



SHARE CLASSES AND SPECIAL RIGHTS



It is often useful for a company to establish different classes of shares, each with different rights. Particularly in these times of uncertain liquidity and opaque valuations, having multiple classes, each linked to different asset pools, can provide helpful flexibility. But care must be taken in creating new share classes because, once established, class rights can only be changed if certain approvals are obtained. And the existence of separate classes can have implications that may not be immediately apparent – for instance, in determining whether the assets of a company will be considered “plan assets” for purposes of the U.S. Employee Retirement Income Security Act of 1974 (“ERISA”) and the U.S. Internal Revenue Code of 1986 when a U.S. pension plan invests in the company. The laws of Bermuda (and other relevant offshore jurisdictions) should not be assumed to be the same as U.S. law in determining whether a group of shares is a “class” for this and other purposes.

Why create different share classes?

There are many possible reasons for creating multiple classes of shares. Classes are often created to give different voting rights to different shareholders. Separate classes may also be used to give special dividend rights to some investors. Another reason for multiple classes, especially relevant to funds companies, is to allocate only to certain shareholders gains and losses from certain assets or pools of assets of the company. This structure may be formalized in a segregated account or cell structure, where each asset pool (and related liabilities), and the corresponding share class, are “ring-fenced” from others by a statutory registration under the Segregated Accounts Companies Act 2000 of Bermuda (or similar legislation in the Cayman Islands and British Virgin Islands), or it may, less formally, be set out in the description of different share rights in the constitution (i.e. memorandum, bye-laws/articles) of the company. Put simply, the creation of different classes of shares allows a company to tailor a variety of forms of equity participation to suit the needs of different investors, as well as the finance and investment strategies of the company.

Liquidity and Side-Pockets

In the current economic environment where many funds face difficult liquidity and valuation issues, a separate share class is often needed to establish a “side-pocket” to hold illiquid assets. Many funds that do not already have a multi-class structure are moving quickly to establish one so as to

allow investors to have at least one class of liquid redeemable shares, while giving management time to find a market for the illiquid assets linked to the side-pocket share class.

Potential Pitfalls

While multiple classes provide flexibility, they also create potential pitfalls. Whenever a company has more than one share class, it can generally alter the special rights of a class only with the approval of the holders of that class, which in some cases may be difficult to obtain. The specific majority required for approval will depend on the constitution of the company and the governing statute. The Companies Act 1981 of Bermuda provides that if a company’s constitution does not address this question, class rights may be varied with the consent in writing of the holders of three fourths of the issued shares of that class, or with the sanction of a resolution passed at a separate general meeting of the shareholders of the class, provided that at least two persons holding at least one third of the issued shares of the class are present.



Another potential pitfall is the effect on existing classes of the creation of additional classes. Where a company already has shareholders and then creates a new class, the question can arise whether doing so in effect alters the rights of the existing class or classes so as to require their separate approval, especially where the new class will have superior rights. The constitution of the company will often address this question. It may deem the creation of new share classes, especially those with superior rights, to be alterations of the existing class rights. But if it does not the case-law indicates that the creation of new shares, even with superior rights, probably does not constitute an alteration of the rights of the existing classes even though it may well indirectly reduce the voting control or economic value of

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the existing classes (what courts have called the shareholders' "enjoyment" of their rights, as distinguished from the rights themselves).

ERISA

For companies with U.S. pension plan investors, the existence of multiple share classes can be relevant to their ERISA status. The issue is whether the company's assets will be deemed to be "plan assets" under ERISA. One test for this is the "25% test". In essence, this test deems a company's assets to be plan assets if 25% or more of the value of the shares of any class is owned by "benefit plan investors". So, in general, the more classes the shares of a company are divided into, and the fewer investors in each class, the higher the likelihood of the 25% test being met and the company's assets being deemed plan assets. Where the company is an offshore company, U.S. advisers will turn to local counsel to help determine the meaning of "class" for this test.

So what exactly is a "class"?

A class of shares is, generally, any group of shares that has rights different from other shares. But the law is unclear whether the relevant rights, often called "special class rights", can be any rights at all or must, in order to distinguish a class, be certain fundamental rights. Traditionally, in a multi-class company, the rights to vote, receive dividends and to receive a portion of company assets on winding up have been viewed as special class rights which cannot be altered without separate class approval. But there is doubt as to whether that list is exhaustive. At least one English case has held that a right to receive payment from a third party (in that case, the British Government under the Coal Industry Nationalization Act, 1946) was a special class

right. One share right that is often the focus of concern in this context is the right of redemption. Redemption rights are most commonly a feature of shares of a funds company, but can also be attached to shares of other kinds of company. While there is little or no case-law on the subject, it seems prudent to view a right of redemption as a special class right. After all, such a right allows the holder to demand a return of his pro-rata share of the company's assets at any redemption date (often monthly, weekly or even daily), without having to wait for the winding up of the company. As such, it is generally a more powerful and economically valuable right than the traditional right of return of capital on winding up. For this reason, it is hard to see how it could be less relevant in establishing a separate class than the latter right. As for other kinds of share right, they should each be examined in context, but when in doubt it is always prudent, where a company has multiple classes, to consider that any share right may be a special class right.

What's in a name?

If a group of shares is, on the above analysis, a separate class, it matters not what it is called. A company may choose to call such a group of shares a "series", a "sub-class", or any other name, but this will have no bearing on the legal characterization of the shares as a separate class. For that reason, we often suggest that our clients use the legal term "class" when a new class is created, to avoid any subsequent confusion as to the approvals required and other legal implications.



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GUIDANCE NOTES: RECLASSIFICATION OF BERMUDA CLASS 3 INSURERS



The Bermuda Monetary Authority ("BMA") has recently issued Guidance Notes in connection with the reclassification of Bermuda's Class 3 insurers. The Insurance Amendment Act 2008 ("Amendment Act") came into force on July 30, 2008 and created three new classes of insurers: Class 3A, Class 3B and Special Purpose Insurers. The Guidance Notes provide additional information in connection with the reclassification application process.

All Class 3 insurers qualifying for reclassification are required to submit a reclassification application to the BMA by December 31, 2008. Any Class 3 insurer otherwise qualifying for reclassification as a Class 3A or Class 3B general business insurer that fails to apply for reclassification within the prescribed time may have its registration cancelled by the BMA.

Additionally, it should be noted that all Class 3 insurers (whether or not they meet the new licensing criteria for reclassification) must still submit the prescribed form (Form T-1). Those companies that otherwise would not qualify to be reclassified are required to provide a brief description of why they believe they should remain licensed as a Class 3 insurer. In such cases, no fee will be charged for this filing.

The specific criteria to be applied in determining whether an

existing Class 3 insurer qualifies for reclassification as a Class 3A, 3B or Special Purpose Insurer are set out in our June 2008 memo. A copy of this memo is available from the Articles section of our website.

Notwithstanding that the application of these criteria might otherwise indicate a different license classification, the BMA has the power, based on the insurer's business model, international profile and/or conditions of its license (including Section 56 directions and any other regulatory approvals), to register that insurer in a class for which it may not technically be qualified.

When determining whether or not to exercise this discretion, the BMA will take into account (i) the nature of the intended relationship between the insurer and its policyholders, the interests of those policyholders and of the public generally and (ii) the level of regulation which is applicable to the different classes of insurer. Thus, this could result in an insurer that qualifies to be registered in a class with increased regulatory oversight being permitted to register in a lower class and vice versa.

GUIDANCE ON THE BMA'S APPROACH TO THE RECLASSIFICATION PROCESS

Affiliated Reinsurers

An affiliated insurer or reinsurer currently registered as a Class 3 insurer (ie. an insurer writing affiliated reinsurance business

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GUIDANCE NOTES: RECLASSIFICATION OF BERMUDA CLASS 3 INSURERS

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where the ultimate insureds are unrelated to the owners of the business) is registrable as a Class 3A insurer if it only assumes reinsurance from an affiliated ceding insurer. An affiliated insurer will be allowed to assume non-affiliated reinsurance of up to 20% of its total net premium written and continue to be registrable as a Class 3A. However, if an affiliated reinsurer assumes in excess of \$50 million non-affiliated reinsurance, it will be registrable as a Class 3B.

Connected Business

The BMA defines “connected business” as “risk which, in the opinion of the BMA, arises out of the business or operations of those persons or any affiliates of any of those persons”. For the purposes of the reclassification process, connected business will be considered as related party business and shall not be included in the unrelated business percentage when determining the appropriate class of registration.

Should any insurer deem certain lines of its business to be connected business, the insurer must provide with its application a detailed description of the connected business providing a rationale for the business to be considered “connected” for licensing determination purposes. The business shall only be considered connected once the BMA has reviewed the details and issued a connected business certificate.

If a company, based on the amount of connected business written by it, believes that it should remain a Class 3 insurer, it must submit the prescribed form (Form T-1) together with a brief description of why the insurer should remain licensed as a Class 3 insurer.

The following are examples of the types of business that have been deemed to be “connected” by the BMA in the past: Credit and Credit Life; Malpractice Insurance (or other Professional Liability cover) of Non-employed Physicians; Employee Benefits; Risk arising from Joint Venture Projects; Warranty; Collision Damage Waiver; Care, Custody and Control; Agency Business (reinsurance only); and Supplier/Contractor Insurance. This list is not exhaustive and it should not be taken that such lines of business would automatically qualify as connected. An applicant would still need to demonstrate (and the BMA will need to agree) that the risks arise out of the operations of the shareholders or its affiliates.

Premium vs. Loss & Loss Expense Provisions

For the purposes of reclassification, any insurer whose net premiums written and/or loss provisions exceed the 50% unrelated test will be required to re-register as a Class 3A or Class 3B insurer, i.e. if a company is not writing in excess of 50% unrelated net premiums but its booked reserves include over 50% of unrelated loss & loss expense provisions, then that insurer would meet the criteria of a Class 3A insurer and accordingly would be required to make application to re-register. If the insurer is also exceeding the \$50 million unrelated premium test then it would be required to re-register as a Class 3B even if such unrelated premiums are less than 50% of the net premiums written.

Net Premiums Written

For the purposes of the re-registration requirement the 50% unrelated test shall apply to an insurer’s net writing position only. The gross written position is not considered.

De minimus Premiums Written

The Amendment Act makes no provision for registration as a

Class 3 insurer if an insurer meets the criteria for registration as a Class 3A insurer, however the amount of net premium written is *de minimus*. Any insurer writing in excess of 50% unrelated net premiums will be required to make application to be registered as a Class 3A insurer regardless of the dollar amount of its net premium written.

However, as noted previously, the BMA has the discretion to register an insurer in any particular class even if that company does not otherwise qualify to be registered in such class, should the BMA deem such registration appropriate. Should an applicant wish to have the BMA consider its continued registration as a Class 3 insurer, the applicant will need to include with its application a detailed description of the rationale for why it would be more appropriately registered as a Class 3 insurer rather than being reclassified as a Class 3A insurer. The BMA has indicated that it will consult with individual firms prior to making a final registration recommendation.



In force Regulatory Approvals

All existing regulatory approvals including but not limited to section 56 directions, relevant asset approvals and other fixed capital approvals will remain in force notwithstanding the reclassification of the insurer.

The BMA will review all such approvals as it reviews the application for re-registration to ensure that such approvals remain appropriate. Should the BMA deem any such prior approval to no longer be appropriate during its review of the re-registration application, the BMA will consult with the applicant prior to amending or revoking any such approval.

Segregated Accounts Companies/Rent-A-Captives

For the purposes of the re-registration process, all Segregated Accounts Companies and/or “Rent-a-Captives” will be allowed to remain registered as Class 3 insurers at this time. However, the BMA has announced that as part of its 2009 Business Plan it intends to review this sector of the market with a view to proposing additional amendments to both the regulatory regime and the fee structure commencing 2009/2010.

Permit Companies

Existing Class 3 insurers operating in Bermuda via a permit under the Companies Act that have also been granted a Section 56 Direction giving approval to file a modified return will also be allowed to retain their current Class 3 license at this time.

In this context, a modified return means the Financial Statements and Returns and other information filed with the Insurance Regulatory Authorities in the country in which the company is incorporated.

As with Segregated Accounts Companies, the BMA has announced plans to review its current regulatory regime

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GUIDANCE NOTES: RECLASSIFICATION OF BERMUDA CLASS 3 INSURERS

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with respect to such permit companies and will be proposing amendments to the current regulatory regime to come into effect in 2009/2010.

Sidecars

Existing Class 3 “Sidecars” established with “fully collateralized” reinsurance policies will not be required to reregister as Class 3A or Class 3B. In this regard “fully collateralized” reinsurance policies means reinsurance policies in respect of which the maximum liability to be incurred thereon at predetermined future dates is assessed at the time of issuance of said policies, and provisions made therein for the meeting of those liabilities in full.

At this time the BMA will not require existing Sidecars or other special purpose type insurance vehicles which were previously registered as Class 3 insurers to re-register as Special Purpose Insurers. However, should any entity wish to avail themselves of this new category of registration, the company will need to make application to the BMA for a change of Class. Such applications will be considered outside of this Class 3 re-classification exercise and be addressed as a routine change of Class by the Licensing & Authorizations Team at the BMA.

Run-off Companies

As per the discussion above, an existing Class 3 insurer which has entered into run-off and is not currently writing any premium will still be required to make application to re-register as a Class 3A insurer if that insurer would qualify as such based on the percentage of unrelated loss provisions included in line 17 of the statutory balance sheet.

Mutual Companies

For the purposes of the current re-classification exercise, insurance and/or reinsurance business written by “mutual” insurance companies will be considered related party business as long as said mutual insurer is insuring or reinsuring the risk of its members only.

Composites

The re-registration requirement is only applicable to the general business insurance license. Long-term licences are not affected by this process.

Financial Information

All financial information required to determine the appropriate class of registration of any applicant must be based on audited Bermuda statutory financial statements.

Financial information based on Generally Accepted Accounting Principles will not be considered.

In addition all financial information included with the application should be based on the 2007 audited accounts or the 2008 audited accounts if such accounts have been finalised at the time of application.

APPLICATION PROCESS

The following documents must accompany the prescribed (T-1) application form:

- a. The company’s original Certificate of Registration
- b. An updated business plan (see 4.1.2 below)
- c. Most recent audited statutory financial statements
- d. Management accounts as at June 30, 2008 or more recent, if available
- e. The applicable application fee \$500 in the case of Class 3A and \$1000 for Class 3B.

All business plans must include (at a minimum) the following information:

- a. Executive Summary which discusses the basis for the class of registration for which the company has made application.
- b. Ownership details.
- c. Description of insurance program(s).
- d. 3 year pro-forma statutory financial statements which shall estimate the percentage of unrelated business and BD\$ amount of net premiums written over the succeeding 3 year period.
- e. Assumptions supporting pro-forma statements.
- f. Any additional information the applicant may deem relevant to support its application in the light of the advice detailed in the Guidance Notes.



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NEW EXEMPTED PRIVATE TRUST COMPANY REGIME IN THE CAYMAN ISLANDS



The Cayman Islands have brought into force new regulations to exempt private trust companies from the trustee licensing requirement. Until recently the Cayman Islands were the only leading offshore jurisdiction to require private trust companies to obtain a trust licence. A change has also been made to the STAR trust legislation to allow an exempted Cayman Islands private trust company to act as trustee of a STAR trust.

Exemption regime

Under the new Private Trust Companies Regulations, 2008 (the "Regulations") a Cayman Islands private trust company which only conducts connected trust business and is registered with the Cayman Islands Monetary Authority ("CIMA") does not require a trust licence.

Connected trust business

The test for determining whether a Cayman Islands private trust company carries on connected trust business for the purposes of the Regulations looks solely at the relationship between the settlors/contributors of the underlying trust assets: each settlor/contributor must be a connected person to all the others. The scope of "connected person" is broadly defined; it includes relationships by blood and marriage between individuals as well as companies within the same group and certain shareholder and company relationships. There is no requirement for the beneficiaries to be connected persons. The majority of private trust companies, which typically are set up by and for individual families, should satisfy the connected persons' test without difficulty.

Other requirements under the Regulations include: that the company must be incorporated in the Cayman Islands and have its registered office provided by the holder of a trust licence; that the company keep at its registered office copies of the relevant

trust deeds and trust documents; and that the company must use the words "Private Trust Company" or the letters "PTC" in its name.

Registration

There is no requirement for a Cayman Islands private trust company to obtain approval either prior to incorporation or at any subsequent stage from CIMA or from any other body. Under the previous licensing and regulatory regime for Cayman Islands private trust companies, substantial disclosure was required and companies were subject to ongoing regulation as well as being obliged to have their annual accounts audited. These requirements and obligations have now been removed and replaced by a basic registration requirement. AML/CFT checks will now be carried out by the licensed trustee providing the registered office. There is no requirement under the Regulations to disclose to any person details of the settlor/contributor or of the beneficiaries of the trusts. Although there is no longer any licence fee, a Cayman Islands private trust company must pay an initial registration fee of CI\$3,500 (US\$4,375) and an annual registration fee thereafter of CI\$3,000 (US\$3,750). A declaration must be filed with CIMA upon initial registration and by 31 January annually thereafter declaring: the names of the company and of its directors; the name of the holder of the trust licence providing the registered office of the company; that the company is only carrying on connected trust business; and that the company is in compliance with the Regulations.

It will still be possible, however, for a Cayman Islands private trust company to obtain a restricted trust licence if it so desires.

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