC to keep cellular and non-cellular assets separate and separately identifiable and to keep assets of one cell separate and separately identifiable from the assets of other cells. Relevantly, when transacting, the directors of a PCC must inform counterparties that they are acting in respect of a PCC and identify the cell in respect of which the transaction relates. A failure to do so can lead to personal liability for the director.

What are core assets?

Core assets or non-cellular assets of a PCC are those assets which are not attributable to any cell or cells of the PCC. The proceeds from an issue of shares that are not cell shares and any income, receipts and other property acquired by a PCC which are not attributable to a cell will be core assets.

Despite the requirement that cellular and non-cellular assets are kept separate, those assets may be collectively invested, provided they remain separately identifiable. Cellular and non-cellular assets may be held by a nominee or even by an underlying company, which may hold cellular or non-cellular assets or both.

Voting rights within a PCC

The voting rights of shares in the cell of a PCC can be structured flexibly. The only statutory right which cannot be denied to all shareholders is the right to approve a variation of class rights. Apart from that, it is feasible that there could be a class of voting shares which hold all the rights in respect of a company or cell and non-voting shares. Generally speaking, cell shareholders will have the right to vote (together with other cell shareholders, core shareholders and on a weighted basis, if necessary) in respect of most matters including the appointment and removal of directors.

The position of creditors, the liability of a PCC and limited recourse

The starting position is that creditors of a cell may only claim against the assets of that cell and have no right to the assets of the core or the assets of any other cell. However, a PCC may enter into a recourse agreement providing for recourse to core assets or the assets of one or more other cells. In the absence of a recourse agreement or any discrepancies in the establishment or operation of a cell, the cellular assets of one cell will be absolutely protected from creditors of other cells and the creditors of the core. The approval of a recourse agreement requires a declaration of the directors that no creditors of the PCC will be unfairly prejudiced by the recourse agreement and, unless the memorandum or articles provide otherwise, a resolution of the members of the cell (if cellular assets) or the PCC (if core assets).

The Companies Law provides that certain terms will be implied into every transaction entered into by a PCC. These terms seek to ensure the integrity of the segregation of assets and liabilities of the cells and the core of a PCC. The Companies Law makes clear that the PCC structure and segregation of the assets of cells and of the core is a matter of substantive law (rather than procedural law). The relevant provision of the Companies Law is stated as having extra-territorial application and would be enforced accordingly by a Guernsey court. It remains questionable whether the relevant provisions would be upheld by the courts of other jurisdictions although the increasing prevalence of similar legislation in the offshore and onshore world would seem to support a foreign court upholding the structure. Nevertheless, suitable wording should be included in contracts governed by non-Guernsey law or contracts where one of the parties is a non-Guernsey entity. That said, the terms of the relevant legislative provisions make it more likely that a foreign court would give substantive effect to the segregation of assets and liabilities if a PCC, or one or more cells of a PCC, became insolvent.

Any liability of a PCC which does not relate to a particular cell is a liability of the PCC to which recourse may be sought from the core assets.

Importantly, if the directors of a PCC fail to inform any person with whom the PCC transacts that it is a PCC or, where relevant, fails to identify or specify the cell in relation to which that person is transacting, the PCC's directors may be personally liable in respect of that transaction. The directors do however have a right of indemnity from the PCC's core assets except in circumstances where they were fraudulent, reckless, negligent or acted in bad faith. There is an additional protection for directors in that, on successful application to the court, a director may be relieved of all or part of any personal liability in certain circumstances and the court may order that such liability be met from core or cellular assets. It is expressly stated within the Companies Law that any contractual provision or provision in the articles of incorporation shall be void if it purports to protect or remove the element of personal liability.

Transfer of assets

The transfer of cellular assets to a third party may be made in order to invest, and change investment of, cellular assets or otherwise to make payments or transfers from cellular assets in the ordinary course of the business of the PCC. Otherwise a transfer of cellular assets may only be made under the authority of the court of Guernsey by means of a cell transfer order. The court will only make an order if it is satisfied that the creditors who might be entitled to recourse to the cellular assets give consent and would not be unfairly prejudiced by the transfer. The GFSC would be consulted on a proposed transfer of assets prior to the court granting a cell transfer order.

An order may contain such conditions as the court thinks fit, including one requiring that creditors be repaid, and it may be made even if a liquidator has been appointed or a receivership order or an administration order has been made.

Arrangements between cells

A PCC may in the ordinary course of its business or the business attributable to any of its cells effect an arrangement meaning a dealing with, a transfer, disposition or attribution of cellular or core assets as between any of the cells of the PCC or as between the PCC and any of its cells.

Provisions are also made for applications to be made to the court in connection with the 'execution, administration or enforcement' of an arrangement.

Liquidation of a PCC

There are particular provisions relating to the liquidation of a PCC. A liquidator must keep cellular and core assets separate and keep cellular assets attributable to particular cells separate from those of other cells.

Receivership orders

Making and effect of a receivership order

Receiverships are not available in Guernsey except in respect of the cells of a PCC. A Guernsey court may make a receivership order in respect of a cell if, inter alia, it is satisfied that the cellular assets of a particular cell are or are likely to be insufficient to discharge the claims of creditors of that cell; that the making of an administration order in respect of that cell would not be appropriate; and that an order would achieve the orderly winding up of the business of the cell. A receiver would be appointed to manage the orderly winding-up of the business of that cell and to attend the distribution of the cellular assets. An application for a receivership order may be made by the PCC, its directors, any creditor of the cell in question, any holder of cell shares in relation to that cell, an administrator (appointed under an administration order) or the GFSC. Notice of the application must be served on the PCC, the GFSC, any administrator and any other person as the court may direct.

Once an application for a receivership order has been made, and during the period of a receivership order, no proceedings may be instituted or continued by or against the PCC in relation to the cell in question except with the consent of the receiver or the leave of the court. The moratorium does not however affect any rights of set-off and secured interests and their rights of enforcement.

Functions of and remuneration of the receiver

While a receivership order is in force, the functions and powers of the directors cease in respect of the business and the cellular assets attributable to the relevant cell.

A receiver of a cell has all the functions of the PCC's directors in respect of the cellular assets of that cell. The receiver is also deemed to be a director of the PCC in respect of assets the subject of a recourse agreement, the benefit of which accrues to the relevant cell or the creditors of the relevant cell.

A receiver is entitled to be paid for his services and be reimbursed for any expenses properly incurred by him in priority to all other claims. Such expenses are to be paid from the cellular assets in respect of the cell for which he was appointed.

Discharge and variation of receivership order

Where it appears that the objectives of a receivership order have been achieved or substantially achieved or cannot be achieved, the court may discharge or vary a receivership order and may direct that any payment made by a receiver to a creditor shall be deemed to be in the full satisfaction of the creditor's claim in respect of that cell. The court may also dissolve a particular cell on any date it specifies, upon discharging a receivership order.

Administration orders

Making and effect of an administration order

An administration order may be made in respect of a cell of a PCC in the same way it would be made for any company. Administration in Guernsey can only be commenced by an order of the court. In contrast, under the Insolvency Act 1986 a company or its directors can initiate administration without a court order.

The PCC itself, its directors, any member, any creditor or the GFSC (in respect of supervised companies and companies engaged in financial services business) have the right to make an application for an administration order in respect of a cell.

As of right, only the company itself is entitled to notice of an application for an administration order, but in respect of supervised companies and/or companies engaged in financial services business, the GFSC must also be given notice. The court has the power to dispense with such notice or, alternatively, the court can order that notice be given to other persons such as the company's creditors. Notice of an application for an administration order must also be delivered to the Registrar of Companies (the **Registrar**) at least two clear days before the day of the making of the application or, if that is not reasonably practicable, then as soon as reasonably practicable.

The objective of an administration order is to achieve the survival of a cell as a going concern or a more advantageous realisation of the business and assets of a cell than would be achieved by liquidation or receivership. Once an application for an order has been made, and during the period the administration order in respect of the PCC or a cell is in force, no proceedings may be instituted or continued by or against the PCC in respect of the relevant cell except with leave of the court or the administrator (where the order has been made). As with a receivership order, the moratorium does not affect any rights of set-off and secured interests and their rights of enforcement.

An administration order in respect of a cell of a PCC may not be made if any of the following circumstances arise:

- a liquidator has been appointed to act in respect of the PCC;
- an application has been made for the winding-up of the PCC; or
- the PCC has passed a resolution for voluntary winding-up.

To the extent that an administration order has been made, it will cease to have effect upon the appointment of a liquidator to act in respect of the PCC, however any acts previously carried out will not be prejudiced.

If a resolution is passed to effect the voluntary winding-up of a PCC which has a cell which is subject to an administration order, the resolution will not be effective without the leave of the court.

It should also be noted that notwithstanding any restriction or limitation which might be contained in an administration order in respect of cells of a PCC, a PCC may be subject to an administration order in the same manner as any other company.

Functions of the administrator

An administrator may be appointed in respect of a cell of a PCC or in respect of a PCC itself. In both cases the administrator may do everything necessary in order to achieve the survival or realisation of the cell or the PCC (as the case may be) and has all the functions and powers of the directors in order to do so.

Liability of the administrator and remuneration

In exercising his powers, the administrator is deemed to act as agent of the PCC and will not incur any personal liability, except to the extent that he is fraudulent, reckless or grossly negligent or acts in bad faith.

Any person dealing with the administrator in good faith is not concerned to enquire whether the administrator is acting within his powers. An administrator is entitled to be paid for his services and be reimbursed for any expenses properly incurred by him in priority to all other claims. Such expenses are to be paid from the cellular assets in respect of the cell for which he was appointed. If an administrator is appointed in respect of a PCC, those expenses are paid from non-cellular assets and, if they are insufficient or where relevant, from cellular assets as the court may direct.

Discharge and variation of administration order

The court may discharge or vary an administration order if it is satisfied that the purpose for which the order was made has been achieved or cannot be achieved. Where an administration order is discharged or varied, the administrator is required to send a copy of the order effecting the discharge or variation (as the case may be) to the Registrar (and any other persons as the court may specify) within seven days of the order.

Contacts

For further information, please get in touch with your usual Mourant contact or, alternatively, a list of contacts can be found here.