



PROTECTING THE PROTECTED CELL

Joseph T. Holahan, partner at Morris, Manning & Martin LLP, examines the best practices participants in a protected cell captive should consider in the light of recent court rulings and the legal principles governing protected cell captives

The segregation of assets and liabilities among the cells of a protected cell captive and between the cells and the 'core' is the defining principle upon which these facilities rely. This article reviews two rulings in the last year from the Grand Court of the Cayman Islands affirming this important concept. See *In the Matter of the Companies Act (2022 Revision)* and *In the Matter of Performance Insurance Company SPC (In Liquidation)*, Grand Court of the Cayman Islands, Financial Services Division, Cause No.: FSD No. 70 of 2021 (RPJ).

The article also discusses certain best practices participants in a protected cell captive should consider in light of these rulings and the legal principles governing protected cell captives.

Recent Cayman Islands rulings

Both rulings from the Grand Court involve a Cayman segregated portfolio company called Performance Insurance Company SPC (Performance). Under Cayman law, a segregated portfolio company may form protected cells known as segregated portfolios (SP). Segregated portfolios have no legal identity separate from the segregated portfolio company, but the assets and liabilities of each segregated portfolio are segregated by law from the assets and liabilities of the segregated portfolio company and every other segregated portfolio.

Thus, under Cayman law, a creditor of any one segregated portfolio has no recourse against the assets of any other segregated portfolio. Similarly, a creditor of the segregated portfolio company has no recourse against the assets of any segregated portfolio, and vice versa.

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Performance was placed in liquidation because of alleged fraud by a consultant in the US involving some, but not all, of its segregated portfolios. The two liquidators appointed to handle the liquidation proposed to allocate the fees and expenses of the liquidation, which were substantial, among all of the segregated portfolios, including those that were not involved in the fraud and were still solvent. The shareholders of two solvent segregated portfolios – Bottini Insurance SP and SSS Insurance SP – took issue with this plan, arguing that it was contrary to Cayman law because the law prohibited recourse against the assets of their segregated portfolios to satisfy the general liabilities or expenses of the segregated portfolio company, including the general expenses of the liquidation.

The shareholders of Bottini SP and SSS SP also argued that the liquidators had a conflict of interest when it came to what was best for their solvent segregated portfolios and what was best for the segregated portfolio company and the insolvent segregated portfolios.

The best outcome for Bottini SP and SSS SP, they argued, would be to leave the segregated portfolio company as soon as possible, incurring as little cost as possi-

ble for the liquidation. The best outcome for the segregated portfolio company and insolvent segregated portfolios, in contrast, would be to keep Bottini SP and SSS SP in the segregated portfolio company for as long possible, helping to shoulder a portion of the liquidation fees and expenses. Because of this conflict, the shareholders argued, the court should appoint an independent liquidator to oversee just the liquidation of their cells.

In a judgment dated 6 April 2022, the court agreed with the Bottini SP and SSS SP shareholders and appointed a third, independent liquidator whose sole authority was to oversee the liquidation of their segregated portfolios. Under the terms of the court's order, from the date of the order forward, the fees and expenses of the liquidators overseeing the liquidation of Performance and its insolvent segregated portfolios would not be allocated to Bottini SP or SSS SP. Instead, from that date forward, the shareholders of Bottini SP and SSS SP would be solely responsible for the fees and expenses of the independent liquidator appointed to oversee the liquidation of their segregated portfolios.

The court's decision on 6 April 2022 is important because it affirms the segregation of general and cell assets and liabilities within a protected cell captive, thus preserving the integrity of this structure. Also important is the court's recognition that the interests of the shareholders of the two segregated portfolios who brought the action could be considered separately and apart from the interests of the segregated portfolio company as a whole, notwithstanding the fact that the segregated portfolios have no separate legal identity

from the segregated portfolio company. Although not expressly stated in the law, this conclusion allowed the shareholders to reach a result that not only protected the assets of their cells from the liquidators' immediate plan, but permitted the appointment of an independent liquidator who would act solely in their interests and the interests of other parties with a direct stake in their cells.

In a more recent judgment delivered on 10 November 2022, also involving Performance, the Grand Court again affirmed the segregation of general and cell assets and liabilities. The court's 6 April 2022 judgment had relieved the shareholder of SSS SP from any liability for liquidation fees and expenses incurred after the date of the judgment, except for those associated with the newly appointed independent liquidator. But considerable costs had been incurred before that date. When the liquidators presented SSS SP with a demand for its share of these costs, the shareholder objected, arguing that the liquidators had not allocated the costs fairly and had not followed the procedures required by Cayman law and the court to account for and allocate these costs.

The liquidators had allocated the fees and expenses of the liquidation pro rata among the segregated portfolios. The court ruled that a strict pro rata allocation, however, was inconsistent with the statutory requirement that one segregated portfolio could not be held accountable for liabilities of any other segregated portfolio or the segregated portfolio company. Rather, the court concluded that only costs that involved SSS SP could be allocated to SSS SP. For example, the court ruled that litigation costs associated with the alleged fraudulent activity that had caused other SPs to become insolvent could not be allocated to SSS SP. Applying this principle of fair allocation, the court ruled the actual amount owed by SSS SP was approximately half what the liquidators had demanded.

Best practices for cell participants

The recent rulings from the Grand Court of the Cayman Islands add to the growing body of law affirming the segregation of assets and liabilities within protected cell captives. Nevertheless, these rulings, earlier legal precedents and the statutory and regulatory requirements generally found in domiciles that license protected cell captives suggest certain best practices



that participants in a protected cell captive should follow to help ensure that a court or arbitration panel respects the segregation of their cell's assets and liabilities if the issue ever arises. Some of these practices are axiomatic and should always be followed. Others are more discretionary or may depend on local law and practices on the particular facts and circumstances surrounding a protected cell.

Here are a few best practices to consider:

- **Use the required nomenclature religiously:** The domestic statutes governing protected cell captives often require the use of certain nomenclature – for example, each separate portfolio of a segregated portfolio company formed under Cayman law must include the words 'segregated portfolio' or 'SP' in its name. The purpose of this requirement is to signal to all concerned that the assets and liabilities of the segregated portfolio are, obviously, segregated. If you have a segregated portfolio or other protected cell of any type, use the required words religiously, every time, without exception.
- **Be certain separate accounts are maintained for each cell and the core:** This is axiomatic and its importance goes beyond any legal considerations.
- **Maintain all accounts with cell assets in the domicile:** The segregation of assets and liabilities for a protected cell captive is defined by the statutes of the captive's domicile. If a third party asserts a right to the assets of a cell, it is best to have a court in the domicile applying the law of the domicile decide the issue.
- **To the greatest extent feasible, have all contracts specify they are governed**

by the law of the domicile and that all disputes brought before a court must be resolved in the domicile: Again, it is the law of the domicile that specifies the segregation of assets and liabilities.

- **Avoid binding arbitration or tighten up arbitration clauses:** A typical arbitration clause, especially those in reinsurance agreements, relieves the arbitration panel from strictly applying the rule of law in reaching a decision. When it comes to the segregation of assets and liabilities in a protected cell captive, it is important that an adjudicator apply the statutory segregation strictly. Consider avoiding binding arbitration or tighten up arbitration clauses to require the arbitration panel to respect the segregation of assets and liabilities strictly.
- **Articles, bylaws, series agreements, contracts and other documentation should clearly state the segregation of assets and liabilities:** This is not a requirement of law, but it is helpful to place all parties who have business with the cell on notice so there can be no mistake if the issue ever arises.
- **Have the cell participation agreement specify that neither the cell nor its owners will be liable for fees or expenses arising from any supervision, rehabilitation or liquidation involving other cells:** In its recent rulings, the Grand Court of the Cayman Islands has clarified this issue for protected cell captives formed in the Cayman Islands, but the issue may need to be litigated to be fully resolved in other domiciles. Contractual provisions clearly defining the parties' rights and obligations could be helpful if the same issue arises elsewhere. 