The decision of the Cayman Islands Court of Appeal in *ABC Limited (SPC) v. J & Co.* (Unreported, May 2012) is a welcome affirmation of the integrity of the segregated portfolio company structure under Cayman Islands law, and an interesting addition to the 'loss of substratum' line of investment fund cases.

A segregated portfolio company or "SPC" is a single legal entity whose assets and liabilities can be allocated to different cells or segregated portfolios within the company. Any asset or liability linked to a particular segregated portfolio is deemed to be separate from the assets or liabilities of other segregated portfolios and from the general assets of the SPC. Such assets or liabilities are held exclusively for the benefit or burden of the owners of that segregated portfolio and any counterparty to a transaction linked to that segregated portfolio. SPCs can thereby contract with a creditor or shareholder so that assets injected by that person are held by the SPC in respect of a particular segregated portfolio and are insulated from any claims of the creditors of other segregated portfolios and of the general creditors of the SPC.

In effect, each segregated portfolio operates like a separate limited liability company but is actually a segregated part of a single company. Whilst the assets and liabilities of a segregated portfolio are ring fenced from the assets and liabilities of other segregated portfolios within an SPC, each segregated portfolio of an SPC does not constitute a legal entity that is separate from the SPC. The provisions of Part XVI of the Companies Law therefore enable a statutory segregation of accounts within a single company that could otherwise only be achieved by incorporating separate subsidiaries.

SPCs are commonly used in insurance, mutual fund structures, securitization transactions, multiple tranche debt transactions and shipping and aircraft transactions. However, due to a certain amount of uncertainty as to how the segregated portfolio concept would be treated (and therefore whether the segregation of assets and liabilities would be upheld) in an offshore bankruptcy case,

some still opt to form multiple companies to ensure effective segregation. Accordingly, any judicial guidance on the effectiveness of SPC structures is greatly welcomed.

In *ABC Company (SPC)*, the petitioners sought to wind up a segregated portfolio company on the basis that certain of the portfolios had failed and redemptions of shares in those portfolios had been suspended, amounting to a loss of substratum for the company. The company sought an order striking out the petition on the basis that it had no reasonable prospect of success as the Court would only have jurisdiction to make a winding up order in respect of the Company as a whole as opposed to an individual portfolio. On this basis, it was argued that the petitioner's case must fail as it was not, and could not, be alleged that the company as a whole had lost its substratum. In fact, the failed portfolios comprised less than a third of the company's total net asset value; the remaining portfolios were trading normally and continuing to process subscriptions and redemptions.

At the lower court, Jones J. was not persuaded that the petition was bound to fail and took the view that "the Legislature must have intended that the shareholders of an SPC should have available to them the same remedies that are available to the shareholders of any other company, taking into account that they may have an economic interest in only one portfolio." Jones J. therefore dismissed the company's application to strike and granted the petitioner leave to re-amend the petition so as to seek, in the alternative, the winding up of one of the portfolios comprised in the SPC.

The matter was appealed to the Court of Appeal, which reversed the earlier decision and struck out the petition for winding up. The Court of Appeal found that there was no realistic prospect of establishing that, as a result of the failure of certain portfolios, the company had ceased to carry on business in accordance with the reasonable expectations of its shareholders based on the representations made in the company's constitutional documents and offering memorandum. The Judge also found it was unnecessary to decide whether Jones J. was wrong to give leave to re-amend the petition so as to seek a winding up order in respect of a particular portfolio as the skeleton argument of the petitioner did not submit that a single portfolio could be wound up and therefore did not rely on the re-amended petition.

Further, the Court of Appeal found that there was no jurisdiction to order the winding up of a particular portfolio on the just and equitable ground. Such an order could be made only with reference to the company as a whole.

The decision is significant for a number of reasons. The Court of Appeal for the first time considers the nature of a segregated portfolio company and expressly affirms our understanding of the fundamental characteristics of such entities. One of those fundamental characteristics is that the insolvency of one portfolio should not impact the company as a whole, or the other portfolios. The Court also held that the Companies Law does not provide free-standing jurisdiction to wind up an individual segregated portfolio on the just and equitable ground; the Court must find it just and equitable to order the winding up of the company before it could consider such ancillary relief. The Court's commentary on its jurisdiction to wind up segregated portfolio companies as a whole, and the status of shareholders of specific portfolios to present such applications for winding up, will doubtlessly be instructive in future cases.

The decision is also an important addition to the string of 'loss of substratum' cases that have resulted from the recent economic downturn. The loss of substratum ground requires an assessment of the reasonable expectations of a company's shareholders. The Court of Appeal in *ABC Company (SPC)* held that those expectations could not be discerned by reference to the company's objects as set out in the memorandum of association alone. It held that it is necessary to have regard to the company's articles of association and offering documents. In this case, no informed investor reading these documents together could have failed to appreciate the risk of illiquidity that was involved with the investment, and the possibility that the right to redeem its shares could be suspended. In fact, the Court found that it would be "impossible" for the petitioner to contend that a good faith exercise of the power to suspend redemptions under a portfolio was outside the reasonable expectations of the holders of those shares.

In reaching its findings, the Court of Appeal made specific reference to the conflicting decisions in the Cayman and BVI Courts on the issue of loss of substratum. In *Re Belmont Asset Based Lending Limited* [2010] (1) CILR 83, Jones J. contended that: "Wherever it is proved that a company established as an open-ended mutual fund is no longer viable as such, for whatever reason, the court will ordinarily conclude that it is just and equitable to make a winding-up order". This reasoning was considered by Justice Bannister of the Eastern Caribbean Supreme Court (British Virgin Islands) in *Aris Multi-Strategy Lending Fund v. Quantek Opportunity Fund* (unreported, 15 December 2010) and rejected. Bannister J. held that "If Jones J. was deciding (as I think he was) that it is just and equitable to wind up an open-ended investment fund on the substratum grounds in circumstances where the company has yet to reach the limit of its possible existence, then unfortunately I have to disagree with him". In *Re Heriot African Trade Finance Fund Limited* (unreported, 4

January 2011) Jones J. responded, commenting, "Bannister J. would say that it will not be just and equitable to appoint liquidators (the equivalent of making a winding-up order) on loss of substratum grounds in respect of an investment fund under the laws of the British Virgin Islands unless and until its management have realized all the assets and distributed all the proceeds to its shareholders. If I have understood his judgment correctly, the law of the British Virgin Islands is not the same as that of the Cayman Islands". The Court of Appeal did not comment on the divergent views directly, but did give a hint as to its feelings on the matter:

> It must be anticipated that an appeal will come before this Court in which it will be necessary to choose between the approach of Justice Jones in *Belmont* and *Heriot*, on the one hand, and that of Justice Bannister in *Aris v Quantek* on the other hand: or, perhaps, to decide that the true approach in this jurisdiction should lie somewhere between the approaches respective adopted in those cases. But this is not that appeal.

This provides a strong indication that the approach in *Belmont* may require reconsideration at the appellate level and will be of great interest to the funds industry in Cayman. In the meantime, the decision in *ABC Company (SPC) v. J & Co Ltd.* provides useful guidance on loss of substratum issues and welcome certainty with respect to segregated portfolio companies in the Cayman Islands.

Maree K. Martin
Associate

Tel+1 (345) 814 7376
maree.martin@conyersdill.com

This article is not intended to be a substitute for legal advice or a legal opinion. It deals in broad terms only and is intended to merely provide a brief overview and give general information.

About Conyers Dill & Pearman

Conyers Dill & Pearman advises on the laws of Bermuda, the British Virgin Islands, Cayman Islands and Mauritius. Conyers' lawyers specialise in company and commercial law, commercial litigation and private client matters. With a strategic global presence in major international business centres spanning 11 countries and multiple time zones, Conyers offers true global reach. Affiliated companies (Codan) provide a range of trust, corporate secretarial, accounting and management services. Founded in 1928, Conyers has 550 staff, including approximately 150 lawyers.

For more information please contact:
Camon Sit
+1 (416) 682-6071
news@conyersdill.com
conyersdill.com