

CELL COMPANY HANDBOOK | 09

Definitive guide to global cell companies
Jurisdictional overviews
Expert advice on diverse use of the cell structure

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From the editor

WELCOME TO THE *Captive Review Cell Company Handbook 2009* – the second edition of our global directory of cell company jurisdictions. Since we last published this directory, the general attitude toward cell companies seems to have shifted up a gear. Whereas single-parent companies have long ruled the captive roost, a slight uptick in the formation of pure captives at the beginning of this year can't hide the fact that growth in this market is still sluggish.

However, with more major players in the captive management sector deciding to set up their own cell companies this year, both in Europe and the US, it appears that the cell concept offers good opportunities right now. Jurisdictions too, seem keen to either upgrade existing legislation to make the formation of protected cell companies (PCCs) easier, to expand legislation to include incorporated cell companies (ICCs) or to add new cell company legislation to the statute books in the very near future.

A recent survey for *Captive Review* magazine showed that among respondents from all the major captive management operations, and the majority of the minor ones, the number of rent-a-captive (RAC) and cell company clients had increased as a percentage of the whole, up to 27%.

In addition, a notable 40% of respondents admitted to owning some form of PCC, ICC or RAC, some 17% said they planned to open their first facility or to add another and 15% said they were considering it as an option in the near-term.

But of course the protected/segregated cell concept is not simply attractive as a vehicle for captive insurance for those who feel the costs involved in setting up a wholly-owned insurance subsidiary are prohibitive.

Protected cells offer an alternative solution to traditional investment fund structures such as umbrella funds, with the additional benefit of a segregated structure. And despite the decline in 2008 of capital market transactions, the use of protected cells as special purpose vehicles for structured finance has revived in 2009.

Once again, the *Cell Company Handbook* is able to offer concise information on the regulatory environment in those domiciles that offer some form of protected cell company structure.

The *Handbook* details the legislation and type of cell company available in the domicile, the total number of cell companies and, where available, the names of individual companies and the number of individual active cells. It also offers practical information on capitalisation requirements, tax regimes, licensing fees and regulatory contact details.

We trust that the 2009 edition of the *Cell Company Handbook* will continue to provide a valuable resource for service providers and cell company clients alike. The cell captive market in 2009/2010 appears to be poised to expand significantly, with more domiciles accommodating the structure and more sponsors setting up protected cell companies. The PCC is finally coming of age!

Adam Saville

Cell Company Handbook editor

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CAPTIVE|REVIEW

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The protected cell evolution

THE PROLIFERATION OF protected cell company (PCC) legislation – a fairly recent creation in offshore jurisdictions including Gibraltar, Bermuda, the Cayman Islands, Guernsey and in the ‘onshore jurisdictions’ of various US states – has been vital to the international recognition for the protected cell regime. Although most commonly utilised as a captive insurance company, the legal structure has also been used for collective investment schemes and in other areas such as ‘repackaging’ (and structured finance transactions).

The idea of one corporate entity representing a number of different economic interests is nothing new and it is not the case that such companies can only operate under a legislative regime for protected cell companies. The concept of a statutory regime for such companies may be relatively new, but the basic mechanics by which they perform their function have been widely used by the banking, insurance and fund sectors over many years.

In the insurance and umbrella funds sector, cell-type structures were a feature in the market long before PCC legislation was ever introduced. Such structures rely on contractual arrangements between the various participants. It is therefore common to refer to them as contractual cell companies. In truth, contractual cell companies and PCCs within the statutory regime can (and do) co-exist side by side. The objective of cell-segregation can therefore be achieved through common law contractual principles without the need for legislation, as it had for many years before the PCC came onto the scene. Despite the common ignorance

today of what a PCC is, it is no different in its intended effect from the tools already widely used in markets of all kinds.

What is a PCC and how does it perform its function?

The intended effect of the PCC statutory regime is to restrict the ability of a cell participant to enforce his claim against all the assets of the PCC. When PCC legislation was first introduced, it was sometimes customary to speak of cells as if they were separate legal entities; in fact they were not. More recently Guernsey has introduced legislation to do precisely that – as seen with the so-called incorporated cell company (ICC). But typically, PCC legislation, while recognising that there is only one legal person, legislates the effect of a contract between the parties by providing for the segregation of cell assets and liabilities and restricting creditor enforcement to what are known as cell assets. This applies to both voluntary and involuntary creditors. The economic (not the legal) effect of a cell is therefore broadly similar for the counterparty to the taking of a security interest over particular assets.

Due to the nature of these companies, they do attract special consideration. There can be no doubt that the critical test of a PCC will come where there is a cross-frontier element (including insolvency) and the company has assets abroad. It is clearly impossible to give a complete global picture of the integrity of such structures. While contract law, driven by the needs of international

commerce, tends to harmonise over time, insolvency laws do not easily do so.

A distinction needs to be drawn between the application of PCC legislation by a local court, and the likely interpretation of the legislation under rules of private international law by a foreign court, for example, if proceedings were instituted against the PCC in such a forum. In any action instituted in the courts of the jurisdiction of incorporation of the PCC, there cannot be any doubt that PCC legislation would be given effect to. Such a court would naturally apply local law. The concern is that the protection afforded to cell assets may be lost where an action is instituted in a foreign court and these assets are situated within that jurisdiction. This however is not a new concern. Even before Guernsey introduced PCC legislation in 1996, those involved in the discussion around the concept of the PCC identified this as an issue – but it was not felt by the Guernsey Financial Services Commission as a good enough reason for not implementing such legislation. Regulators in other jurisdictions (initially at least) took a more cautionary approach. The Isle of Man government, for example, at first decided against introducing PCC legislation and did not do so until 2004 – even so, the use of the PCC was restricted initially to the carrying on of insurance business. This prevarication resulted in Guernsey having a head start over all its offshore competitors, although this was not without its challenges. Twelve months into its legislative life, PCC

legislation in Guernsey came under the scrutiny of a leading UK counsel instructed by a potential PCC user regarding the likely interpretation of the legislation by the English courts.

In the context of an EU insolvency of a PCC insurance company domiciled and incorporated in the EU (e.g. Gibraltar), cross-frontier applications to or from other EU countries would now be governed by the EU Insurance Insolvency Directive. As a general rule, therefore, an EU-based PCC insolvency should be recognized throughout the EU and accordingly PCC legislation would have to be respected.

In the context of a non-EU insolvency, the House of Lords unanimous decision in *McGrath v Riddell* [2008] UKHL 21 has recently come to the aid of the PCC. The House of Lords considered whether an English court should remit assets when faced with a request to do so by a foreign court when that foreign court could arrive at a radically different distribution of the assets (to the UK) of the insolvent entity. The House of Lords ruled that the English assets of the HIH Group must be remitted to the Australian liquidators to be distributed in accordance with Australian insurance insolvency law. The request from the Supreme Court of New South Wales had been declined by the court at all instances (including the Court of Appeal) on the basis that creditors would not be treated according to the statutory *pari passu* principle then applying in England.

Unsurprisingly, the PCC structure has not been widely marketed in Europe. This is because the



existing companies established in Guernsey cannot write direct into the EU (via the EU passport) while it is only recently that Gibraltar (as the then only European PCC domicile) began to actively engage the market with Malta following closely behind after it joined the EU. There seems little doubt that the PCC is now an established part of the international insurance market and will continue to be so.

PCC-type structures have proliferated in recent years in many jurisdictions. They have received acceptance in many international transactions and the market for these structures are no longer the exclusive domain of captive insurers or the large banks. Instead we are seeing an increase in the numbers of PCCs being set up for HNWIs.

The PCC and the investment fund

The use of investment funds, as a tool for raising and investing capital, is now widely used in the international markets the world over. The large majority of such vehicles are established in zero tax jurisdictions guaranteeing a tax-free return on its investments. Over recent years investment funds have been the catalyst for the growth of many PCCs. They include hedge funds and property investment companies. While larger funds will invariably be set up as single vehicles (in the same way as multinationals would set up their own insurance captives), there are undoubtedly gains in smaller funds pooling together under a PCC. Such structures are also fairly easy to establish. As in multi-issue Note Programmes which were previously adopted by banks over many years for repackaging deals for institutional and very wealthy individuals, the documentation has become very standardised and easy to produce.

In the EU, Luxembourg and Dublin have both made provision for segregated cell-type structures for use by investment funds. A number of jurisdictions have also implemented experienced investor (otherwise also known in some jurisdictions as, qualified investor) funds legislation aimed at

streamlining and relaxing the burden of regulation in funds sold only to experienced investors. Such investors are not deemed to require the same protection as retail investors who invest in such funds, informed as to the risks that they take. In general, this relies on a system of self-certification by relevant industry professionals, with local lawyers and fund administrators in particular assuming the central role of ensuring statutory requirements are satisfied (via a process of registration with the local regulatory body). Within the EU, Gibraltar has been at the forefront of the development of a regulatory framework for EIFs. The typical fund is established as a bespoke PCC to raise money for specified investments.

The PCC structure can clearly be a very useful tool in international transactions where investing in a single corporate entity, via separate classes of shares with differing investment objectives and to which specific assets are attributed, is essential. Fund managers in particular have set up PCCs to introduce the platform to their clients. For each separate investment a new protected cell is set up. The promoters can in fact use the PCC for any business transaction based on the investment objectives of its investors. The investment management role can be delegated and performed by the fund manager. The investors have the economic rights over the cell and are also exposed to the risk of loss in respect of the activities of the cell. The promoters, on the other hand, retain the ownership risk related to the PCC and its core assets in order to obtain the benefits of the PCC's management.

There is clearly a significant case in favour of the PCC as a means of raising and segregating funds within a single vehicle.

The PCC life company

The PCC is also an efficient vehicle through which to execute life policies for the account of separate cells supported by segregated cell assets. The PCC structure is sufficiently flexible to also permit cell

assets to be managed by separate investment managers selected by individual policyholders (mainly HNWIs). There are some life policies which are structured with the underlying portfolio being units in a fund of funds or even a fund linked 'Note' or portfolio bond. In this structure, in essence, the HNWI obtains exposure to the underlying portfolio through a life insurance policy.

This type of company looks similar and performs a similar function to an 'investment fund'. The big difference is that the product offering for regulatory purposes constitutes insurance, even if it has some of the characteristics of an investment 'wrapper'.

To qualify as life assurance, it is ordinarily sufficient if there is a right to benefit which is related to life or death. As a consequence, investment products that include provision to pay out a benefit on death or survival to a certain age should qualify as assurance.

Such a structure (which is essentially a hybrid between an umbrella fund and a life company) allow HNWIs to organise their personal, tax and financial affairs through the medium of a bespoke life assurance company. The bespoke company would be established as a PCC, where in return for the payment of premium (for example, handing over investments) an 'insurance policy' replaces the investment portfolio which in turn sits in a segregated cell. Each segregated life sub-fund is then invested using asset managers arranged for and approved by the PCC. Through the use of

separate protected cells the assets are linked or tailored to the cashflows of each individual policy. An alternative to a 'life wrapper' in the UK is to use a SIPP as a 'pension's wrapper'.

Linked life policies in particular lend themselves well to the concept of the PCC given that policy benefits are highly correlated to the value of a defined pool of assets. For linked policies, generally, there is no need to encourage diversification. If asset values decrease, then the policy values decrease. This correlation eliminates an important source of risk for an insurance company.

In essence, a PCC life company allows an investment wrapper for investors to transfer existing funds, bonds and equities with an insurance product.

The general features of such a structure within the jurisdiction of incorporation are:

- No tax on investments held within the wrapper
- No tax on sales or purchases within the wrapper
- No tax on deposit interest

Some jurisdictions in turn provide tax benefits for policyholders, namely no tax on dealing within the wrapper and tax free withdrawals.

Interestingly, a number of jurisdictions who do not currently have PCC legislation are in the process of consultation with a view to implementation.

Nigel Feetham is the co-author of the book 'Protected cell companies: a guide to their implementation and use'.



Worthy of DC consideration

THE AMERICAN AND WORLD economies are suffering and together with the soft insurance market, there is a general slowdown in the formation of both captives and risk retention groups. However, as in many situations, a downturn in one area leads to opportunities in others. In this current situation, the segregated cell captive seems to be benefiting. In the United States in late 2008 and continuing into 2009 the formation of segregated cell entities is leading the way in the alternative risk arena. While cell captive formation generally is very strong, the District of Columbia's incorporated cell law seems to be attracting significant attention from a broad array of both domestic and offshore alternative risk professionals.

Cell captives are being formed and used by a wide variety of interests. These include insurance companies, insurance producers, associations, health-related entities and entrepreneurs to mention some who are taking advantage of the many opportunities cell entities create. Similarly cells are being formed for tax planning situations utilising Internal Revenue Code § 831(b) which defines entities that qualify for favourable small insurance company tax treatment. One attraction of cell captives is that they are typically less expensive to form, capitalise and operate. Cell entities also benefit from the consequent cost reduction of multiple cells sharing the expenses of the various service providers. Once a protected cell captive is created, additional cells become a turn-key operation and can be rapidly formed by the captive.

The District of Columbia captive law, even be-

fore the advent of the incorporated cell provision, was very forward thinking and flexible. The Best Practices provision which permits the regulator to allow a captive to do anything in the District that would be permitted to a captive in any other captive jurisdiction in the world is a huge advantage. Consequently, the District's captive laws will always be on the cutting edge as new and creative developments occur elsewhere in the world. The law also permits credit for reinsurance to a captive provided by a reinsurer that would not necessarily fall within the strict National Association of Insurance Commissioners (NAIC) reinsurance guidelines, but nonetheless was financially sound. It also permits captives to make sound investments that might not otherwise be permitted by the NAIC's somewhat restrictive investment guidelines and allows the captive to book these investments at reasonable valuations. A US branch captive provision in the law facilitates formation of branches in the District of Columbia by alien insurance companies. Such entities must maintain capital in an amount and in a form satisfactory to the regulator, thus avoiding the complex capitalisation and trust requirements of traditional branch laws. Several offshore entities currently are exploring the creative opportunities US branch captive operations may afford.

The District of Columbia's law regarding the formation and structure of protected cell companies and cells is keeping it a leading choice of onshore captive insurance company domiciles. The law, unlike that of many other onshore

domiciles, permits any entity to form a segregated cell captive. Other jurisdictions may require that an insurance company, captive or reinsurer must serve as the sponsor of the cell captive and may require a fronting carrier or otherwise limit the types of business a segregated cell can write. The District's law permits the segregated cell itself to directly insure any line of business except personal automobile and homeowners; a significant difference from other jurisdictions.

The next generation

The District's law most recent revision created the next generation of protected cell legislation in the US. Following the lead of Jersey and other alien domiciles, the law authorises the formation of separately incorporated cells and provides greater detail describing the core and cell relationships. It also specifically authorises cell-to-cell agreements, a significant advantage which clearly enables multiple cells to share risk. The greater specificity provided by the law is very appealing because it provides greater certainty to captive owners, managers, regulators and the courts regarding

the status and actions of protected cell companies and protected cells. The meticulously described characteristics, relationships and powers of the protected cell company and the incorporated cell company and both protected cells and incorporated cells exists in no other American captive law.

The law provides for the creation of two types of cells: traditional protected cells, which do not have their own legal identity, and incorporated cells. An incorporated cell is defined as a separate company within a company with its own legal identity. It may hold assets, sue and be sued in its own name, file its own tax return and do anything that an ordinary corporation can do. This structure is intended to eliminate any doubt as to the strength of the firewall between cells and cell and core, as assets and liabilities are segregated as effectively as they would be among subsidiaries in a group structure.

The law specifically permits a protected cell to enter into an agreement with the protected cell captive or with another protected cell of the same captive, even if it is not organised as a legal entity. This eliminates an uncertainty that has limited the



use of the protected cells and should facilitate the creation of reinsurance or risk pooling cells within a protected cell structure, perhaps even paving the way for the segregated cell risk retention group. At least one such entity has been formed and was registered in almost all states, although it never became active due to other reasons.

Affording flexibility

One of the strengths of the law is the flexibility it affords to the protected cell captive structure. It provides that a traditional captive may convert to a segregated cell captive. It also provides that an existing captive insurer may become a protected cell of a protected cell captive, and a protected cell may separate from its protected cell captive insurer and become an independent captive insurer. These fundamental changes generally require approval of the cell participants and creditors or, if a sufficient number of creditors cannot be located, a finding by the commissioner that creditors will not be materially prejudiced by the transaction, which is another attractive and meaningful feature.

The District's protected cell laws offers many

clear advantages over other American domiciles, including the choice of incorporated or unincorporated cells, the right of cells to contract with each other, and flexibility with respect to the ownership, uses and operation of cells.

Current users of incorporated cells include real estate investment trusts – which may form cells as limited liability companies to achieve pass-through taxation – traditional insurance companies providing risk sharing cells for agents, a life insurer that provides cells for both its agents and insureds and an association that provides cells for its sponsored programmes and is offering turn key cells to association members. Other protected cell companies utilise cells for small insurance company tax planning purposes.

It is clear that the District of Columbia has demonstrated its long-term commitment to being a domicile worthy of consideration. It is likewise committed to continuing to evaluate and update its laws to be a cutting-edge domicile in a fast-growing and sophisticated arena.

Arthur Perschetz, partner, Kilpatrick Stockton





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