



Conyers Dill & Pearman

Securitization in Bermuda

Foreword

This memorandum has been prepared for the assistance of those who are seeking information on securitization 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 securitization transaction, persons are advised to consult their tax, legal and other professional advisers in their respective jurisdictions.

This memorandum has been prepared on the basis of the law and practice as at the date referred to below.

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 attitude of the Bermuda government towards, and open communication with, the private sector encourages the promotion and maintenance of 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 securitization transactions.

2. SECURITIZATION TRANSACTIONS GENERALLY

Securitization is the process of transforming an asset into a security which can be sold to investors in the capital markets. Securitization 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 it can be securitized.

In a basic securitization transaction, a special purpose vehicle (an “SPV”) is incorporated and is often owned by a trust. The SPV then purchases an asset, which usually has 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 and the accompanying cash flow.

3. SPECIAL PURPOSE VEHICLES (“SPV”)

3.1 Incorporation of the SPV

SPV’s in Bermuda are generally incorporated as ‘exempted’ companies, meaning that they do not generally do business locally. The Bermuda Monetary Authority (the

“BMA”) must approve the incorporation of all Bermuda exempted companies. The BMA requires that each of the ultimate beneficial owners holding 5% or more of the shares of the proposed SPV sign 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 on file with the Registrar of Companies. It is a matter of public record and available for inspection by the public at the offices of the Registrar of Companies.

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.

The bye-laws of a Bermuda SPV generally regulate the day to day activities of the company. These are not filed with the Registrar of Companies and are not generally available for inspection by the public. The bye-laws will set out the rights and duties as between the SPV, the 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, and a postal box is not sufficient. Certain records are required to be kept at the registered office, and the location of the registered office must be provided to the Registrar of Companies and is a matter of public record.

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 securitization 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 securitization 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 Bermuda exempted company is required to have at least one director and a secretary. A secretary of an exempted company may be an individual or a company. A director of an exempted company 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 or a company.

To satisfy the residency requirement contained in the Companies Act, the secretary or at least one director must be ordinarily resident in Bermuda. A company 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. It is usual to provide for alternate directors in respect of, at least, the Bermuda directors.

Neither directors nor alternate directors need hold any shares in the SPV in order to act as such.

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.

3.4 Shareholders

An SPV must have at least one shareholder. For the standard securitization orphan SPV (about which more information can be found below) the shareholder will 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 the member, the amount paid up on the shares, the date on which the person was entered in the register as a member and the date on which the person ceased to be a member. 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 such companies 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 securitization 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 declare and pay a dividend, or make a distribution out of contributed surplus, provided there are reasonable grounds for believing that after any such payment (i) the SPV will be able to pay its debts as they become due and (ii) the realisable value of its assets will be greater than its liabilities.

3.8 Public Offers

If the intention is to take the SPV public, the SPV may be required to file a prospectus with the Registrar of Companies. Exemptions exist where the shares or notes are to be issued (i) to less than 35 persons or (ii) in the case of a private character offer (including an employee share scheme). The prospectus must contain certain designated particulars including a timely auditor's report or statement that the SPV has not yet carried on business.

3.9 Auditors

The shareholders of an SPV must appoint auditors. This requirement may be waived if all of the shareholders and all of the directors, either in writing or at a general meeting, agree that there shall be no auditor. Auditors may not be directors of companies which they audit.

3.10 Books and Records

Proper records of accounts must be maintained and, if these records are kept outside of Bermuda, there is a requirement for regular reporting to the directors of the SPV's financial condition. 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.

The following records of an SPV are available for public inspection at the office of the Registrar of Companies:

- (a) the memorandum of association of the SPV and any amendments thereto;
- (b) the certificate of incorporation;

- (c) the notice stating the registered address of the SPV;
- (d) the register of charges of the SPV; and
- (e) any prospectus filed with the Registrar of Companies.

In addition, the register of directors and officers and the register of members must be available for inspection by the public at the registered office of the SPV.

3.11 Exchange Control and Taxes

At the date of this memorandum, there is no Bermuda income or profits tax, withholding tax, capital gains tax, capital transfer tax, estate duty or inheritance tax payable by an SPV or its shareholders, other than shareholders ordinarily resident in Bermuda. An SPV may apply for and is likely to receive from the Minister of Finance under the Exempted Undertakings Tax Protection Act, 1966 an assurance that, in the event of there being enacted in Bermuda any legislation imposing tax computed on profits or income, or computed on any capital assets, gain or appreciation, or any tax in the nature of estate duty or inheritance tax, such tax shall not until March 2035 be applicable to the SPV or to any of its operations or to the shares, debentures or other obligations of the SPV except insofar as such tax applies to persons ordinarily resident in Bermuda and holding such shares, debentures or other obligations of the SPV or any land leased or let to the SPV.

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 of Companies maintains a public register of charges in respect of every company. Any charge over the assets of an SPV may be submitted to the Registrar of Companies for registration. Failure to register a charge does not affect its validity. A registered charge will have priority over any subsequently registered charge and any unregistered charge, with few exceptions. Priority is based on the date of registration and not on the date of creation of the charge. There is no time limit to file notice of a security interest.

5. OFF BALANCE SHEET TRANSACTIONS

5.1 “Orphan” Special Purpose Vehicles

Although many securitization transactions involve an SPV that is directly owned by a parent, 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 securitization. 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 securitization.

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 securitization 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 securitization 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 SECURITIZATIONS

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

There are two common forms of an insurance securitization 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 and therefore, there is no credit risk to the insured. There is no credit risk to the insured because the loan notes are of limited recourse and the investors in the loan notes agree that the SPV's obligation to repay is diminished by the amount that the special purpose insurance company 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 securitization transactions.

This publication is not a substitute for legal advice nor is it a legal opinion. It deals in broad terms only and is intended merely to provide a brief overview and give general information.

About Conyers Dill & Pearman

Conyers Dill & Pearman advises on the laws of the Cayman Islands, British Virgin Islands, Bermuda, Mauritius and Cyprus. Conyers' lawyers specialise in company and commercial law, commercial litigation and private client matters.

The combination of Conyers' structure, culture and expertise enables the highest quality, responsive, timely and thorough legal advice. Conyers' strategic global presence in major international business centres allows a seamless 24 hour service.

Conyers' sophisticated client base includes FTSE 100 and Fortune 500 companies. Working with leading local and international firms, Conyers advises on highly complex multi-jurisdictional projects.

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Founded in 1928, Conyers has 600 staff, including more than 150 lawyers.

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