

GUIDANCE NOTE

NOTE ON SEGREGATED
PORTFOLIO COMPANIES



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NOTE ON SEGREGATED PORTFOLIO COMPANIES

Cayman Islands: Segregated Portfolio Companies

The Companies Law (as Revised) (the "**Law**") extended the scope of the segregated portfolio companies provisions in Cayman Islands company law by permitting any exempted company to apply to the Registrar of Companies to be registered as an exempted segregated portfolio company ("**SPC**").

Once registered, exempted companies can operate segregated portfolios with the benefit of statutory segregation of assets and liabilities between portfolios. The principal advantage of an SPC over a standard exempted company is to protect the assets of one account from the liabilities of other accounts.

A segregated portfolio company must include the letters "SPC" or the words "Segregated Portfolio Company" in its name.

Benefits of the SPC Structure

The benefit of SPCs is significant in that standard mutual fund structures such as multi-class hedge funds, umbrella funds and master-feeder structures benefit through the ability to set up a statutory "ring-fence" to protect against cross liability issues between assets and liabilities of the segregated portfolios within an SPC. Furthermore, the use of an SPC facilitates a more streamlined offering structure for certain mutual funds.

What can an SPC do and what can it not do?

1. Under Cayman Islands law an SPC is a legal corporate entity with full capacity to undertake any object or purpose subject to any restrictions imposed on the SPC in its Memorandum of Association ("**Memorandum**"). The Memorandum of SPCs usually gives the SPC full capacity to pursue very broad objects as they are unrestricted. The Memorandum of an SPC typically has a clause such as this in its Memorandum of Association (words underlined for emphasis):

"The objects for which the Company is established are unrestricted and the Company shall have full power and authority to carry out any object not prohibited by the Companies Law...or any other law of the Cayman Islands."

2. **Creation of segregated portfolios and the Law** - Section 216 (1) of the Law permits an SPC to create one or more segregated portfolios in order to segregate the assets and liabilities of the SPC held within or on behalf of a portfolio from the assets and liabilities of the SPC held within or on behalf of any other segregated portfolio of the SPC or the assets and liabilities of the SPC which are not held within or on behalf of any segregated portfolio of the company.
3. As explained below the Law requires an SPC to make a distinction between "**segregated portfolio assets**" (which are assets of the SPC that have been designated or allocated for the account of a particular segregated portfolio of an SPC) and **general assets** (which are assets of the SPC that have not been designated or allocated for the account of any particular segregated portfolio of the SPC).



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4. The Law also requires an SPC to make a distinction between “**segregated portfolio liabilities**” (which are liabilities of the SPC that have been designated or allocated for the account of a particular segregated portfolio of an SPC) and **general liabilities** (which are liabilities of the SPC that have not been designated or allocated for the account of any particular segregated portfolio of the SPC).
5. **Segregated Portfolio is not a separate legal entity** - The crucial point to note is that although a segregated portfolio of the SPC must be separately identified (e.g. with separate bank accounts, separate custodian accounts, etc), under section 216 (2) of the Law, a segregated portfolio is not a separate legal entity separate from the SPC. Accordingly **it is the Memorandum and Articles of the the SPC that will dictate what the SPC is empowered or is not empowered do for and on behalf of its segregated portfolios.**

Governance Issues

6. **Who can bind an SPC or a segregated portfolio?** - Section 218 (1) of the Law states that:

“Any act, matter, deed, agreement, contract, instrument under seal or other instrument or arrangement which is to be binding on or enure to the benefit of a segregated portfolio or portfolios shall be executed by or on behalf of the directors and on behalf of such segregated portfolio or portfolios which shall be identified or specified, and where in writing it shall be indicated that such execution is in the name of, or by, or for the account of, such segregated portfolio or portfolios.”
7. Accordingly the SPC has the capacity to enter transactions “**for and on behalf**” of one or more segregated portfolios. The SPC must identify the relevant segregated portfolio(s) and state that it is acting “**for and on behalf of**” the particular named segregated portfolio(s). It is the board of Directors of the SPC (or other person to whom the Directors have delegated authority, e.g. the investment manager (under the terms of an investment management agreement between the investment manager and the SPC) or the manager of the SPC fund) that will be able to bind the SPC and the relevant segregated portfolio in respect of which the SPC is acting.

Directors at segregated portfolio level? - There will not be a board of Directors at the segregated portfolio level because it is not a separate corporate entity. Usually the board of Directors of the SPC in a fund structure will delegate management of the SPC and the segregated portfolios to an investment manager.
8. **Therefore a contract (under scope of delegated powers) with a segregated portfolio as counterparty might be executed by:**
 - a. the investment manager of the relevant segregated portfolio as follows “ **signed by [name of investment manager] duly authorized by the board of Directors of [insert name] SPC for and on behalf of [insert name] Segregated Portfolio**”; or



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- b. the Directors of the SPC as follows “ ***signed by [] as Director of [insert name] SPC for and on behalf of [insert name] Segregated Portfolio***”
9. **Obtain authority to enter contract** - When contracting with the SPC “***for and on behalf of***” any segregated portfolio, it is advisable:
- to obtain a copy of the board minutes or board resolution approving the transaction or contract; or
 - if one is dealing with an officer of the investment manager or sub-advisor of the segregated portfolio, to obtain written evidence of that person’s authority to act; or
 - obtain a legal opinion as to due authority.

Directors Liability

10. With reference to paragraph 7 above, under section 218 (2) of the Law the Directors of the SPC will incur **personal liability** if they fail to satisfy the requirements of section 218 (1) of the Law. This liability is subject to a right of indemnity against the particular segregated portfolio's assets provided that the Directors were not fraudulent, negligent, reckless or acting in bad faith. A Director may also be relieved of liability by the court where he was not aware of the circumstances giving rise to the liability or expressly objected and exercised his rights as a Director to try to prevent the matter in question occurring.

Segregated assets and liabilities

11. Section 219 (6) of the Law requires that the Directors of the relevant SPC have a statutory duty to establish and maintain (or cause to be established and maintained) procedures to identify and segregate and keep segregated:
- each asset as either a “**general asset**” (i.e. an asset which is not held within or on behalf of any segregated portfolio of the company) or a “**segregated portfolio asset**” and in the case of a segregated portfolio asset, the segregated portfolio to which it is attributed; and
 - each liability as being that of a “**general creditor**” (i.e. a creditor which is not a creditor of any segregated portfolio of the company) or a “**segregated portfolio creditor**” and in the case of a segregated portfolio creditor, the segregated portfolio of which such person is a creditor.
12. The Law also requires the Directors of the SPC to ensure that assets and liabilities are not transferred between segregated portfolios otherwise than at full value.
13. **How are segregated portfolio assets comprised?** - According to section 219 (4) of the Law the assets of a segregated portfolio comprise (a) assets representing the share capital and reserves (“reserves” include profits, retained earnings, capital reserves and share premiums) attributable to the segregated portfolio; and (b) all other assets attributable to or held within the segregated portfolio.



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14. **Issue of shares** - The Law permits shares to be issued in respect of a particular segregated portfolio, the proceeds of which are included in the assets of such segregated portfolio and which may carry the right to distributions from that segregated portfolio.

Rights of creditors

15. According to section 220 of the Law, segregated portfolio assets:

“(a) shall only be available and used to meet liabilities to the creditors of the segregated portfolio company who are creditors in respect of that segregated portfolio and who shall thereby be entitled to have recourse to the segregated portfolio assets attributable to that segregated portfolio for such purposes; and

(b) shall not be available or used to meet liabilities to, and shall be absolutely protected from, the creditors of the segregated portfolio company who are not creditors in respect of that segregated portfolio, and who accordingly shall not be entitled to have recourse to the segregated portfolio assets attributable to that segregated portfolio.”

16. The Law states that a creditor will only have recourse to assets from segregated portfolios with which it has contracted and creditors will have no recourse to the assets of other segregated portfolios of the SPC which are protected under the Law. The Articles of Association of the SPC will have provisions which reflect the Law in the respect.

17. **Transfers to General Assets to meet expenses** – Sometimes the Articles of Association of the SPC empowers the Directors of the SPC to transfer segregated portfolio assets to the general assets of the SPC (and, if more than one segregated portfolio is in existence, pro rata in proportion to the net asset value of each segregated portfolio or in such other proportion as the Directors determine) in order to discharge the following liabilities: government registration fees, annual return fees, professional fees, service provider fees, taxes, fines and penalties and any other liabilities or a recurring nature necessarily incurred in maintaining the continued existence and good standing of that SPC.

Segregation of Liabilities and rights of third parties

18. Section 221 (1) of the Law states that (words underlined for emphasis):

“Where a liability of a segregated portfolio company to a person arises from a matter, or is otherwise imposed, in respect of or attributable to a particular segregated portfolio –

- (a) such liability shall extend only to, and that person shall, in respect of that liability, be entitled to have recourse only to –*

firstly, the segregated portfolio assets attributable to such segregated portfolio; and

secondly, unless specifically prohibited by the articles of association, the segregated portfolio company’s general assets, to the extent that the segregated portfolio assets attributable to



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such segregated portfolio are insufficient to satisfy the liability, and to the extent that the segregated portfolio company's general assets exceed any minimum capital amounts lawfully required by a regulatory body in the Islands; and

(b) such liability shall not extend to, and that person shall not, in respect of that liability, be entitled to have recourse to the segregated portfolio assets attributable to any other segregated portfolio."

19. Accordingly the liabilities to a person arising from a matter imposed on, or attributable to, a particular segregated portfolio, only entitle that person to have recourse to that particular segregated portfolio in the first instance and then to the general assets of the SPC unless the articles of association of the SPC prohibits payments from the general assets of the SPC.

Do share classes get ring-fenced?

20. Sometimes the Articles of Association of the SPC seek to ring-fence the assets held in each class or series account of the participating shares by stating that such assets "*shall be applied solely in respect of Participating Shares of the Class or Series to which such Class or Series account relates and no holder of Participating Shares of a Class or Series shall have any claim or right to any asset allocated to any other Class or Series.*"

21. It is important to note that:
- the Law does not expressly permit or prohibit SPCs from attempting to ring-fence assets in such a manner but this provision in the Articles of Association is a contractual term and would probably be binding as between the shareholders;
 - this is a ring-fencing of assets from other shareholders of another class or series of Participating Shares rather than a ring-fencing of assets from creditors or third parties;
 - this is a ring-fencing of assets rather than a ring-fencing of liabilities;

22. It is unlikely that such a provision in the Articles of Association of an SPC would be enforceable against a third party creditor of the relevant segregated portfolio.

Risks associated with the SPC

23. The law in the Cayman Islands was only amended in 2001 to permit segregated portfolio companies to be used for investment funds. Accordingly, the legislation is relatively new and has not (to our knowledge) been considered by any court in any jurisdiction. It is the intention of the Cayman Islands legislation applicable to segregated portfolio companies that the assets of one segregated portfolio are not available to creditors of another segregated portfolio of the same company. However, each segregated portfolio company is a single legal entity which may operate or have assets held on its behalf or be subject to claims in other jurisdictions which may not necessarily



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recognize such segregation accordingly such segregation may not be respected by a court outside the Cayman Islands with the result that the assets of one segregated portfolio could be available to satisfy the debts of another segregated portfolio. There is no way of avoiding the risk of a creditor seeking to bring a claim in a jurisdiction which the creditor believes may support a challenge to the SPC.

24. Where the SPC is a registered mutual fund in the Cayman Islands and is registered with the Cayman Islands Monetary Authority (“**CIMA**”) the segregated portfolios of the SPC are required to be audited separately and the inability of the auditors of an SPC to complete an audit of any of the segregated portfolios may affect the good-standing of the SPC with the CIMA. CIMA issues one registration certificate for an SPC rather than a registration certificate for each segregated portfolio. Consequently CIMA may impose restrictions on an SPC which is unable to file an unqualified audit due to the activities of any one segregated portfolio.
25. If the SPC is not a registered fund with CIMA then there is no requirement for the SPC to be audited by an approved auditor and there is no requirement for the SPC to be in good standing with CIMA. A third party (e.g. a lender) dealing with an SPC which is not audited may find it very difficult to verify what assets are held by any of the SPC’s segregated portfolios.
26. If an SPC was to acquire tax residence in another jurisdiction or establish a branch there, it may become subject to the jurisdiction of a foreign tax or regulatory authority. Whilst the tax or regulatory authorities in the Cayman Islands would be expected to respect the segregation of assets and liabilities in a segregated portfolio structure, there is no guarantee that a foreign authority would.

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