Bermuda Court reinforces the integrity of the Segregated Accounts regime

In *Ivanishvili v Credit Suisse Life (Bermuda) Ltd* [2022] SC Bda 56 Civ (***Ivanishvili***) Hargun CJ said:

> "*In general, the concept of a segregated accounts company is that the company, as a separate legal entity, may create segregated accounts such that the assets and liabilities of each segregated account are separate from the assets and liabilities of each other segregated account (and from the general assets and liabilities of the company). A segregated accounts company comprises (i) a general account containing assts and liabilities which are separate from the assets and liabilities of other segregated accounts; and (ii) the segregated accounts. A fundamental feature of a segregated accounts company is that assets linked to the segregated account may only be used to discharge liabilities which are linked to that segregated account. This fundamental feature is reinforced by a number of provisions set out in the SAC Act*."

The Courts in Bermuda have always respected the concept of segregation and separate accounts. In *Re CAI Master Allocation Fund Ltd* [2011] Bda LR 57 Kawaley J observed that such separation is "*sacrosanct*" and a "*statutory Iron Curtain*", and in *BNY AIS Nominees & Gottex ABL (Cayman) Ltd v New Stream Capital Fund* [2010] Bda LR 34 that a segregated account is a "*company within a company*" whose assets are behind a "*firewall*".

Following a directions hearing lasting 5 days, the Chief Justice has delivered an important judgment concerning, and upholding, the integrity of the statutory regime governing the creation and operation of Segregated Accounts Companies (**SAC**s) in Bermuda. That judgment provides the first comprehensive review of the statutory regime under the Segregated Accounts Companies Act 2000 (**SACA**).

The application for directions (the **Application**) was made to the Supreme Court by Rachelle Frisby and John Johnston, the Joint Provisional Liquidators (**JPLs**) of two insolvent companies, Northstar Financial Services (Bermuda) Ltd (**Northstar**) and Omnia Ltd (**Omnia**).

Michael Todd KC and **Tom Hall** (of **Erskine Chambers**) and **Christina Herrero** (of **MDM Ltd (Bermuda**), who represented the JPLs, consider this recent decision of Hargun CJ.

Each of Northstar and Omnia had operated, or purported to operate, segregated accounts under various Private Acts, which acts entitled the Companies to operate SACs in respect of policies of insurance and other investment products provided by them. In addition, on 4 April 2008, Northstar registered as a SAC under SACA. Thereafter, it issued further policies, the operation of which business was governed by SACA.

Northstar was incorporated in 1998. In 2007, it amalgamated with Metlife International Insurance Ltd (**Metlife**) and in 2012 with NFSB Investment Ltd (**NFSB**). In August 2018, Northstar was acquired by BMX Bermuda Holdings Ltd (**BMX**). Omnia was incorporated in 2000. In 2017, Omnia was acquired by PBX Bermuda Holdings, Ltd. (**PBX**). PBX was another company ultimately owned by Greg Lindberg (**Mr Lindberg**).

In essence, Northstar and Omnia had issued two categories of policies and investment products, namely variable investment plans (**variable plans**) and fixed investment plans (**fixed plans**).

Variable plans entitled policyholders to invest in a range of different mutual fund assets, with the return being "variable", in the sense that the return would depend upon the performance of an underlying mutual fund investment.

By contrast, fixed plans sought to guarantee a particular defined return to policyholders over a set period. Under those plans, the policyholder would provide funds to the relevant company, which company would invest those funds with a view to using the proceeds of those investments to pay policyholders the guaranteed return. Unlike the variable plans, the fixed plans did not offer policyholders a choice of underlying investments.

Following both companies' acquisition by Lindberg-controlled entities, a significant proportion of the liquid fixed income securities and investment-grade assets were

replaced with illiquid debt instruments and equity issued by other entities affiliated with Mr Lindberg. Those transactions are the subject of proceedings in the US Bankruptcy Court for the Southern District of New York.

In March 2021, on petitions presented by the Bermuda Monetary Authority (**BMA**), each of Northstar and Omnia was ordered to be wound up by the Court on the basis, amongst others, that it was unable to pay its debts.

It was the effect of the replacement of the companies' liquid fixed income securities and investment-grade assets with illiquid debt instruments and equity issued by entities affiliated with Mr Lindberg which underlined the importance of determining the manner in which the companies' businesses were operated and, in particular, the integrity of the segregation of the companies' fixed and variable accounts.

As the Chief Justice observed in *Ivanishvili*, the linkage of assets and liabilities to particular accounts is a fundamental feature of the statutory regime under SACA. In the Application, the Chief Justice identified a number of provisions of SACA which achieved, and indeed emphasised, the importance of, such linkage.

For present purposes, we identify just three of those provisions, two of which are definitional and the third of which is an operative provision.

Firstly, section 2(1) of SACA defines "*segregated account*":

> "'*segregated account' means a separate and distinct account (comprising or, including entries, recording data, assets, rights, contributions, liabilities and obligations linked to such account) of a segregated accounts company pertaining to an identified or identifiable pool of assets and liabilities of such segregated accounts company, which are segregated or distinguished from other assets and liabilities of the segregated accounts company for the purposes of this Act*".

Secondly, section 2(1) defines the concept of "*linkage*":

> "'*linked' means referable by means of:*

(a) an instrument in writing, including a governing instrumental contract;
(b) an entry or other notation made in respect of a transaction in the records of a segregated accounts company;
(c) an unwritten, but conclusive indication which identifies an asset, right, contribution, liability, or obligation as belonging or pertaining to the segregated account".

The Court found that the touchstone for "*linkage"* is the ability to identify an asset or liability with a given segregated account (by writing or conclusive indication), rather than the segregation of funds (for example by the maintenance of separate bank or securities accounts). He emphasised that:

> *"The relevant provisions of the SACA, do not impose any more demanding requirements for effective segregation than that particular assets that are capable of being segregated for the benefit of a particular Policy are connected to that Policy in the records maintained by the company."*

In particular, he found that it is not necessary that the assets *"linked"* to an account can be demonstrably derived from an original investment. Segregation simply requires that the segregated assets can be identified.

Thirdly, the Chief Justice found that section 17 of SACA sets out the consequences of linkage. In particular, section 17(5) provides:

> *"Unless otherwise expressly agreed in writing by the affected parties—*
>
> *(a) …*
> *(b) …*
>
> *where a liability of a segregated accounts company to a person arises from a transaction or matter relating to, or is otherwise imposed in respect of or attributable to, a particular segregated account, that liability shall—*
>
> *(c) extend only to, and that person shall, in respect of that liability, be entitled to have recourse only to, the assets linked to that segregated account;*
>
> *(d) not extend to, and that person shall not, in respect of that liability, be entitled to have recourse to, the assets linked to any other segregated account; and*

(e) not extend to, and that person shall not in respect of that liability, be entitled to have recourse to, the general account."

The Chief Justice referred to the Explanatory Memorandum accompanying the Bill as a result of which SACA was passed. That described section 17 as:

> *"the crux of the Bill [which] sets out the operative law that effects the separation of accounts. The assets of the segregated account are held exclusively for the benefit of the beneficial owner or counterparty and can only be applied to the liabilities of the account and a statutory 'firewall' insulates those assets from the claims of other creditors."*

On the facts, the Chief Justice found that Northstar and Omnia did establish segregated accounts in respect of all those policies in which they represented that they would create segregated accounts.

In relation to the variable plans, the Court rejected an argument that there were no assets linked to the segregated accounts. It had been argued that a policyholder in respect of such a plan was not credited with any shares in the underlying mutual fund but instead was allocated a number of units in respect of that fund, and that those units simply conferred a right to receive a payment from the company equivalent to the value of those units. Essentially, the units were simply an accounting mechanism rather than actual assets belonging to the segregated accounts.

The Court found that as a matter of record keeping, the units were both a measure of value of the variable assets that had been acquired pursuant to a particular policy and that they could be used to identify the particular variable assets that had been acquired. In principle, therefore, such assets were capable of being effectively allocated to a segregated account.

The variable policy holders are entitled, therefore, to those variable assets linked to their accounts.

In relation to the fixed plans, all parties to the Application agreed that it was not possible for there to have been effective segregation of the underlying investments. There were no arrangements, and hence no records, pursuant to which the underlying investments were connected to the particular policies under which investments had been made.

The question therefore arose as to whether the policies issued under the fixed plans gave rise to segregated accounts. This question was of importance because the limitations imposed by section 17(5) of SACA apply only "*where a liability of a segregated accounts company to a person arises from a transaction or matter relating to, or is otherwise imposed in respect of or attributable to, a particular segregated account*". If the policies did not give rise to a segregated account, no policyholder would be constrained from looking to the assets of the company held in its general account.

The Court found that the time for considering whether a segregated account had been established was upon its creation; at the very moment the policies were entered into and funds committed, there was a liability linked to the account being the liability under the policy. Even if no underlying asset was purchased with the sums invested, the companies' books would record the funds committed both as an asset and a liability of the segregated account. Further, the Court found that the fact that underlying investments were not linked or subsequently ceased to be linked did not result in a segregated account ceasing to be a segregated account.

As to the issue of linkage, and the question of what, if any, assets were to be treated as segregated for the benefit of a segregated account, the Chief Justice found that, in respect of variable plans, there was sufficient connection in the companies' records between the underlying investments and the particular policies in respect of which those investments had been made for those investments to be classed as segregated assets. In contrast, the necessary record-keeping for the purposes of effective segregation was not present in relation to the investments that had been made pursuant to fixed plans. Accordingly, the Court found that those fixed policyholders with segregated accounts (in common with variable policyholders) do not have a claim against the general account assets of the companies.

The comprehensive judgment of the Court will repay a careful reading and consideration. But there are ten points that clearly can be taken away from it.

First and foremost is that, following a comprehensive review of the statutory regime under SACA, the Court has delivered an important judgment concerning, and upholding, the integrity of the regime in Bermuda governing the creation and operation of SACs.

Second, the integrity of a segregated accounts structure will depend upon strict compliance with the provisions of SACA.

Third, the essential ingredient for the creation of a segregated account is the concept of linkage.

Fourth, all that is required for effective segregation is that particular assets that are capable of being segregated for the benefit of a particular policy are connected to that policy in the records maintained by a company.

Fifth, it is not necessary that the assets *"linked"* to an account can demonstrably be derived from an original investment. All that segregation requires is that the segregated assets can be identified.

Sixth, the time for determination of whether an account is a segregated account is when the account is opened or established. It matters not that assets may subsequently cease to be connected to the account.

Seventh, on the facts of the Application, segregated accounts were established when the accounts were opened.

Eighth, it matters not that assets which were purchased and were to be used to satisfy claims to fixed policyholders were exchanged for other, less valuable assets, because those purchased assets were never connected to those fixed accounts in any event.

Ninth, the fact that valuable assets were wrongfully exchanged for less valuable assets is no reflection on the segregated accounts regime in Bermuda or on its integrity. That could happen in any company, whether or not it is an SAC.

Tenth, SACA does not purport to, and cannot, prevent fraud or other unlawful conduct by officers and others, any liability for which would have to be pursued outside of the SACA regime

As we stated at the beginning of this article, as the Chief Justice said in *Ivanishvili:*

> *"In general, the concept of a segregated accounts company is that the company, as a separate legal entity, may create segregated accounts such that the assets and liabilities of each segregated account are separate from the assets and liabilities of each other segregated account (and from the general assts and liabilities of the company)."*

Michael Todd KC (of **Erskine Chambers**) appeared with **Christina Herrero** of **MDM Ltd (Bermuda)**, and were assisted by **Tom Hall** (of **Erskine Chambers**), for the **JPLs**

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