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Securitisation in Bermuda

Preface

This publication has been prepared for the assistance of those who are seeking information on securitisation or structured finance transactions in Bermuda. It deals in broad terms with the establishment and operation of special purpose vehicles. It is not intended to be exhaustive but merely to provide brief details and information which we hope will be of use to our clients. We recommend that our clients and prospective clients seek legal advice in Bermuda on their specific proposals before taking steps to implement them.

Before proceeding with the incorporation of a Bermuda company as part of a securitisation transaction, persons are advised to consult their tax, legal and other professional advisers in their respective jurisdictions.

Conyers Dill & Pearman

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1. INTRODUCTION

Modern company, trust, banking, insurance and other related laws have made Bermuda a leading offshore financial centre. The Bermuda government's attitude towards and open communication with the private sector encourages the promotion and maintenance of Bermuda's offshore business. The island enjoys sophisticated telecommunications systems, an abundance of professional service providers, as well as economic and political stability. These factors combine to make Bermuda one of the jurisdictions of choice for offshore securitisation transactions.

2. SECURITISATION TRANSACTIONS GENERALLY

Securitisation is the process of transforming an asset into a security which can be sold to investors in the capital markets. Securitisation transactions are a fast expanding facility used by businesses all over the world. They provide the opportunity to employ innovative mechanisms for financings of all kinds. If there is an asset – securities, mortgages, receivables, royalties, rentals, or, indeed, just a “thing” – that produces income, then that asset can be securitized.

In a typical Bermuda securitisation transaction, a special purpose vehicle (“**SPV**”) (often owned by a Bermuda purpose trust) is incorporated. The SPV purchases an asset or assets which have some form of regular cash flow and issues loan notes or preference shares to investors in the capital markets to finance the purchase. The repayment of principal and interest on the notes is then secured by the purchased asset(s) and the accompanying cash flow.

3. SPECIAL PURPOSE VEHICLES (“SPV”)

3.1. Incorporation of the SPV

SPVs in Bermuda are generally incorporated as ‘exempted’ companies¹, meaning that they do not generally do business locally. The Bermuda Monetary Authority (“**BMA**”) must approve the incorporation of all Bermuda exempted companies. The BMA requires that each of the individuals with an ultimate beneficial interest in 10% or more of the shares of the proposed SPV signs a declaration. By the declaration, each beneficial owner attests to his or her good standing in any other Bermuda operations and generally. The ultimate beneficial owner's identity must in all instances be disclosed. If the SPV is to be owned by a trust, the application to the BMA will be made in the trust's name, with the trustees as beneficial owners.

The memorandum of association and the bye-laws together form the constitution of the SPV. Only the memorandum of association is a matter of public record and on file with the Registrar of Companies (the “**Registrar**”) and available for inspection by the public at the offices of the Registrar. The bye-laws are not subject to scrutiny by the BMA, the Registrar or the Ministry of Finance. However, the SPV will need to file with the Registrar an extract of the bye-laws information relating to (i) transfer of shares; (ii) duties of the SPV's secretary; and (iii) the number of shareholders which constitute a quorum for any general meeting of the SPV.

The memorandum of association will generally contain the names of the initial subscribers. It is usual to provide for nominee subscribers to the memorandum of association.

¹ Limited liability companies may also be used as securitisation SPVs in Bermuda.

The bye-laws of a Bermuda SPV generally regulate the day to day activities of the company. The bye-laws will set out the rights and duties as between the SPV, its shareholders and the directors. In particular, if the SPV is to have various classes of shares with differing rights, it is usual to set out the rights attaching to each class of shares in the bye-laws.

An SPV must have a registered office in Bermuda, the address of which is registered with the Registrar. A post box cannot be used as a registered office. In general, the share register and records of the company must be kept at the registered office. Duplicate records may be kept at any other office outside Bermuda.

3.2. Objects

The memorandum of association may provide that the objects of the company are unrestricted, or it may set out the specific objects of the SPV. Generally, companies will adopt unrestricted objects. However, in many securitisation transactions, the company's promoters will prefer that the SPV have restricted objects. By restricting the objects of the SPV to those matters required to enable it to carry out its obligations pursuant to the securitisation transaction, other parties and rating agencies can take comfort that the SPV is not carrying on any other business.

3.3. Requirements for Officers or Representatives in Bermuda

Each SPV is required to have at least one director and a secretary. A secretary of an SPV may be an individual or a company. A director of an SPV may be an individual or any type of legal person (including any company or association or body of persons, whether corporate or unincorporate). For practical reasons, it is most common for the office of director to be filled by an individual.

To satisfy the residency requirement contained in the Companies Act 1981 of Bermuda, the secretary or one of the directors must be ordinarily resident in Bermuda. Alternatively, an SPV may satisfy the residency requirement by appointing either an individual or a company to act as its resident representative in Bermuda.

Alternate directors may be appointed with power to act in the place of an absent director. An alternate director has the full authority of a director and is entitled to exercise the full powers of such office at any time when the director for whom he is alternate is not present.

Neither directors nor alternate directors need hold any shares in the SPV.

An SPV must maintain a register setting forth the names and addresses of its directors and officers. The register of directors and officers must be kept at the registered office and must be available for inspection by the public.

An SPV must file with the Registrar a list of directors containing the names and addresses of its directors. An SPV must also notify the Registrar of any change in directors within 30 days of any such change.

3.4. Shareholders

An SPV must have at least one shareholder. For the standard securitisation orphan SPV (see paragraph 5.1 "Orphan" Special Purpose Vehicles below) the shareholder will typically be the trustee of a Bermuda trust. The names and addresses of the shareholders must be entered on a register of members kept by the SPV. In addition, the register must set out the number of shares held by each

member, and, in respect of any share that is not fully paid, the amount paid or agreed to be paid on the shares. The register of members must be kept at the registered office (or, upon filing an appropriate notice, at some other address in Bermuda) and must be available for inspection by the public. Bearer shares are not permitted under Bermuda law, but shares may be registered in the name of a nominee.

3.5. Share Capital

There is no minimum share capital for an SPV, but securitisation SPVs are typically incorporated with US\$10,000.

3.6. Issue and Transfer of Notes

The issuance or transfer of shares or notes that contain terms permitting the holder to vote for or appoint directors requires the consent of the BMA. For a securitisation transaction, consent for the issuance and free transferability of such shares and notes is usually obtained prior to closing. The bye-laws may contain provisions restricting the ability of shareholders to freely transfer their shares.

3.7. Dividends

An SPV may not declare and pay a dividend, or make a distribution out of contributed surplus, if there are reasonable grounds for believing that:

- (a) the SPV is, or would, after the payment be, unable to pay its liabilities as they become due; or
- (b) the realisable value of the SPV's assets would thereby be less than its liabilities.

3.8. Auditors

The shareholders of an SPV must appoint auditors and must fix the remuneration of the auditor or delegate authority to fix such remuneration to the board of directors. However, this requirement may be waived if all of the shareholders and all of the directors, either in writing or at a general meeting, agree. Auditors may not be directors of companies which they audit.

3.9. Books of Account

An SPV must keep proper records of account with respect to its business activities. These records must be kept at the registered office or at such other place as the directors think fit. The records are required to be available for inspection by the directors at any time. Where the books of account are kept outside Bermuda, the SPV must maintain sufficient records in Bermuda as will enable the directors to ascertain with reasonable accuracy the financial position of the company at the end of each quarter. The records of account must be kept for a period of five years from the date on which they were prepared.

The directors are required to lay before an annual general meeting financial statements prepared under generally accepted accounting principles of an approved jurisdiction with an auditor's report thereon or, if the company has elected to dispense with annual general meeting, to make such documents available to its members within a prescribed time line. Copies of the accounts are required to be made available to members of the SPV but, except in the case of public companies, the members may, by unanimous consent, waive the presentation of audited financial statements.

3.10. Exchange Control and Taxes

At the date of this publication, Bermuda corporate income tax (CIT) applies only to certain Bermuda constituent entities that are members of Multinational Enterprise Groups with consolidated financial statements showing annual revenue of at least 750 million Euros for at least two of the last four fiscal years. For all Bermuda companies which are out of scope of CIT, there is no Bermuda income or profits tax, withholding tax, capital gains tax, capital transfer tax, estate duty or inheritance tax payable by such Bermuda company or its shareholders, other than shareholders ordinarily resident in Bermuda.

No stamp duty is payable in respect of any instrument executed by an exempted company or in respect of an instrument relating to an interest in an exempted company. Stamp duty may, however, be payable in respect of transactions involving Bermuda property.

Bermuda is independent for the purposes of exchange control. Exempted companies are designated non-resident for exchange control purposes. The non-resident designation allows these entities to operate free of exchange control regulations and enables them to make payments of dividends, to distribute capital, to acquire, hold and sell any currency and foreign securities without reference to the BMA.

4. REGISTRATION OF SECURITY INTERESTS

The Registrar maintains a register of charges in respect of every company. Any charge over the assets of a Bermuda SPV may be submitted to the Registrar for registration against that SPV. Registration constitutes notice to the public of the interest of the charge in or over the charged assets. To the extent that Bermuda law governs the priority of a charge, any registered charge will have priority over any subsequently registered charge and any unregistered charge, except a charge created prior to 11th July 1984. Priority is based upon the date of registration and not on the date of creation of the charge. Subject to the foregoing, there is no time limit within which a charge must be registered in order to be effective.

5. OFF BALANCE SHEET TRANSACTIONS

5.1. “Orphan” Special Purpose Vehicles

Although many securitisation transactions involve an SPV that is directly owned by a parent company in its group, often a transaction will require an “orphan” SPV, meaning that it is not part of the originator’s corporate group. By selling the asset to the orphan SPV, the asset is removed from the originator’s balance sheet. When an orphan is required, the SPV is incorporated with all the shares issued to a trustee (also offshore) pursuant to a charitable or purpose trust. The SPV then issues securities such as notes to raise funds to purchase the asset pool from the originator. The asset pool is then “ring fenced” by the grant of a security interest over the asset pool in favour of the indenture trustee. The income flow from the asset pool is used to pay the transaction fees and costs and interest to the note holders.

5.2. The Trust

As noted above, the shares of the SPV are usually issued to a trustee pursuant to either a charitable or purpose trust. A purpose trust is a trust designed to fulfil purposes rather than one for beneficiaries, while a charitable trust has charities as the beneficiaries.

The main advantages of the purpose trust are threefold:

- (1) The purposes of the trust and therefore the duties of the trustees can be clearly linked to the contemplated transactions, being to subscribe for shares of the SPV, retain those shares and support the activities of the SPV in the transactions. The duties of the trustees of a charitable trust are to maximise the benefits for the charity or charitable purposes and, depending on circumstances, a conflict of interest may arise.
- (2) A charitable trust that is created primarily to facilitate a particular structure or transaction and where the benefits to the charity are not maximised may be exposed to a “substance over form” argument that the trustees are really acting in the interests and for the benefit of those who benefit from the structure.
- (3) Most offshore centres that follow English common law principles, like Bermuda, grant jurisdiction to the Attorney General (or some similar public official) to enforce charitable trusts that are not being properly administered for the benefit of the charity. Whilst it is not known of any instance where the Attorney General has sought to enforce a charitable trust that is being used in a commercial structure, the risk cannot be entirely discounted in any jurisdiction where such enforcement powers exist.

The advantage of the charitable trust over the purpose trust is mainly one of nexus. It could be argued in some circumstances that a trust appearing to be for a certain purpose or purposes is in fact a trust for the benefit of an ascertainable person. This might give rise to a tax liability in the home jurisdiction of such person. There is English case law authority to the effect that where the benefit to a person is so indirect or intangible or is otherwise so framed so as not to give such person any locus standi to apply to the Court to enforce the trust, the trust would be considered as a purpose trust. However, if the benefit is not so indirect, the trust may conversely not be considered a purpose trust. Of course, the taxation rules in the home jurisdiction may apply different tests to determine whether a taxable benefit arises and those rules would need to be considered carefully. A properly structured charitable trust from which distributions are made from a realistically set level of dividend paid by the SPV may therefore be preferable as the charities would be the persons deriving a benefit.

6. “TRUE SALE” OR “NON-CONSOLIDATION”

Where the transaction is intended to be off balance sheet it is vital that the SPV be regarded as separate from the originator and will not be consolidated for on-shore accounting and regulatory purposes. In order to obtain the off balance sheet accounting treatment the sale of the underlying asset pool by the originator to the SPV must be a true bona fide sale. The transaction must not be characterised as a mortgage, which in substance involves the originator raising financing by charging the underlying asset pool. Nor should the SPV be regarded as a subsidiary of the originator. Accordingly, as mentioned above, the SPV is incorporated with all of the shares issued to a trustee pursuant to a purpose or a charitable trust.

The relevant accounting rules differ depending on the jurisdiction of the originator. While this is primarily an accounting question, factors which may be taken into account include the means by which the originator withdraws profit from the SPV, the extent of influence wielded by the originator over the SPV, the identity of directors of the SPV, the name of the SPV, the extent to which the originator has underwritten the SPV's liability to the investors or other third parties and the ability of the originator to redeem the underlying asset pool at the end of the transaction. Accordingly, most SPV's are organised with unrelated names and directors and officers who are all members of an offshore service provider

such as the offshore law firm. For instance, in certain cases, particularly where the entire transaction is the subject of pre-determined contractual obligations, Conyers Dill & Pearman and its related service companies will provide directors resident in Bermuda.

7. BANKRUPTCY REMOTENESS

When establishing the structure for the SPV, it is important to ensure that the SPV is bankruptcy remote. Although the SPV may be established with very broad objects and powers while the transactions are being negotiated, prior to the transactions being entered into the objects and powers of the SPV should be limited to allow the SPV to only enter into the specific transactions related to the securitisation. This is also necessary if the securities the SPV is issuing are to be rated by one of the rating agencies. The rating agencies will want to ensure the SPV is not able to carry on any business other than the securitisation.

It is also important that the trustee pursuant to the purpose or charitable trust not be allowed to sell the shares, amalgamate the SPV, continue the SPV into another jurisdiction or make any other structural changes to the SPV such as amending its constitutional documents. If a purpose trust is used these requirements can be set out in the purpose trust. If a charitable trust is used the trustee may agree pursuant to a separate agreement that it will not change the structure of the SPV. Again, this is one of the advantages of using a purpose trust whereby everything can be set out in one document.

Finally, it is important to ensure that the SPV will not be petitioned into winding up (bankruptcy). The trustee will agree as a term of the trust not to petition the SPV into bankruptcy. Further, the note holders, indenture trustee and other service providers such as a collateral manager will agree in the indenture and other transaction documents that they will not petition the SPV into bankruptcy. Also, the transaction documents will usually contain a provision for the extinguishment or diminishment of obligations if at any point the liabilities are greater than the assets so that the liabilities will be extinguished or diminished to be less than the assets. This will ensure that the SPV is at all times solvent and thus could not be petitioned into bankruptcy.

8. CREDIT RATINGS

The rating agencies apply selected criteria to assign credit ratings to companies carrying out structured finance transactions. A blanket statement of what will be considered by the rating agencies is not possible. Standard and Poor's emphasizes that there are many variables taken into consideration in evaluating the risk involved in a securitisation transaction, too many to detail here. However, as a rule, the rating agencies take particular notice of the following factors in assigning a credit rating to international securitisation transactions:

- (1) whether the securitized assets can be sufficiently separated from the transferor so that an insolvency of the transferor will not affect the creditworthiness of the assets;
- (2) the overall creditworthiness of the asset pool being securitized; and
- (3) whether any legal issues may affect the cash flow of the transaction.

As mentioned at the outset, Bermuda has in place legislative bankruptcy and corporate schemes which are particularly amenable to SPV's seeking to establish bankruptcy remoteness. SPV's incorporating in Bermuda therefore have the opportunity to achieve high credit ratings, so long as the asset pool in

question is otherwise creditworthy.

9. INSURANCE SECURITISATIONS

The traditional securitisation transaction discussed in this publication focuses on the conversion of an asset into a security which can be sold to investors. However, there is another innovative use for the securitisation transaction: to transform a risk or liability into a security. This idea is best demonstrated by the insurance securitisation transaction.

There are two common forms of an insurance securitisation transaction: a CAT bond transaction and a transformation transaction. In a CAT bond transaction, a reinsurance company looking for retrocessional cover will enter into a retrocession agreement with an SPV and pay a premium to the SPV. The SPV then issues limited recourse loan notes to investors usually in an amount that, when added to the premium received by the SPV, equals the aggregate exposure under the contract.

Accordingly, the SPV becomes the perfect insurance company from the point of view of the insured, as it has assets equal to 100% of its maximum liabilities. Therefore, there is no credit risk to the insured as the loan notes are of limited recourse and the investors agree that the SPV's obligation to repay pursuant to the loan notes is diminished by the amount that the SPV is required to pay to the underlying insured.

In a special purpose transformation transaction, an SPV may be used to transform a single financial guaranty insurance contract into a credit default swap and thereby permit a financial institution to assume the credit default risk. Alternatively, an SPV may be used to enable a primary purchaser of insurance to access reinsurers on a bankruptcy remote basis.

10. CONCLUSION

The basic offshore structure, while adding the benefit of no offshore taxation, is not complicated. However, it is very important to ensure that a Bermuda SPV is properly organized to ensure that the treatment of the underlying asset pool is off balance sheet and there will be no consolidation with the originator, that the SPV is bankruptcy remote and that the SPV will only and can only enter into the specific securitisation transactions.

This publication should not be construed as legal advice and is not intended to be relied upon in relation to any specific matter. It deals in broad terms only and is intended merely to provide a brief overview and give general information.

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