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Article

BVI Multi-Class Funds

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In this series of articles we consider two of the more common requests we see in terms of fund structuring options: *Multi-Class Funds*, and *Hybrid Funds*. This first article in the series will consider Multi-Class Funds. Hybrid Funds will be considered in a separate article, available here.

Many sponsors looking to launch a new offshore fund will have well-defined ideas about the common terms that should apply with respect to the pooling of investments and liquidity rights for investors. However, for those clients looking for something more bespoke, two of the more common requests we see in terms of fund structuring options are for:

Multi-Class Funds

These can be described as funds with a mandate that allows them to pursue two or more different strategies (or to acquire two or more different investments or buckets of investments) within a single fund vehicle that are to be treated as distinct and separate from one another, such that investors in a given strategy only participate economically in that particular strategy and not any other strategies (or investment holdings) of the fund.

Hybrid Funds

These are funds which hold a mix of both liquid and illiquid investments and seek to combine elements of fund terms customary for both hedge funds (for liquid investments) and private equity funds (for illiquid investments) within a single fund vehicle.

Such alternative strategies can present certain unique issues and challenges from a structuring perspective but the British Virgin Islands ("BVI") fund industry is very well adapted to cater for this given the jurisdiction's flexible legal regime and unique set of well-regarded, innovative and cost-competitive fund products.

Multi-Class Funds

Clients may wish to segregate two or more different investment strategies (or two or more different investments or buckets of investments) within a single fund rather than setting up two or more separate fund vehicles for cost saving, administrative efficiency or other reasons. In this instance, they have two key choices in terms of fund structuring options: (i) Contractual Segregation, and (ii) a Segregated Portfolio Company.

i. Contractual Segregation:

This generally entails (a) creating two or more different classes of investor interests in the fund (classes of shares, for a fund company structure; or classes of partnership interests, for a GP/LP structure), and linking each such class to a particular investment strategy or investment holding(s) of the fund; and (ii) giving the operator of the fund broad powers to allocate items of capital, income and gains, and costs, expenses and liabilities as between the accounts of the fund maintained for the different classes of investor interests (thereby altering investors' respective distribution entitlements) such that the different classes (and their respective investment strategies and holdings) are, in effect, segregated from one another as a matter of contractual agreement as set out in the constitutional documents of the fund.

The key benefit of this approach is that it is relatively simple and cost-effective to implement.

The key potential downside is that the said segregation regime shall only take effect as a matter of contractual agreement as between the fund and its investors (and potentially also any contractual counterparties which expressly agree to such a segregation regime, which is rare in practice). Critically, contractual segregation shall not bind third parties more generally (such as creditors or other potential claimants of the fund). This raises a potential risk of cross-contamination of liabilities as between the different investment strategies and holdings of the fund (contrary to the intended segregation). By way of illustration: Investors could subscribe for Class A

Interests in a fund in the expectation they would participate economically only in the Class A investment strategy and holdings of the fund; however, were the fund unexpectedly to incur significant liabilities with respect to, say, the Class B investment strategy and holdings of the fund, claimants against Class B could potentially also seek recourse against all assets of the fund not just those attributable to Class B (including against Class A, even though the liabilities may have arisen in the context of Class B only). Such an eventuality could prejudice the Class A investors (with them effectively and unwittingly underwriting liabilities incurred with respect to Class B).

This risk of potential cross-contamination of liabilities across classes could be disclosed to investors in fund offering documents, and may potentially be bearable for those funds with an especially low risk profile, although would certainly not be advisable for those funds where there is a material risk of potential claw-backs or other third party claims.

ii. BVI Segregated Portfolio Companies:

A Segregated Portfolio Company ("SPC") may potentially be used to overcome this key practical limitation to the efficacy of contractual segregation (namely, the inability to bind third party creditors and other claimants generally).

An SPC is a company limited by shares which is permitted to create one or more 'segregated portfolios' (or 'cells') linked to a particular class or classes of shares in order to segregate the assets and liabilities held in or on behalf of a segregated portfolio (and such related classes) from the assets and liabilities of the SPC: (a) held in or on behalf of any other segregated portfolio (and related classes) of the SPC; and (b) which are not held within or on behalf of any segregated portfolio of the SPC ('general assets').

A BVI SPC is one discrete legal entity. A segregated portfolio (and related class) is not a separate legal entity but a record, or collection of records, detailing transactions relating or linked to each other. In the BVI context, SPCs are necessarily corporate structures as there is no concept of a 'segregated portfolio limited partnership' under BVI law.

Assets linked to a particular segregated portfolio (and related class) are held by the company as a separate fund. Such assets are not available to meet the company's general liabilities, and cannot (unless otherwise agreed) be made available to satisfy liabilities linked to other classes and corresponding accounts of the company. Critically, such statutory segregation is, as a matter of BVI company law, binding upon third party claimants generally (not just those claimants which have expressly agreed to limit their recourse by way of contract).

These unique aspects make SPCs potentially suitable and attractive for multi-strategy or umbrella fund structures. An SPC allows multiple different fund strategies to be operated as distinct portfolios (or 'cells') under the umbrella of one single segregated portfolio company with common management and functionaries/service providers, if desired, and with the unique benefit of statutory segregation. Significant costs savings (relative to forming and operating multiple distinct fund structures) can potentially be realised, provided there is sufficient scale.

However, SPCs are a somewhat complicated and bespoke product and, in our experience, are generally only suitable for use by sophisticated sponsors with strong internal control mechanisms in place (in order to ensure compliance with the special operational rules which apply to SPCs under BVI company law) as well as sufficient scale to justify the upfront formation costs.

Other potential challenges with SPCs include:

a) statutory segregation applies as a matter of BVI company law but has not been tested in the courts of many other jurisdictions outside of the BVI – this raises a potential risk that the statutory segregation regime under BVI law may not necessarily be upheld in jurisdictions outside of the BVI (and that risk may be acute in those jurisdictions that are not familiar with the use of segregated portfolio companies);

b) we understand from onshore advisors that the potential tax treatment of SPCs is not entirely clear in certain jurisdictions; and

c) as SPCs are much less common in practice than regular offshore companies, the ability for SPCs to implement certain corporate transactions such as mergers and continuations to other jurisdictions etc. may not have been tested extensively in practice – in short, there is often additional complexity, more uncertainty, and additional costs involved when dealing with SPCs.

Further general information about BVI Segregated Portfolio Companies can be found here

For those fund sponsors for which contractual segregation and SPCs are not viable solutions, the sensible (and more conventional) approach would often be the creation of two or more separate and distinct fund vehicles.

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