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Restructuring and Insolvency: Cayman Islands Segregated Portfolio Companies

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May 2020 marks the twenty second anniversary of the Cayman Islands segregated portfolio company. [1] This article takes a look back at the segregated portfolio company's first two decades and particularly the principles established by the courts concerning insolvent segregated portfolio companies.

These cases have posed some interesting and novel questions for the Cayman courts to resolve and the decisions have put flesh on the bones of the statutory provisions as regards the status, duties and powers of office holders appointed in connection with segregated portfolio companies.

What is it?

A segregated portfolio company (**SPC**) is an exempted company that is permitted to create segregated portfolios in order to legally segregate the assets and liabilities of the portfolios from each other and from the general assets and liabilities of the SPC itself. The utilisation of these innovative legal structures has developed considerably since their first introduction in May 1998. Initially limited to use by licensed insurers, they are now popular investment vehicles employed across the spectrum of financial services offerings wherever there is a need to set up a statutory ring fencing of assets and liabilities. The SPC structure is widely used by investment funds, captive insurers, and in structured finance transactions.

Treatment in Insolvency Situations

Part XIV of the Cayman Companies Law (2020 Revision) (the **Law**) provides for the establishment and operation of SPCs and their treatment in insolvency situations. Under the Law, the portfolios of an SPC do not constitute separate legal entities; however, in practical terms, they operate like separate limited liability companies and the assets and liabilities of each portfolio are ring fenced: with the effect that shareholders and creditors have recourse only to the assets of the particular portfolio to which their shares are allocated. Liabilities of one portfolio cannot be met by the assets of another; nor can they be met from the general assets of the SPC where this is prohibited in the articles of association (which is the usual position). When a portfolio is insolvent the Court may appoint a receiver to realise and distribute its assets. Official liquidators may only be appointed over the entire SPC. The effect of Part XIV is that the insolvency of one portfolio does not contaminate the other portfolios of an SPC. As shall be seen from the below survey of the cases, this principle has faced challenge, but has ultimately been upheld by the Cayman courts.

ABC Company (SPC) v J & Co. Ltd

In the matter of ABC Company (SPC) v J & Co. Ltd, the Court of Appeal reversed the Grand Court's decision not to strike out a petition to wind up ABC brought on the just and equitable grounds. The SPC had suspended the calculation of net asset value for several years and the payment of redemptions in a number of its portfolios. The investment manager was winding down the suspended portfolios so as to make distributions over time. The remaining portfolios (at least two thirds) were still trading normally, were accepting subscriptions and were paying redemptions in the usual way. Nevertheless, a petition to wind up the entire SPC was filed by a shareholder in one of the suspended portfolios on the grounds that the SPC had lost its substratum and that it was just and equitable that the SPC be wound up.

On appeal, the petitioner accepted that: (a) the Court had no jurisdiction under the Companies Law to wind up an individual portfolio; (b) the appointment of a receiver over a portfolio was only available if the assets attributable to that portfolio are or are unlikely to be insufficient to meet the liabilities of creditors to that portfolio (it is balance sheet insolvent) but not on a just and equitable basis; and (c) the only remedy was to seek to wind up the entire fund on the just and equitable grounds. Upon a review of the SPC's articles of association and offering documents, the Court of Appeal held that the petitioner had no realistic prospect of establishing that, as a result of the failure of certain segregated portfolios, the SPC had ceased to carry on business in accordance with the reasonable expectation of its shareholders nor was there any other basis upon which it was or could be said that the SPC as a whole had lost its substratum. This decision was the first case to affirm the proposition that the statutory segregation of an SPC's Portfolios will be upheld by the Cayman Courts.

The Axiom Portfolios

2012 and 2013 saw further welcome clarification of the status, duties and powers of receivers appointed over a portfolio. In the 2012 case of *JP SPC 1 and JP SPC 4*, winding up petitions were presented by the directors of two SPCs. A feeder SPC had six portfolios, one of which was the Axiom Legal Financing Fund (**Axiom**) representing 74% of the SPCs' investors. Axiom's only assets were its shares in Axiom Legal Financing Fund Master SP, the master portfolio. The assets of the master portfolio were receivables from loans made to a number of English law firms conducting class actions. Allegations had been made concerning the activities of the Investment Manager of Axiom and the master portfolio. Initial analysis suggested that the value of the loans had been overstated and further investigations were necessary. Notwithstanding the principles confirmed in ABC, one of the investors originally sought to argue that despite the health of the other unaffected portfolios, the whole SPC should be wound up. The investor ultimately agreed that the appropriate course was for receivers to be appointed over the Axiom portfolios, and receivership orders were made.

The Axiom receivers subsequently returned to the Grand Court to seek directions clarifying their duties and powers so as to bolster an (ultimately successful) application for their recognition in England under the English Cross Border Insolvency Regulations 2006 (the **Regulations**) which have their roots in the UNCITRAL model law on Cross Border Insolvency. Ordinarily, receivers in their traditional role do not qualify for such recognition, but the Regulations take a substance-over-form approach, and require an assessment of the actual status, duties and powers of the officeholder and thus whether relief is available. Further hurdles to the application were that SPCs as a concept are unknown under English law, consequently so too are receiverships of individual portfolios, and there has yet to be an onshore bankruptcy case recognising the segregation principle which SPCs embody.

There is one bankruptcy case from 2007, *In re Refco Inc* (06-5786-bk(L)), which is a US decision relating to the Sphinx group and which is sometimes referred to as a case showing that the US courts are unlikely to recognise the segregation principle. Here the US Court of Appeal considered an appeal by the Liquidators of the Sphinx Managed Futures Fund SPC. The Liquidators challenged the validity of a settlement agreement previously agreed by Sphinx where US$263 million was paid in contravention of the segregation principle, and argued that the US bankruptcy court ought to have considered Cayman law before approving the settlement, which would have led to a different result. The US Court of Appeals, however, determined that because the Liquidators now stood in the shoes of the Sphinx board, which had approved the agreement, they were precluded from pursuing the appeal (as Sphinx itself would be). The US Court of Appeal therefore concluded that it did not need to decide any issues of Cayman Islands law and affirmed the underlying order. So, although reported as cutting across the segregation principle of SPCs, in our view the Sphinx decision does not provide any guidance as to the likely approach of the US courts with respect to the segregation principle as the US court simply declined to consider any provisions of Cayman law.

Interestingly, and following on from the recognition of the Axiom receivers in the UK, the Cayman Court has for the first time itself recognised receivers of a foreign segregated account (the Bermudian equivalent to the segregated portfolio) in the 2019 decision of *In the Matter of Silk Road Funds Ltd*. [2]

In *In the Matter of JP SPC 1 and JP SPC 4* (known as ***Axiom***) [3] the Court removed certain doubts as to what powers would be available to the receivers of portfolios. The decision considered and compared in significant detail the statutory powers available to, and duties owed by, receivers appointed over a portfolio on the one hand and the powers and duties of liquidators of a Cayman company on the other; and the decision has consequently provided a useful, detailed, and thorough exploration of this area.

Statutory powers available under Part XIV of the Law:

- **Section 224(3)** - a receiver appointed over a portfolio is tasked with the "orderly closing down of the business of or attributable to" the portfolio and the distribution of its assets to entitled persons
- **Section 226(1)** - a receiver is conferred with a general power to do all such things as may be necessary to complete that task, and has all the functions and powers of an SPC's directors in respect of the portfolio's business and assets
- **Section 226(6)(b)** - the receiver may attend SPC board meetings, and he may vote at board meetings on matters concerning the SPC's general assets where creditors of the portfolio over which he is appointed have an interest in those general assets
- **Section 226(3)** - a receiver is deemed to be an agent of the SPC and "shall not incur personal liability except to the extent that he is fraudulent, reckless, negligent, or acts in bad faith"
- **Section 226(2)** - a receiver may apply to Court for directions in relation to the extent of or exercise of his functions or powers
- **Section 226(5)** - an automatic stay of proceedings against the SPC in relation to a portfolio comes into force as soon as an application for a receivership order is made and any would be litigants are compelled to seek the Court's permission to commence any claims
- **Section 228** - finally, a receiver's remuneration and expenses are payable only from the assets of the portfolio over which he is appointed

The case confirmed that the receiver of a portfolio will be considered as possessing duties akin to those of a liquidator of a Cayman company, and, for most purposes, a receiver is to be attributed with the appropriate powers of a liquidator (confined in their application to the portfolio and its assets, shareholders or creditors). In particular the following practical points emerge:

(a) It is now clear that a receiver may be granted any of the powers usually conferred on liquidators by Part V of the Law, with appropriate modifications, to suit the particular circumstances of the receivership. Such powers range from the ability to conduct investigations into the affairs of the portfolio and the ability to seek to unravel transactions on the basis that they are a preference, an undervalue transaction, or constitute fraudulent trading.

(b) It is notable in the *Axiom* case that the Grand Court granted the receivers all the powers of liquidators exercisable under part I (exercisable with sanction) and part II (exercisable without sanction) of the Third Schedule to the Law. Such powers, particularly those exercisable with sanction, are considerable and include the power to carry on the business of the portfolio, to compromise any claims with creditors or shareholders, to deal with or sell portfolio assets, to obtain credit, and to engage staff, attorneys, or other professional advisors.

(c) More generally, the Court confirmed that the basic duty of a receiver appointed over a portfolio is to collect in and realise the assets of the portfolio and to make distributions in accordance with the statutory regime, with any surplus being returned to shareholders (which is the fundamental duty of a liquidator of a Cayman company), to exercise any necessary corporate powers to fulfil their duties, to convene meetings of creditors and/or shareholders, and even to promote a scheme of arrangement.

(d) A receiver of a portfolio is considered by the Court, to have power to commence legal proceedings on two grounds. Firstly, on the ground that this is a power exercisable under part I of the Third Schedule to the Law. Secondly, on the basis of the proper construction of Part XIV, the Court considered that whilst a portfolio's assets are segregated from the assets of other portfolios and the general assets of the SPC, the portfolio's assets are nonetheless "company assets", and the receivers, in displacing the SPC's directors in respect of the particular portfolio's assets and business, and being deemed an agent of the SPC, are entitled to bring proceedings in name of the SPC in respect of and on behalf of the portfolio over which they are appointed.

In subsequent proceedings to wind up the investment manager of the Axiom portfolios (Re *Tangerine Investment Management Limited April 2013 1 CILR 375* it was argued that the *Axiom* receivers were not entitled to appear on another creditor's petition to wind up Tangerine, on the basis that a portfolio had no separate legal identity to its SPC, and any debt would therefore be owed only to the SPC. The Grand Court firmly rejected these arguments. Despite the *Axiom* portfolios lacking separate legal personality, the Court considered that the receivers had sufficient standing to be heard. Its reasoning relied on the significant statutory powers afforded to, and duties owed by, the receivers, and particularly their effective displacement of the portfolios' directors' functions and powers as regards the particular portfolios, the fact that there was no liquidator appointed over the *Axiom* SPCs (who would have had standing to appear in the proceedings on the opposing creditor's analysis), and also that the nature of the receivers' powers was such that they could procure the SPC to act (such as in respect to the commencement of legal proceedings). Interestingly, in Tangerine, the Court went on to appoint one of the receivers jointly with the opposing creditors' choice of appointee as an official liquidator of the *Axiom* portfolios' former investment manager.

In the case of Calibre SPC, a case concerning the winding up of an entire SPC and its two portfolios on the insolvency basis, the Grand Court provided guidance as to which requirements of the Companies Winding Up Rules (**CWR**) would apply as regards the individual portfolios (as technically only the SPC itself would be caught by the requirements of the CWR). This was helpful as the Law does not address the finer administrative details of what needs to be done in the liquidation of a portfolio. The Grand Court clarified that liquidators were to perform their statutory obligations contained in the Law (and thus the CWR), in respect of each Portfolio separately. This meant, amongst other things, that each portfolio would require separate certificates of solvency, liquidation committees, reporting and accounting, and that there would need to be an appropriate apportionment of expenses, including liquidation fees, between the SPC and its individual portfolios.

In *In the Matter of Primary Development Fund (Cayman) SPC 2016 2 CILR 143*, which related to the discharge of a receivership order, the Grand Court considered what options are available to receivers when a segregated portfolio has exhausted its assets though the remuneration of receivers and no assets are available for distribution to the creditors. Section 227(3) of the Law provides that "the Court may direct that any payment made by the receiver to any creditor of the company in respect of that segregated portfolio shall be deemed full satisfaction of the liabilities of the company to that creditor in respect of that segregated portfolio". However, where no payment, or only an offer of payment (which was not accepted) was made to the creditors, the Court was unable to make such a direction. The Court advised that in these circumstances the receivers could terminate the segregated portfolio under section 228A(1) of the Law which provides that where a segregated portfolio has no segregated portfolio assets or liabilities the SPC may, by resolution of the directors (or other authority provided for in the articles of association) terminate the segregated portfolio. The 'or' in this provision is to be construed disjunctively so that it is not necessary for both conditions to be satisfied.

Finally, *Re Centaur Litigation Unit Series 1 Ltd* [4] concerned substantial intermingling of assets between the segregated portfolios of Centaur Litigation SPC (**CLSPC**), an entity which formed part of a litigation funding business. CLSPC was involved in a substantial fraud involving a Ponzi scheme and the misappropriation of approximately US$27 million. CLSP held five segregated portfolios and on applying the "cash is king" principle (tracing the cash from investors through each of the funds and on to the investments) there were a broad range of investment returns depending on the portfolio to which the investor subscribed (from 1% to 55% of the value of the principal investment). This was due to the fact that the funds invested in the later series were not used to fund legal cases, but were misappropriated by management or used to prop up the Ponzi scheme. The investors had thought, based on the Offering Memorandum and Master Memorandum, that they were investing, together with the other segregated portfolios, in a "master portfolio" of cases. The Liquidation Committee of CLSPC argued that the JOLs should honour the intention expressed in these documents, despite the fact that no master portfolio could have existed under Cayman Law, or did in fact exist, and should notionally pool the proceeds of all cases funded by CLSPC and allocate them pro rata across the five segregated portfolios. The Court held that it could not give effect to the "master portfolio" structure because:

(a) under Cayman Law segregated portfolios under and SPC are not permitted to invest in, hold shares in or loan money to one another (section 216(1) of the Law)

(b) if assets are transferred between segregated portfolios, or between segregated portfolios and the general assets of the company, it must be for full value (section 219(6)(c) of the Law)

and that in any event a pari passu distribution among the segregated portfolios would not be the fairest approach in the circumstances. The Court held that there was no sufficient justification to depart from the "cash is king" approach to the distribution model.

The above review illustrates that Cayman Islands jurisprudence in respect of SPCs has developed significantly, providing greater certainty in the treatment of SPCs and their portfolios in insolvency situations, which will be of great assistance to practitioners and their clients deriving benefits from the SPC structure. However, some interesting questions remain as do possible differences in treatment between receivers appointed over portfolios and liquidators appointed over Cayman companies. These are considered below.

SPCs and Litigation Funding

Axiom made it clear that receivers appointed over portfolios, like a liquidator, possess the power to bring legal proceedings in the name of the SPC on behalf of the portfolio over which they are appointed. Liquidators have the benefit of seeking litigation funding from creditors (or, less commonly but increasingly, from unrelated third parties [5] in the business of providing litigation funding) to assist their recovery efforts; but a receiver's ability to obtain funding from third parties is less clear. Confronting any recipient of third party litigation funding in the Cayman Islands is the problem of whether these arrangements can be attacked as falling foul of the archaic, but still applicable, doctrines of maintenance or champerty. The former is the assistance or encouragement of proceedings by someone who has no interest in the proceedings or any motive recognised by the law as justifying interference; and champerty is an aggravated form of maintenance, whereby the assistance is provided in exchange for a share of any fruits of the action. Should a litigation funding contract be found to involve maintenance or champerty it is treated as contrary to public policy and unenforceable. Creditors providing a fighting fund for a liquidator need not fear falling foul of the doctrines (provided that they do not seek to usurp the liquidator's control of the action) as they are considered to have a legitimate interest in actions which may have the effect of swelling the size of the liquidation pot for ultimate distribution. The difficulty arises when the proposed litigation funder is an unrelated party.

An exception or safe haven has developed over time which protects liquidators and other office holders from the application of the doctrine of champerty. It provides that a liquidator is able to sell legal claims belonging to the entity in liquidation to unrelated third parties for a share of the recoveries of the litigation. [6] The exception has been rationalised by the English courts to arise as a result of the liquidator's statutory empowerment to sell an insolvent entity's assets coupled with their duty to realise the assets comprised in the insolvent's estate. [7] It is plainly arguable that the receiver of a portfolio ought to benefit from this safe haven in the same way as liquidators may - on the basis, as established in *Axiom*, that a receiver possesses an almost identical duty to realise the portfolio's assets and statutory power to sell those assets. However, the issue has yet to be tackled by the Cayman courts.

The critical issue is whether the funding agreement has a tendency to corrupt public justice, undermined the integrity of the litigation process or gave rise to a risk of abuse. The features which are likely to be significant, include:

> "(a) the extent to which the funder controlled the litigation... (b) the ability of the funder to terminate the agreement at will... (c) the level of communication between the funded party and the lawyer... (d) the prejudice likely to be suffered by the defendant if the claim failed... (e) the extent to which the funded party was provided with information about... the litigation... (f) the amount of profit the funder stood to make... (g) whether or not the funder was a professional funder and/or was regulated." [8]

Test for Insolvency

The test for the appointment of a receiver over a portfolio is in effect a balance sheet insolvency test: an order may be made where the assets attributable to that portfolio are or are likely [9] to be insufficient to discharge the claims of creditors in respect of that portfolio. In contrast, the insolvency test applied to any Cayman Islands' company on an application for its winding up is the traditional cash flow test: can the company meet its debts as they fall due? A receiver could therefore be appointed over a portfolio which would otherwise be considered solvent were it an individual company. In *Axiom*, the portfolios were not insolvent on a cash-flow basis, but they were likely to be insolvent as a result of imminent future lending obligations, and so, because of the lower insolvency threshold, the Axiom portfolios were able to be put into receivership. The reasoning behind this apparent difference in treatment is unexplained; [10] but the wider gateway may perhaps go some way to mitigating the fact that a shareholder in a portfolio is not entitled to petition to wind up a portfolio on the just and equitable ground.

Remedies for Portfolio Shareholders

Where a shareholder of a company is able to demonstrate that it would be just and equitable that a company be wound up, the court has jurisdiction to grant "unfair prejudice" type relief under section 95(3) of the Law (discussed above). The ABC case has confirmed that it is not possible to appoint a liquidator or receiver over an individual portfolio on just and equitable grounds, even if such grounds exist and this therefore leaves stakeholders without any ability to seek the alternative remedies that would be available to a shareholder of a company where grounds to wind up exist. Again, in our view there does not appear to be any basis for this distinction and this may well be the subject of future legislative reform.

Schemes of Arrangement

Like any Cayman company, SPCs can enter into a scheme of arrangement on behalf of the entire company. [11] A scheme is a court supervised compromise made between a company and its creditors and/or members whereby an arrangement can be made binding on such persons provided that certain safeguards are met. Schemes are commonly used in the Cayman Islands but it remains unclear whether a portfolio would have standing to enter into a scheme in its own right or whether an SPC could enter into a scheme on behalf of one or more of its portfolios. Interestingly, the cell of a Jersey "Protected Cell Company" (similar to an SPC) has been found by the Royal Court in Jersey to possess such standing, although unlike in Cayman, the relevant Jersey company statute provides that a protected cell is to be treated, for all purposes, as if it were a company and it can be liquidated independently of its cell company (See *Re Ashburton Global Funds PCC January 2014*). In Cayman, it is probable, under Axiom principles, that an SPC could enter into a scheme on behalf of one or more of its portfolios (which was the position in Jersey prior to the Royal Court's decision in Ashburton).

Conclusion

SPCs are a firmly established in the Cayman Islands, and the jurisprudence over the last 22 years indicates that the segregation principle will be upheld, and that receivers of insolvent portfolios are to be considered as possessing the standing and powers of a liquidator, as regards their portfolio and it's affairs. There has yet to be any substantial onshore test or confirmation of the SPC segregation principle; and there is still no certainty in relation to the legality of third party funding of receivers of a portfolio to bring claims on behalf of the portfolio. However, the past few years have provided answers on the treatment of portfolios when there has been a substantial intermingling of assets and in relation to the discharge of a receivership order.

[1] A number of years after the creation of the SPC, in 2015, section 5 of the Insurance (Amendment) Law 2013 was implemented, providing for subsidiary companies held by a portfolio in regulated structures established to carry on insurance business without the need for a separate licence. This development provided flexibility in managing the risk element in

insurance.

[2] Unreported, published on 30 May 2019.

[3] 2013 (1) CILR 330.

[4] Unreported 28 November 2017.

[5] A Company and A Funder FSD 68 of 2017 (NSJ) 2017 2 CILR 710.

[6] (*Seear v Lawson* (1880) 15 Ch D 426 and more recently in *Norglen Ltd v Reeds Rains Prudential* [1998] 1 All ER 218 HL and *ANC Ltd v Clark Goldring & Page Ltd* (2000) The Times 31 May).

[7] *In ICP Feeder Fund & ICP Master Fund* (Unreported 4 April 2014), the Cayman Court reviewed the applicable principles regarding litigation funding for liquidators and re-affirmed that the position in the Cayman Islands was the same as in England.

[8] A Company and A Funder FSD 68 of 2017 (NSJ) 2017 2 CILR 710.

[9] Although there are no Cayman authorities on this issue, we consider that the degree of probability necessary to satisfy this test is likely to be 'more probable than not' following *Re AA Mutual International Insurance Co Ltd* [2004] EWHC 2430 (Ch).

[10] The test for the appointment of a receiver over a portfolio is similar to the English test for the appointment of an administrator under the Insolvency Act 1986, where an administrator may be appointed if the company in question "is or is likely" to become unable to pay its debts and the administration order is reasonably likely to achieve the stated purpose of the administration. The rationale for the wider gateway in the case of administrators arguably stems from the fact that administration (which is the UK equivalent of the US Chapter 11) is intended to give a company breathing space and allow for the possibility that a corporate rescue, scheme of arrangement, or an otherwise more advantageous outcome can be achieved for creditors should the company eventually be wound up. There would not appear to be any similar justification justifying the broader gateway afforded to portfolios as the process of administration does not exist in the Cayman Islands.

[11] The Court sanction a scheme of arrangement for the Sphinx Group, for the compromise of investor claims which included a number of SPCs on 22 November 2013.

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