Protected cell companies — Legal issues¹

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Abstract The paper explores the 'legal frontier' area of Protected Cell companies. Legislation relating to this new type of company is becoming widespread and the concept is attracting very substantial funds. The concept raises difficult new questions connected with insolvency and enforcement of the concept in England and other countries which do not have the concept. The subject has not been considered yet by the courts and poses considerable challenges in terms of legal analysis.

Keywords: *company; insolvency; liability; conflicts; recognition; enforcement*

Introduction — captive insurance companies

'The captive insurance concept — now seen as an essential aspect of corporate risk management — is a comparatively recent invention. The idea of a manufacturing company setting up a wholly-owned insurance subsidiary in a tax benign domicile had obvious financial advantages. It became apparent in the 1960s and 1970s that captives offered a solution to the inflexible pricing and limited coverage provided by commercial insurers'.²

A captive may have one substantial parent or may be the captive of an association or group. There is also an important business offering 'rent-a-captive' facilities. In these cases the management of the captive will be contracted out to a management company.

Captive insurance companies can be provided as single legal entities.

Alternatively a single captive can be offered to a number of different proposed policy holders. The legal difficulty that arises from one corporate entity acting as a captive for more than one 'parent' is that, in an insolvency, the assets are, in any civilised jurisdiction, likely to be divided *pari passu*, ie, rateably among the creditors in accordance with their liabilities. This possibility is a serious drawback in the case of a shared captive.

Attempts have been made to mitigate or eliminate this difficulty. The principal routes used are the contractual route and the legislative route.

The contractual route

One approach is to make provisions by contract for dividing the captive company, or rather its assets and liabilities, into 'cells'. Each cell relates to a single or a group of customers for the

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rent-a-captive service. The aim of the contractual provisions is to ensure that the liabilities of one customer or group of customers is matched to the appropriate assets, ie, those which are considered to 'belong' to that customer or group.

The contractual route can be made to work in the absence of insolvency proceedings and in the absence of attacks on the captive's assets in amounts greater than the net assets of a particular 'cell'.

This can be illustrated as follows. Assume a captive has been rented out in the offshore jurisdiction of Utopia, where the law is similar to that of England. A contract is made between customers 1–10 and the captive, to the effect that assets put into the captive, less expenses etc, would be treated as held in separate 'cells', with each cell being answerable only to the liabilities of that particular customer. The contract contains 'evening up' provisions whereby if, for example as a result of actions by a creditor, the assets of cell 1 are used to pay the liabilities of customer 2, the assets of customer 2, to the extent necessary, are transferred to cell 1 to compensate for the depletion.

If, however, a creditor succeeds in attaching all the assets in cell 1 for the liabilities of customer 2, and if the assets of cell 2 are smaller than the assets attached, then customer 1 will lose out. Moreover, even if that does not happen, but if the captive becomes insolvent so that its total assets are less than its liabilities and goes into liquidation, the 'evening up' provisions of the contracts will be struck down and all the assets of the captive will be distributed rateably over all its liabilities, ignoring the cell structure: see *British Eagle v Air France* [1975] 1 WLR 758 (HL).

It is because of these serious limitations of taking a purely contractual

route that some offshore jurisdictions have enacted, or are considering enacting, capital Protected Cell Company (PCC) legislation.

Multilateral contracts

There is another 'starting-block' legal difficulty with the contractual route. Normally the making of a contract requires a consensus by way of a process of 'offer and acceptance' between the parties intended to be bound³ by the contract. This is not easy to achieve where parties in the shape of customers join the captive at different times. There are legal techniques for dealing with this, but it is important to be aware of the point so as to ensure that it is dealt with.

One solution is for customers to be made shareholders subject to a memorandum and articles of association, and to set out or cross-refer to the relevant contractual provisions in the articles. If the company law of Utopia is similar to English law, including older English company law, there will be a statutory provision to the effect that the articles operate as an effective multilateral contract binding all the shareholders: see section 14 of the Companies Act 1985 (UK).

The statutory route

The aim of PCC legislation is to reinforce the usual types of contractual provision and give the cellular concepts statutory force, so as to avoid the limitations of a purely contractual approach. Thus the legislation, while recognising that there is only one legal person, will legislate the effect of the contract between the parties by providing for the matching of cell assets and liabilities, and restricting creditor enforcement to the 'appropriate' cell

assets. There is the added complication that in a rent-a-captive situation, there may also be 'non-cell' assets, ie, ones not matched to liabilities. The legislation will probably make provision for non-cell assets also.

One tricky issue which any legislation has to face is how the statutory separation of cell assets and liabilities is going to be reconciled with the universal *pari passu* distribution approach of the insolvency legislation. One possible approach is to set up specific types of insolvency proceedings relating to cells as if they were separate entities,⁴ and also separate insolvency proceedings for the captive which would ensure that the cell structure is not upset during those proceedings. Another possible approach would be to legislate 'carve-outs' from existing insolvency legislation, as has been done for some financial market transactions in the Insolvency Act 1986 (UK).

The notion of separating out assets within a single corporate entity, and treating them and the matching liabilities as if they belong to separate corporate entities, has a precedent in England in rule 5 of the Insurance Companies (Winding up) Rules 1985. Rule 5(2) provides:

'The assets of the company which ... are available for meeting the liabilities of the company attributable to its long term business shall ... be applied in discharge of those liabilities as though those assets and those liabilities were the assets and liabilities of a separate company'.

The statutory route has the undoubted and substantial benefit of binding creditors within Utopia and thereby makes the assets of each cell safe from attack, whether inside or outside insolvency proceedings, from inappropriate creditors. The principal

remaining difficulty, however, is that very often the assets, particularly those in the form of investments, will be outside Utopia and the question arises whether creditors will be able to attack cells inappropriately outside the jurisdiction, either outside or within insolvency proceedings.

Extra-territorial effect

The exact extra-territorial effect of PCC legislation is unclear and in many ways this is a 'frontier' question. Obviously, a foreign jurisdiction will not regard the legislation of Utopia as applying in a direct way in its territory: eg *Banque Indosuez v Ferromet* [1993] BCLC 112, where it was stated that the statutory provisions of US Chapter 11 proceedings had no direct application in England. However, much is now being done on the fronts of EU legislation and statutory and non-statutory judicial assistance for foreign insolvency proceedings.

EU Insolvency Regulation 2000

Council Regulation 1346/2000 of 29th May 2000 on insolvency proceedings⁵ will come into force on 31st May 2002. It applies throughout the EU, except Denmark, but including Gibraltar where PCC legislation is awaited. The UK has 'opted in'. However, the Regulation expressly excludes 'insurance undertakings',⁶ so that captives are unlikely to be affected. There is a Draft Directive on Insurance Undertakings which will, when finalised, eventually fill the gap. The Regulation also has a saving for prior irreconcilable provisions with the Commonwealth,⁷ which appears to ensure that rights under s.426 of the Insolvency Act (UK) are not affected in any event.

Section 426 of the Insolvency Act 1986 (UK)

This is a special statutory provision for judicial assistance by UK courts for other parts of the UK, offshore islands and certain colonies and Commonwealth countries. Bermuda, Cayman Islands, Gibraltar and Guernsey are all included.

The UNCITRAL Model Law

S.14 of the Insolvency Act 2000 (UK) enables delegated legislation to be made to give effect, with or without modifications, to the UNCITRAL Model Law on cross-border insolvency.⁸ It is not known when such legislation will be passed. The Model Law itself almost encourages, and certainly allows, insurance companies to be excluded.

Case-law on judicial assistance

There is a growing body of case-law suggesting that even outside the confines of specific statutory provisions, judges in England will assist foreign insolvency proceedings, including reorganisations, wherever possible. For example, in *Banque Indosuez v Ferromet* [1993] BCLC 112 it was said that the English courts would assist US Chapter 11 reorganisation proceedings, even in the absence of any insolvency proceedings in England. Both Bermuda and the Cayman Islands, each with PCC legislation, were recently involved in a massive global reorganisation of ICO Holdings companies, one of which was incorporated in Bermuda and the other in the Cayman Islands. The judges of the Delaware Bankruptcy Court and the Bermuda and Cayman courts successfully co-ordinated this complex rescue, involving close judicial co-operation across all three jurisdictions. An application objecting to this co-operation was soundly rejected in Bermuda.⁹

Public policy exemption

In all areas of statutory and case-law recognition, enforcement and assistance, there are public policy exceptions. Given the segregation of long-term business assets and liabilities in a liquidation of an insurance company under English law, PCC legislation should not be held to be contrary to the public policy of English law, but of course much will depend on the particular provisions. English courts are historically reluctant to brand foreign law as being contrary to English public policy, even if the law is contrary to English notions of justice.

For example, in *Liverpool Marine Credit Company v Hunter* (1868) 3 Ch. App. 479, counsel for the mortgagee of a ship likened the provisions of Louisiana law, which refused to recognise transfer of title to a mortgagee without delivery, to the actions of a 'savage king', but this approach was rejected by the Chancery Court of Appeal. More recently, in *England v Smith* [2000] 2 WLR 1141 (CA), the Court of Appeal applied South Australian case-law which allowed an examination on oath of a witness in insolvency proceedings in the middle of massive Australian litigation on the same subject matter, in which the witness was alleged to be a defendant. The English case-law regarded such an examination as being oppressive, but the Court of Appeal allowed the examination to take place in England under South Australian law with the safeguards applied in that jurisdiction.

Substance and procedure

Let us suppose that a question arises in relation to the extra-territorial effect of PCC legislation in Utopia before the courts of England, or some other non-Utopian jurisdiction which follows English-type private international law principles. The first question that might

be asked about the Utopian PCC legislation is whether, from the point of view of English law, it is regarded as making provisions which relate to 'substance' or 'procedure'. The significance of this distinction is that English law will sometimes accept the effect of a foreign law if it goes to the 'substance' of some issue but not if it goes to 'procedure', since procedure is always a question for the court hearing a matter.

Thus, for example, if the Utopian PCC legislation simply provides that creditors whose debts relate to cell 1 shall have no remedy against cells 2-n, English law might well see that as a procedural direction to the Utopian courts rather than a provision of substantive Utopian law. If so, the English courts would not recognise that provision as being relevant in relation to the question of whether a creditor of cell 2 can attack the assets of cell 1 in England. On the other hand, if the creditor's rights were governed by Utopian law and if it were a substantive provision of that law that the creditor's rights were against the assets of cell 1 and not against any other assets of the captive, that might be enforced by the English courts.

Liability of a company/liability of its members

The subject is further complicated by the use of expressions such as 'limiting a company's liability' when, as a matter of law, what is happening is a limiting of the liability of its members. Thus in English private international law, questions of a company's general liabilities, eg, under contract or tort, are governed by rules which look at the connection between the contract or tort and the parties and, in the case of contract, at the expressed intention of the parties if they have chosen a

particular system of law. On the other hand, questions such as the rights and liabilities of the members of a company to outsiders are regarded by English private international law as being governed by the law of incorporation of the company.

In the usual case, English private international law would recognise a limitation of liability in relation to a company provided by the law of the place of incorporation. However, that does not mean that English law would allow a foreign jurisdiction to create a monster with immunity from liability which could be sent to plague England. All that this expression means is that English private international law recognises the ability of the law of the place of incorporation to limit the liability of the *members* in respect of the liabilities of the corporation.

The old cases

The author has not been able to find any modern authority which bears on the question of whether the Protected Cell structure enacted by the law of Utopia would be recognised in England. There are, however, some interesting old cases.

In *Melan v The Duke de Fitzjames* (1797) 1 Bos & Pul 142, the Duke entered into a document governed by French law under which he made a promise of payment and under which he mortgaged his property. Uncontested evidence of French law was given to the court that there was no personal liability on the Duke under this document and that it only bound the mortgaged property for repayment of the debt. The uncontested evidence was accepted by the English court and, as a result, it held that the Duke was not liable for imprisonment as a debtor in England. Had there been a personal debt, English law at that time would have made him

liable to be imprisoned in relation to the debt. Heath J distinguished between the substantive provisions of the contract as interpreted under French law on the one hand, and the remedies available in the respective courts of France and England on the other. He held that one would look to French law as governing the contract to see what the nature of the obligation was, but that one would look to the court where the proceedings were taking place to see what the means of enforcement of the contract were.

In *De la Vega v Vianna* (1830) 1 B & AD 284, a debt was said to have arisen in Portugal, owed by a Portuguese to a Spaniard. At a time when both of them were in England, the Spaniard had the Portuguese arrested for the debt. An arrest was then available under English law for a debt, although arrest was not available under Portuguese law. The court followed the distinction between substance and procedure in the previous case but concluded that in this case the question of arrest was one of remedy, and that this remedy was available to the Spaniard against the Portuguese in the English courts. The fact that the remedy was not available in the Portuguese courts was irrelevant.

De la Vega v Vianna has been cited and followed on various occasions since on the distinction between substance and procedure, eg in *Liverpool Marine Credit Company v Hunter* (1868) 3 Ch. App. 479, referred to above.

Debt governed by foreign law

Assuming these old cases are still to be followed, they present some interesting problems for the question of extra-territoriality in the case of PCC legislation.

If a creditor's debt is governed by Utopian law, and if the legislation is drafted in such a way that it is accepted

as being 'substantive' by the English courts, it seems very arguable that he should not have a remedy against an inappropriate cell asset in England, because that would be contrary to the substantive nature of his rights under Utopian law. Although this conclusion would seem right in principle, it has to be remembered that it depends not only on the drafting of the Utopian legislation, but also the willingness of the courts to interpret a 'cell' provision as being one which goes to substantive rights and not to remedies. English courts will no doubt find this a strange concept, but provided that they are reminded of the precedent in English law in relation to long-term business in insurance company winding up, they may accept the approach suggested here.

Debt not governed by foreign law

The question may be much more difficult in relation to a creditor whose debt is not governed by Utopian law. In this case, reliance cannot be placed on the substantive law of the debt, and the argument would no doubt be that the liability of the captive as a corporate entity is limited under Utopian law in such a way as to prevent a creditor of cell 2 from attacking the assets of cell 1. Put another way, it could be argued that the liability of the member who 'owns' cell 1 is limited to liabilities which are referable to cell 1. Again, the English legislative precedent could be cited in support of the idea that this concept is not totally foreign to English law notions. Realistically, however, there must be a significant danger that the English courts would, in the case of a creditor whose claim is not governed by Utopian law, interpret the legislation as attempting to limit the liability of the company rather than that of its members. It seems very unlikely that the English

courts would ever accept a limit or restriction to the liability of a foreign corporate entity, in view of the Frankenstein-like possibilities that that would open up.

Insolvency proceedings on England

Another significant aspect of this is the possibility of insolvency proceedings in England. The Utopian captive could be wound up in England if there is a sufficient connection with the English jurisdiction. The authorities on this point were recently reviewed in *Re Latreefers Inc.* The problem which would arise from an English winding up would be that the mandatory provisions of the Insolvency Act 1986 would on its face require *pari passu* distribution of all of the captive's assets among all its creditors, irrespective of the cell structure. This might well be seen as defeating any recognition that the Utopian Protected Cell legislation might have received prior to the liquidation.

One possible counter might be for the captive to argue that it should not be wound up in England because Utopia would be a more appropriate forum: see *International Westminster Bank v Okeanos* [1988] Ch 210; *Re A Company ex parte Nyckeln Finance* [1991] BCLC 539; *Re Wallace Smith & Co Ltd* [1992] BCLC 970; *Re Wallace Smith Group Limited* [1992] BCLC 989. That may turn out to be quite a powerful argument, provided that there is, or there is likely to be, an insolvency proceeding in Utopia which adequately deals with creditors' claims. Whether the process will be thought to be adequate may depend on the nature of the creditor: if it is a creditor whose debt is governed by Utopian law, it may be just to leave him to Utopian insolvency proceedings. On the other hand, if his debt is not governed by

Utopian law and particularly if he is an English involuntary creditor, such as the Revenue, this discretionary ground for refusing a winding up order may not be operated by the English courts. It may even be that, notwithstanding the fact that Utopia is a more appropriate forum, the English court decides, if there are assets in England, that there should be an ancillary proceeding here,¹¹ primarily to collect the assets in England.

With regard to creditors whose claims are governed by Utopian law, the captive could also try to oppose the making of a winding up order on the grounds that the creditor is abusing the process by trying to evade the PCC legislation which applies to his debt. This may be a forceful point. It would be even more powerful if the creditor is himself a customer trying to evade the statutory provisions on the basis of which he became involved in the company.

Ancillary liquidation

Assuming a situation where the principal liquidation is in Utopia, the role of an ancillary liquidation in England will normally be to collect the assets and then remit them, with any claims, to the principal insolvency proceedings. Unfortunately, this rather logical scenario has been dented at first instance in *Re BCCI SA (No 10)* [1997] 1 BCLC 80. In that case it was held that, since the English statutory rules of insolvency set-off were mandatory, assets had to be held back from the principal liquidation in Luxembourg to compensate creditors in England who would have been better off under English rather than Luxembourg set-off principles.

Doubts have been expressed about the correctness of this decision.¹² However, as matters stand there must be a substantial risk that the equally mandatory *pari passu* principles of English

statutory insolvency law will be held to override the ancillary nature of the winding up, leading to a situation where the liquidator in England is directed to hold back assets to compensate English creditors who will be disadvantaged by Utopian insolvency law and, in particular, its respect for the projected cell structure.

The unhelpful *BCCI* case in England is matched in New South Wales by an equally unhelpful decision on insurance creditor ring-fencing. In *Re National Employers' Mutual General Insurance Association Ltd.* (1995) 15 ACSR 624¹³ an English incorporated insurance company was in liquidation in England and in Australia. Normally, the Australian liquidator would have forwarded the assets to the principal liquidation in England for *pari passu* distribution. However the judge in New South Wales held that the Australian insurance creditor ring-fencing legislation, which gave priority to Australian insurance creditors, took precedence, and the monies needed to pay these claims would be kept in Australia.

Cross-frontier co-operation

Utopia may well, as we have seen, be one of the countries nominated within section 426 of the Insolvency Act 1986, and there is therefore the further complication that the courts of Utopia could, under that provision, ask the English courts to apply Utopian insolvency law rather than English insolvency law. For example, the law of South Australia has been applied in a s.426 case dealing with examinations on oath in relation to an Australian liquidation: *England v Smith* [2000] 2 WLR 1141 (CA).

However it is established, at least up to Court of Appeal level, that the English courts are not absolutely bound

to give effect to such a request and can refuse it, for example, on public policy or analogous grounds: *Hughes v Hanover Re* [1997] BCC 921. The grounds for refusing to assist include the fact that a request is incompatible with English mandatory insolvency rules: *Re Focus Insurance Co Ltd* [1997] 1 BCLC 219. Although *England v Smith* [2000] 2 WLR 1141 may have the effect of restricting the grounds on which assistance will be refused where the foreign law is applied, *Focus* was not overruled and still seems to apply. Thus there is a serious doubt whether a request under section 426 could get round this difficulty, as the law stands. The House of Lords did give leave to appeal in the *Hughes v Hanover* case although that case was settled before the appeal could take place. *England v Smith* [2000] 2 WLR 1141 was also settled before it could go to the Lords. The whole area is therefore still subject to review in the House of Lords.

Tentative conclusions

Although the extra-territorial effect of PCC legislation is not clear, there seems to be a reasonable prospect of creditors whose debts are governed by the law of the offshore jurisdiction being bound, at least short of insolvency proceedings in the foreign jurisdiction. Moreover, an attempt by such a creditor to start insolvency proceedings in the foreign jurisdiction in order to try to trump a substantive limitation on his claim could be regarded as an abuse of process. It is also true that PCC legislation undoubtedly has important and potentially beneficial effects within the offshore jurisdiction itself. In particular, it gives statutory backing to the contractual set-up and, perhaps even more importantly, prevents the contractual provisions being outflanked by

subsequent insolvency proceedings in the offshore jurisdiction.

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References

- 1 I have been helped in updating this topic by Daniel Bayfield, Barrister, of 3–4 South Square, Gray's Inn, London WC1R 5HP.
- 2 O'Neil and Woloniecki (1998) 'The Law of Reinsurance, Sweet and Maxwell, London, p. 45.
- 3 English law now has a means of conferring a benefit on a third party by means of a contract, by the use of the Contracts (Rights of Third Parties) Act 1999, but the Act does not allow for the imposition of burdens.
- 4 As in the case of the Guernsey legislation.
- 5 A summary of this legislation may be found in Fletcher, 'A New Age of International Insolvency', (2000) 13 *Insolvency Intelligence* 57.
- 6 Article 1(2).
- 7 Article 44(3)(b).
- 8 For a summary, see Fletcher, 'Making a Better World', (1999) 12 *Insolvency Intelligence* 20–22.
- 9 *Re ICO Global Communications (Holdings) Ltd* (Unrep., Ward C.J., 10th November 1999).
- 10 Court of Appeal, *Times*, 15th March, 2000.
- 11 See the section on ancillary liquidation.
- 12 See, for example, Oditah (ed), 'Insolvency of Banks', chapter 6 and Moss and Segal, 'Cross Border Issues', p. 79.
- 13 See also the discussion of the case in 'Cross-Frontier Insolvency of Insurance Companies' (2001), (ed. Moss and others), Sweet and Maxwell, London.