Recognising your limits: The treatment of segregated portfolio companies in onshore liquidations

Like most other developed offshore jurisdictions, the British Virgin Islands promotes a type of company which seeks to compartmentalise the assets and liabilities of various "portfolios" away from other portfolios and the company's general assets. In the British Virgin Islands these are known as segregated portfolio companies (or "**SPCs**") but in other jurisdictions the equivalent type of company is often known as a protected cell company or segregated cell company.

For those not already familiar with SPCs, a very brief summary is in order: an SPC is a company which compartmentalises its assets into designated portfolios. A creditor of one portfolio may only have recourse to the assets attributable to that portfolio and (when those are exhausted) to the assets attributable to the company as general assets. However, a creditor will *not* have recourse to the assets of a different portfolio (which are similarly ring-fenced for the benefit of that portfolio's creditors). But, despite the segregation of assets and liabilities into these different portfolios, the SPC is still regarded as a single legal entity.

However, in the rush to create new corporate structuring products, the draftsmen creating the legislation for SPCs were always left with one nagging doubt: what happens if a bankruptcy court in an onshore jurisdiction simply refuses to recognise the statutory segregation of assets and liabilities? Until that day actually comes, it is impossible to answer that question with certainty, but this article will seek to explore the likely way in which a court in an onshore common law jurisdiction (such as the United Kingdom, Hong Kong or Singapore) may deal with the various issues which would arise in relation to an insolvent British Virgin Islands SPC.

In the British Virgin Islands SPCs are regulated by the BVI Business Companies Act, 2004 (the "**Act**"). The Act broadly contains three methods by which the draftsmen hoped to secure the recognition of segregation of assets and liabilities.

(1) As a starting point, the statute simply provides that as a matter of British Virgin Islands law creditors of one portfolio will not have recourse to the assets of another portfolio (sections 145 and 146 of the Act). This may be referred to as the "*Limited Liability Argument*".

(2) Secondly, the Act specified that each agreement which an SPC enters into shall have implied into it certain terms, providing broadly that, each party to the agreement accepts and will abide by the segregation of assets (section 144(2)(a) of the Act). This may be referred to as the "*Implied Terms Argument*".

(3) Thirdly, the Act provides that if any property is taken by a creditor in breach of the segregation provisions, then that property will be held by the creditor on trust for the SPC (section 144(2)(c) of the Act). This may be referred to as the "*Constructive Trust Argument*".

It is sometimes said in legal arguments that if you can't make one good point, at least try to make lots of bad ones. The real danger in the approach employed by the draftsman of the Act that the wide array of measures employed to protect the segregation of assets betrays something of a lack of confidence that any one of those measures would be sufficient on its own.

Taking the weakest of those points first, it seems highly unlikely that the Implied Terms Argument would persuade any court in a common law jurisdiction that the recourse had been so limited. This is for two key reasons. Firstly, as a matter of the conflict of laws, the terms which are implied into an agreement are determined by the governing law of the agreement. That may be British Virgin Islands law, but most frequently it will not be. The prospect of a court in Hong Kong determining that terms should be implied into a Hong Kong law governed contract by the corporate statute from the domicile of one of the parties to the agreement is entirely fanciful. Secondly however, there is very clear common law authority that parties cannot by agreement reach a system of distribution which is different from that provided for by the bankruptcy legislation (see *British Eagle v Air France* [1975] 1 WLR 758).

The Resulting Trust Argument is slightly stronger. Although the mechanics of this statutory trust seem rather sparse, there is at least clear precedent suggesting that a property transfer in one jurisdiction can be the subject of a constructive trust in another (*AG for Hong Kong v Reid* [1994] 1 AC 324). However, looked at more closely, similar problems seem to arise. Other cases of cross-border constructive trusts usually arise as a result of tracing claims (ie. the trust asset is a derivative asset, rather than the original property), and they tend to involve a degree of moral turpitude which encourages the court to reach conclusions which strip wrongdoers of the gains from their crimes. It is unlikely that the segregated portfolio provisions would be seen in quite the same light, and possible that they may be seen in the opposite light (foreign technicalities preventing creditors of an insolvent company from full recourse to the assets).

If the Resulting Trust Argument was a stand-alone statutory provision imposing a trust, it might constitute a stronger argument. But the real weakness in it is the same as that for the Implied Terms Argument. The British Virgin Islands legislation does not impose a stand-alone statutory trust

– it provides for an implied term into any agreement that such a trust would arise. For the reasons set out above in relation to conflicts of laws when considering the Implied Terms Argument, it is highly improbable that any common law legal system would accept that the law of one party's domicile may imply terms into a contract governed by the laws of a different jurisdiction. But where the agreement is in fact governed by British Virgin Islands law, it may provide a basis for segregation.

Which brings us to the third and final argument – that British Virgin Islands law simply provides that, for this type of legal entity, there is no recourse against certain assets in certain circumstances. Although most onshore jurisdictions do not have a concept of segregated portfolio or protected cell companies, the idea of segregation of assets and liabilities is not an alien concept. In the United Kingdom for example, in the liquidation of insurance companies, assts and liabilities for long term business are so segregated (see The Insurers (Winding Up) Rules 2001 (SI 3635 of 2001), Rule 5).

In his excellent article on this subject from the perspective of English law (*Journal of Pensions Management*, Vol 7, 1, 14-22), Gabriel Moss QC expressed the view that there does not appear to be anything in segregated portfolio legislation which should be held to be contrary to public policy. Furthermore, Mr Moss points out that there does appear to be very old common law authority which suggests that a limitation in the recourse of a creditor which arises under a foreign law may be recognised and given effect to (see *Melan v The Duke of Fitzjames* (1797) 1 Bos & Pul 142, where the court accepted that because the defendant's creditors were subject to limited recourse under the laws of France, his creditors would be so limited in England).

Whilst it is not possible to definitely state how a foreign bankruptcy court will treat the segregation of assets and liabilities upon the liquidation of an SPC, at least in common law jurisdictions there are reasons for cautious optimism that these provisions should be respected. However, it does seem unfortunate that the draftsman of the Act chose to diminish his strongest argument by seeking to bolster it with weaker ones.

Further Information

The foregoing is for general information purposes only and not intended to be relied upon for legal advice in any specific or individual situation.

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