



Guide to the use of Derivatives in Bermuda and the Enforceability of Netting Agreements with Bermuda Counterparties

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PREFACE

This Guide presents an overview of the use of derivatives in Bermuda, both in terms of the products available and the types of derivatives transactions Bermuda counterparties typically enter into with foreign financial institutions. It also discusses the legislative landscape in Bermuda vis-à-vis derivatives products and the ability of Bermuda entities to enter into such transactions. In particular, we discuss the enforceability of netting agreements adopting the International Swaps and Derivatives Association's ("ISDA") Master Agreement form.

Appleby, as counsel to ISDA since the introduction of the 1992 ISDA Master Agreement, is well versed in advising global financial institutions on the enforceability in Bermuda of netting agreements, particularly in the insolvency of the Bermuda counterparty. This Guide serves as an introduction to each of the post-insolvency netting analyses that can apply depending on the type of Bermuda counterparty, eg companies, segregated account companies, insurance companies, partnerships and trusts. Thus, various themes are covered in terms of how a netting agreement should be structured in order to ensure that the anticipated contractual effect of the agreement is given the same practical and commercial effect in the insolvency of the Bermuda counterparty. Various other practical issues regarding enforcement of contracts in Bermuda and collateral arrangements are also discussed.

It is recognised that this Guide will not completely answer the detailed questions that clients and their advisers may have. It is intended to provide a sketch of Bermuda's legal and regulatory environment in relation to derivatives and the enforceability of netting agreements. This Guide is therefore designed as a starting-point for a more detailed and comprehensive discussion of the issues.

Whilst this Guide speaks of Bermuda law, Appleby can advise on the laws of all the offshore jurisdictions listed at the end of this Guide and the effect that such laws can have on derivatives and netting agreements.

Whilst we have made every effort to ensure the accuracy of the statements made herein, we accept no liability for any errors. In all cases expert legal advice from a qualified practitioner of Bermuda law should be obtained.

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Hamilton, Bermuda
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1. The Derivatives Market and Legislative Landscape in Bermuda

a. Current Markets Overview

Bermuda is a relatively small market for derivatives products. There are only four banks in Bermuda (due to regulatory policy regarding the issuing of banking licences), and just two of these – HSBC (Bank of Bermuda) and Butterfield Bank – enter into derivatives transactions with customers on any significant scale. However, Bermuda counterparties frequently enter into derivative transactions with foreign financial institutions.

The principal driver for the development of derivatives transactions within Bermuda and across its borders has been the growth of the insurance industry: Bermuda is the third largest insurance market after London and New York, and insurance companies established in Bermuda are regular purchasers of various types of derivatives. There is also a significant investment funds market, and such funds are regular purchasers of derivatives, again, typically, from financial institutions outside Bermuda.

All derivative transactions with Bermuda counterparties are arranged bilaterally, whether with a local bank or a foreign financial institution. There is no public exchange of standardised derivatives; although the Bermuda Stock Exchange does list certain debt products, these are typically custom bonds or credit-linked notes, rather than standardised derivatives.

The bulk of the derivatives transactions appear to take place between a Bermuda counterparty and a non-Bermuda financial institution, usually based in either London or New York. There are no regulatory restrictions or prohibitions on the types of derivative transactions that are entered into by Bermuda counterparties. Both domestic and cross-border transactions typically involve, for example, Credit Default/Total Return/Asset Swaps, Credit Linked Notes/Trusts, Interest Rate Swaps/Caps/Floors/Collars, Currency Options or Foreign Exchange Contracts.

There have been no indications of any significant changes to Bermuda's present market for derivatives.

b. Current Legal Framework Overview

There are no specific statutes governing derivatives in Bermuda. There is general freedom of contract, and any party may enter into a derivative with any other party irrespective of its place of incorporation, save that Bermuda legislation does, subject to certain exceptions, prohibit Bermuda-established entities classified as "Exempted Undertakings" from transacting business with purely domestic Bermuda-established entities.

Bermuda's foreign exchange controls may give rise to certain issues where the Bermuda counterparty is designated as "resident" for exchange control purposes. This issue is discussed more fully in section 4.b. below.

The economic and contractual effect of certain provisions of a typical ISDA Master Agreement are also affected by certain laws of Bermuda, but such laws are incidental and are not intended to regulate derivatives per se. This is also discussed further below.

2. General Aspects of Cross-Border Over the Counter Derivatives Documentation and Enforceability in Bermuda

Cross-border over-the-counter derivatives between a Bermuda counterparty and a foreign (non-Bermuda) counterparty would typically be documented using one of the ISDA Master Agreement formats. Both the 1992 and 2002 versions are in use. There appears to be no pattern of use of one form versus the other dependent on the type of entity. There is no local Bermuda form.

Apart from any applicable foreign exchange control restriction, the principal procedural matters for a Bermuda entity will be to ensure the proposed derivative transaction is within its powers, as contemplated by its constitutional documents. Thus, a Bermuda company must act within the terms of its memorandum of association and Bye-laws, or, in the case of a company established by Private Act of the Bermuda Legislature, the terms of such Act; partnerships will need to comply with the terms of their deeds of partnership; and trusts with the terms of the settlement of the trust, including the trust deed and any applicable instructions to the trustee of the relevant trust. Generally, the directors or managers of the entity concerned would also need to adopt board or management resolutions expressly authorising the transaction.

Bermuda entities will also be regulated to the extent they are registered under specific legislation, such as the Insurance Act 1978, the Investment Business Act 2003, the Banks and Deposit Companies Act 1999, the Segregated Accounts Companies Act 2000 or the Investment Funds Act 2006. Upon registration under one of these Acts, a Bermuda entity may, in a given case, be restricted to engage in certain types of business. Such restrictions or conditions may be inscribed on the certificate of registration or licence. Although not a common occurrence, an entity may be restricted, or specific consents may be required from the Bermuda Registrar of Companies or the Bermuda Minister of Finance in order to engage in derivatives transactions.

In the case of a Governmental entity, for example the national pension fund for the Bermuda Government, capacity and authority would be determined by reference to the instruments which created that entity, be they statutes or statutory instruments. The relevant instrument would identify the scope of permissible investments and also the Minister or other person entitled to bind the fund or other Government entity. Generally, however, there is no restriction on a Bermuda Government entity conducting cross-border transactions.

Finally, Bermuda does not have a comprehensive netting statute specifically crafted to take into account derivatives transactions using a typical ISDA Master Agreement structure. There is no current proposal to introduce any such legislation.

During the solvency of the Bermuda counterparty, the terms of a derivatives contract are generally enforceable in accordance with their terms, including terms relating to netting or automatic early termination. Further, in the event of an insolvency, the economic effect of a derivatives contract can usually be preserved, particularly where credit support has been taken. However, in certain circumstances Bermuda's Bankruptcy Act 1989 will take precedence over contractual provisions relating to netting and set-off and, accordingly, the close-out mechanism may not operate according to the precise terms of the relevant contract. In addition, the post-insolvency netting analysis can be affected by Bermuda legislation where the counterparty is registered under, for example, the Segregated Accounts Companies Act 2000 or the Insurance Act 1978, although with the appropriate drafting of the relevant agreement the thrust of the economic intentions of the netting provisions can be preserved, even in the insolvency of the Bermuda counterparty. This is discussed in greater detail below.

3. Specific Aspects of Enforceability of ISDA Provisions in Bermuda

Enforceability¹ of the ISDA Master Agreements is considered in relation to two main areas, namely (a) Set-off, Netting and Close-out Netting and (b) the Early Termination provisions of the ISDA Master Agreement.

Generally, there is no distinction between Bermuda domestic and cross-border transactions in terms of contractual enforcement; save that enforcement of a money debt in a currency other than Bermuda Dollars may require the permission of the Bermuda Monetary Authority. The current policy of the Bermuda Monetary Authority is to give such permission.

Under the laws of Bermuda, the provisions relating to the above areas are generally enforceable in the context of cross-border over the counter derivatives transactions between a local party and an international party. This is so even in the event of Bankruptcy, though a number of qualifications arise in such a case.

The term “Bankruptcy”, as broadly defined in the ISDA Master Agreements, would encompass (among other things) the liquidation of companies, the appointment of a receiver by the court or under private instrument and bankruptcy proceedings commenced in respect of natural persons. However, the appointment of a receiver is rare in Bermuda and individuals are not often counterparties to ISDA Master Agreements. Therefore, for practical purposes, Bankruptcy usually refers to the liquidation of a company. For that reason, the discussions below concerning Bankruptcy and insolvency refer to and contemplate company liquidation.

a. **Validity and Enforceability of Set-off, Netting, and Close-out Netting Provisions**

- **During Regular Performance or Triggered by an Event of Default or a Termination Event, other than Bankruptcy**

The Set-off, Netting and Close-out Netting provisions typical to the ISDA Master Agreements can be validly entered into by local entities. The provisions are enforceable and there are no requirements peculiar to the law of Bermuda that must be reflected in the actual agreement to ensure their validity and enforceability. This is so both in terms of the regular day-to-day performance of the agreement, and in a case where an Event of Default or Termination Event has occurred, other than a Bankruptcy (discussed in the following section).

- **Triggered by Bankruptcy**

Subject to the discussion below, the Set-off, Netting and Close-out Netting provisions typical to an ISDA Master Agreement are enforceable in a Bankruptcy event. In particular, these provisions are enforceable in Bermuda in the event of insolvency², solvent or insolvent liquidation, and receivership by order of the court or under the terms of a private instrument.

The provisions of the ISDA Master Agreements provide for the netting of termination values in determining a single lump-sum termination amount upon the insolvency of a counterparty. Such

¹ The term “enforceable” in this context means that the obligations of the Bermuda counterparty are of a type that the Bermuda courts will enforce. It does not mean that such obligations will necessarily be enforced in all circumstances in accordance with their terms where, for example, enforcement may be limited by general principles of equity or where claims for enforcement may be barred under statute.

² For these purposes “insolvent” mean the inability to pay debts, taking into account contingent and prospective liabilities, and the term “insolvency” imports this definition.

a provision is enforceable under the law of Bermuda. Provided there are no issues of preferences and illegal conveyances, Bermuda insolvency law will not be implicated if the Early Termination Date is prior to the commencement of the insolvent winding-up of the Bermuda counterparty. Even if the Early Termination Date is after the commencement of an insolvent liquidation of the Bermuda counterparty, a court could enforce the ISDA Master Agreements on their terms without reference to the mandatory set-off provisions which become applicable in an insolvent liquidation in Bermuda if it can be said that there are no “mutual debts” between the parties pursuant to section 37 of the Bankruptcy Act (discussed below). As the ISDA Master Agreements themselves provide for the substitution of a single net balance owing by one party or the other for the rights and obligations under individual Transactions, arguably the computation of the single net balance is a matter of simple accounting between the parties and may generally (if not always) be accomplished without reference to insolvency set-off.

We note, however, the decision reached in *Enron Australia v TXU Electricity* [2003] NSW SC 1169 in which the flawed asset provisions of the ISDA Master Agreements were enforced. In *Enron*, the liquidators of Enron, relying on the court’s power to disclaim onerous property and make consequential orders, were seeking to accelerate the non-defaulting party’s obligations by obtaining an order which would require payment as though an early payment date had been designated. The court declared that it did not have the power to rewrite the contract in the way that the liquidators proposed and also affirmed the validity of the flawed asset provision in the ISDA Master Agreement. In the ordinary course of events, if Enron were not in default, the non-defaulting party would have been required to make payments as each transaction matured (rather than, if at all, only when all of them had done that). But, as construed by the court, the ISDA Master Agreement enabled the non-defaulting party to cease making payments as they fell due.

The *Enron* case alludes to but does not determine the question whether the non-defaulting party would ever have to make payment (i.e., even after all relevant transactions had matured and even after applying set-off). Such a “windfall” result may be contrary to a proper construction of the ISDA Master Agreement and (among other things) the notion that Bermuda insolvency set off is mandatory and will override any inconsistent contractual provisions, presumably including the flawed asset provision if necessary.

Accordingly, and in any event, even if the position were to be determined by application of insolvency set-off, the commercial result would be substantially (albeit not precisely) in accordance with the terms of the ISDA Master Agreements. Pursuant to Section 235 of the Companies Act 1981 (the “Companies Act”), the rules that prevail under the law of bankruptcy with respect to the rights of secured and unsecured creditors, debts provable and the valuation of future and contingent liabilities also apply in the winding-up of an insolvent company. Among these rules is Section 37 of the Bankruptcy Act 1989 which provides:

"Where there have been mutual credits, mutual debts or other mutual dealings, between a debtor against whom a receiving order shall be made under this Act and any other person proving or claiming to prove a debt under the receiving order, an account shall be taken of what is due from the one party to the other in respect of mutual dealings, and the sum due from the one party shall be set off against any sum due from the other party, and the balance of the account, and no more, shall be claimed or paid on either side respectively; but a person is not entitled under this Section to claim the benefit of any set off against the property of a debtor in

any case where he had, at the time of giving credit to the debtor notice of an act of bankruptcy committed by the debtor and available against him."

It is not possible to contract out of these statutory provisions: they will override the provisions of the ISDA Master Agreements to the extent of any inconsistency. The statutory provisions provide for mandatory set-off and are generally applied and construed quite broadly. Whilst there are subtle differences (which local counsel can advise on), there is no substantive inconsistency between set-off in an insolvent liquidation pursuant to these provisions and the provisions for netting under the ISDA Master Agreements when entered into with a "standard" Bermuda company (i.e., a company incorporated by registration under the Companies Act).

Notwithstanding that insolvency set-off as described above should generally coincide with the netting provisions under the ISDA Master Agreements, certain differences in terms of calculations and timing are possible. For example, there is the requirement that calculation of foreign currency claims in an insolvent liquidation must be made as at the date of the winding-up order against the insolvent company, even if the ISDA Master Agreements might select a different date.

In the context of insolvency set-off, a potential issue may arise as to the obligation to deliver commodities. Such an obligation cannot be brought into the insolvency set-off account. The ISDA Master Agreements envisage that such an obligation would be converted into a pure monetary obligation. While there is some uncertainty on this point, a court is likely to recognise the conversion of the delivery obligation into a monetary obligation, in which event (a) either insolvency set-off does not arise at all (as discussed above) or (b) the monetary obligation will be brought into the mandatory insolvency set-off account.

Issues may also arise where a counterparty to the ISDA Master Agreements is a company registered to operate segregated accounts or licensed to carry on insurance business. Further issues also arise where the counterparty is a partnership or a trust, since in some circumstances the mutuality requirement under insolvency set-off may not consistently be satisfied in respect of the partnership or the trustee (see further discussion of these entities below).

b. Validity and Enforceability of Early Termination Provisions

i. Triggered by an Event of Default or a Termination Event, other than Bankruptcy

Under Bermuda law the Early Termination provisions typical to the ISDA Master Agreements, including Additional Termination Event provisions, can be validly entered into by local entities, and are enforceable. The parties are generally free to stipulate the conditions upon which a contract or obligations under it will terminate. There are no requirements peculiar to the law of Bermuda that must be reflected in the actual agreement to ensure their validity and enforceability. This is so both in terms of the regular day-to-day performance of the agreement, and in a case where an Event of Default or Termination Event has occurred, other than a Bankruptcy (discussed in the following section).

ii. Triggered by Bankruptcy

The Early Termination provisions typical to the ISDA Master Agreements can be validly enforced when triggered by a Bankruptcy event. This is so notwithstanding the broad scope of the

definition of “Bankruptcy” under the ISDA definitions. In particular, these Early Termination provisions are enforceable in Bermuda in the event of insolvency, solvent or insolvent liquidation, receivership by order of the court, or under the terms of a private instrument.

c. Cherry-Picking in the Event of a Bankruptcy

Section 240 of the Companies Act provides that a liquidator may, with the leave of the court, disclaim any right under a contract which in his opinion is “onerous for the company to hold or is unprofitable or unsaleable”. On the basis that all Transactions concluded under a single ISDA Master Agreement constitute a single contract, a liquidator of the Defaulting Party should not be in a position to “cherry pick” between Transactions under a single ISDA Master Agreement terminating some derivative agreements and repudiating or leaving standing others. The liquidator could only disclaim the ISDA Master Agreement as a whole, whereby the Non-defaulting Party would be entitled to prove in liquidation for the amount of its loss or damage.

In the case of multiple ISDA Master Agreements between two parties, a liquidator could not exercise his rights to disclaim under Section 240 in respect of the ISDA Master Agreements where its provisions operate automatically to terminate the agreements upon the occurrence of an insolvency, or where the Non-defaulting Party exercises an option to terminate in those circumstances. At that time, there would be no ongoing obligations to disclaim.

Section 240 of the Companies Act is rarely invoked and most likely does not have practical application in a case involving ISDA Master Agreements.

In the absence of such a disclaimer power, a liquidator could not have an effective mechanism for cherry-picking among Transactions, whether they be a single ISDA Master Agreement between two counterparties, or where there are multiple ISDA Master Agreements between two counterparties.

d. Validity and Enforceability of Foreign Law and Foreign Jurisdiction Provisions

Under Bermuda law, the Governing Law and Jurisdiction provisions typical to the ISDA Master Agreements, both pertaining to the applicability of New York law or English law and the irrevocable submission to English courts and the courts of the State of New York, as the case may be, can be validly entered into by local entities, and they are enforceable.

There are no requirements peculiar to the law of Bermuda that must be reflected in the actual agreement to ensure their validity and enforceability. This is so both in terms of the regular day-to-day performance of the agreement, and in a case where an Event of Default or Termination Event has occurred, including a Bankruptcy.

In particular, where the parties’ intention is manifested in an express term which selects the law of the contract, a court in Bermuda seized of the action would give effect to that choice, provided that such choice of law is *bona fide*, legal, valid as a matter of the chosen law and there is no reason for avoiding it on the grounds of public policy. It is essential, too, that the choice of law provision is expressly pleaded in any action before a court in Bermuda. In the absence of any such pleading, the court will apply

Bermuda law. In our opinion, the courts in Bermuda would uphold the choice of law to govern the ISDA Master Agreements.³

Further, the submission by a counterparty to the jurisdiction of foreign courts is not contrary to Bermuda law and would be recognised by the courts of Bermuda as a legal, valid and binding submission, if such submission is legal, valid and binding under the laws of the place selected.

e. Known Local Issues with the Validity and Enforceability of Collateral Arrangements and Guarantees

Under Bermuda law, the typical collateral arrangements and guarantees accompanying ISDA Master Agreements can be validly entered into by local entities, and they are enforceable.

There are no requirements peculiar to the law of Bermuda that must be reflected in the actual agreement to ensure their validity and enforceability. This is so both in terms of the regular day-to-day performance of the agreement, and in a case where an Event of Default or Termination Event has occurred, including a Bankruptcy.

Charges over the assets of Bermuda companies wherever situated, and charges on assets situated in Bermuda granted by or to companies incorporated outside Bermuda, (in both cases excepting real property in Bermuda or a ship or aircraft registered in Bermuda) are capable of being registered in Bermuda in the office of the Registrar of Companies under Part V of the Companies Act. Registration under the Act is the only method of registration of charges over the assets of Bermuda companies in Bermuda (except charges over real property in Bermuda or ships or aircraft registered in Bermuda). Registration under the Companies Act is not compulsory and does not affect the validity or enforceability of a charge and there is no time limit within which registration of a charge must be effected. However, in the event that questions of priority fall to be determined by reference to Bermuda law, any charge registered pursuant to the Companies Act will take priority over any other subsequently registered charge and all unregistered charges over the same assets.

The English form of ISDA Credit Support Annex stipulating an outright transfer of title may create issues in insolvency in that the transferee of the asset may have no right akin to a right of redemption. That could be a problem where the value of the asset transferred exceeds the value of the claims the asset was meant to secure.

Guarantees of the kind typical in respect of the ISDA Master Agreements should not give rise to any issues of enforceability under the law of Bermuda.

4. Special Areas of Consideration in Bermuda

a. General Tax Considerations

Bermuda is a tax neutral jurisdiction and offshore entities will typically obtain a Tax Assurance Certificate from the Minister of Finance which provides that, even in the event of tax being imposed on the island, the entity will be exempt from taxation until at least March 2016. Accordingly, no significant tax issues

³ *Vita Foods Products Inc. v. Unas Shipping Co., Limited* [1939] 1 All ER 513 (P.C.), a decision of the Judicial Committee of the Privy Council.

should arise in respect of the ISDA Master Agreements or cross-border payments made under a derivatives agreement.

b. Applicable Foreign Exchange Controls

The Bermuda currency is the Bermuda Dollars, which by law is fixed at par with the United States Dollars.

Under Bermuda foreign exchange controls Bermuda entities are designated as “resident” or “non-resident”. Virtually all exempted entities, which are the usual form of entity adopted for international business purposes, are designated as “non-resident”. An entity designated as non-resident is free to trade in any currency other than the Bermuda Dollars and the Exchange Control regulations will not affect its obligations in currencies other than the Bermuda Dollars. Local entities, however, are generally regarded as “resident” for Exchange Control purposes, and appropriate permission would need to be obtained from the Bermuda Monetary Authority before any transaction was entered into with such an entity.

Under the law of Bermuda, the conversion of foreign currency for the purpose of determining the value of net claims against a company are probably to be calculated at the date of the winding-up order.⁴ Under the definition of “Termination Currency Equivalent” referred to in the ISDA Master Agreements, a different date for converting foreign currencies may apply. The rates as at the date of the winding-up order will likely prevail over those on the contractual date, if these are different. We note, however, that the conversion will have to be calculated by reference to the date of the winding-up order, not only for the purposes of filing any proof of claim in respect of a liability of a Bermuda, but probably also for the purposes of calculating rights of set-off.⁵

c. Others

As stated above, the post-insolvency netting analysis can be affected by Bermuda legislation where the counterparty (being a corporate entity) is registered under, for example, the Segregated Accounts Companies Act 2000 or the Insurance Act 1978, or is governed by a private Act of the Bermuda legislature. Further, the account provided above only takes into consideration a corporate Bermuda counterparty. What follows, therefore, is an outline of the impact that certain applicable legislation may have on the post-insolvency netting analysis described above (where Bermuda insolvency law is applied), together with an analysis of the enforceability of the netting provisions of the ISDA Master Agreements when entered into with partnership and trust counterparties.

i. Segregated Accounts Companies

Bermuda’s Segregated Accounts Companies Act 2000, as amended (“SACA”) provides that a Bermuda company may register as a segregated accounts company (“SAC”) and establish, operate and maintain segregated accounts.

⁴ *Re. Dynamics Corporation of America* [1976] 2 All ER 669; *Re. Lines Brothers Limited* [1983] Ch.1.

⁵ This paragraph assumes that termination under the ISDA Master Agreement occurs as a direct result of the liquidation of the Defaulting Party. The result would be different if close-out took place prior to and unconnected with any subsequent liquidation. Close-out under such circumstances should give rise to a valid settlement based on the contractual conversion rate because creditors’ rights in liquidation become crystallized as at the date of the winding-up order and valid transactions up to that point are unaffected by the liquidation.

To the extent that contractual dealings of an SAC are allocated to a segregated account (“Account”) maintained on that company’s books (in the manner prescribed by SACA), any creditors will be afforded a restricted recourse against any assets, and will be entitled to make their recoveries only as against assets allocated and credited to the specific Account to which their respective contracts are also allocated. Such creditors will not be legally entitled to make recovery against assets allocated and credited to any other Account of the SAC, or (save to the extent otherwise provided in any relevant contract) against the general assets, being those assets which have not been allocated and credited to any segregated account of that SAC.

Prior to an insolvency, transactions which are booked to the same Account and which would be regarded as a single contract under the governing law of the relevant ISDA Master Agreement, providing for the payment of one net sum and not a series of contracts, would be so regarded in Bermuda law.

To avoid mutuality issues, all Transactions to be included for the purposes of Close-out Netting in respect of an ISDA Master Agreement executed with an SAC in respect of an Account should be allocated (i.e., “booked”) to the same Account.

If assets, rights, obligations and liabilities which relate to the Transactions under an ISDA Master Agreement are not successfully segregated to a particular Account of an SAC (following a failed attempt so to do) the Close-out Netting provisions of the ISDA Master Agreement between the counterparties could still be enforceable. Following a rare failed attempt to segregate, the liabilities and rights in relation to a given Transaction will fall into the general account of the SAC (“General Account”). As regards all claims by and against the General Account, the netting process will operate as before. Only assets which are not segregated (i.e., the General Account assets of the SAC only) will be available to apply towards the settlement of any net sum which the SAC is liable to pay as the result of the netting (provided that the governing instrument, be it an ISDA Master Agreement or Confirmation (or other evidence of a Transaction) so permits).

The insolvency of the General Account of an SAC as well as the insolvency of any relevant Account is pertinent to the discussion. Insolvency of the General Account of an SAC may trigger the winding up of an Account (even though that Account itself might be solvent). In addition, the tests of insolvency that apply under general law in Bermuda, apply equally to an Account. An Account may therefore be insolvent where the general account of the SAC is still solvent.

ii. Insurance Companies

From a netting prospective, there are three types of insurers in Bermuda: general business insurers, long-term business insurers (life and annuity products, for example) and composite business insurers, (i.e. insurers that carry on both general and long-term business). For the purposes of the analysis of the enforceability of the netting provisions of an ISDA Master Agreement post-insolvency of an insurer, general business insurers are treated like Bermuda companies, while long-term and composite insurers are treated differently.

A long-term business insurer must maintain its accounts in respect of that long-term business separate from any accounts it has in respect of any other business. All receipts must be carried to, and form part of, a special fund referred to as the ‘long-term business fund’. No payment from a long-term business fund may be made directly or indirectly, other than for a purpose of the

insurer's long-term business; except insofar as such payment can be made out of any surplus certified by the insurer's approved actuary to be available for distribution otherwise than to policyholders. Accordingly, composite insurers must keep their general business capital, assets and liabilities segregated from their long-term business capital, assets and liabilities and, with one exception, must file two returns — one dealing with the general business in its portfolio and one dealing with the long-term business.

Insolvency set-off in relation to composite insurers is more complicated than it is for general insurers or those carrying on only long-term business. Pursuant to Section 36 of the Insurance Act, on the winding-up of a long-term or composite insurer, net balances owing by the insurer may only be paid out of the long-term business fund if all of the transactions entered into under the ISDA Master Agreement are attributable to the long-term business of the insurer. If the transactions are not attributable to the long-term business fund, then the net claim against the insurer may only be paid out of the assets which are not included in its long-term business fund. Accordingly, mutuality issues can arise as those transactions entered into under an ISDA Master Agreement may only be netted and paid out of the fund to which those transactions are attributed, be it the long-term business fund or the other assets (the general account) of the (composite) insurer.

- **Partnerships**

The basic problem in applying the insolvency set-off principles set out above to (usually limited) partnerships in Bermuda is the requirement for mutuality in relation to debits and credits sought to be set-off. Only claims owed by and against each general partner (typically a Bermuda company) may be set off if the mutuality requirement is satisfied in respect of each partner (or group of the same). This mutuality requirement will be affected by changes in respect of partners of the partnership, brought about either by agreement amongst the partners (e.g., admissions or withdrawals), or by operation of law as a result of the dissolution, bankruptcy or death of a partner. Appropriate mechanisms can, however, be built into the deed of partnership whereby assets and liabilities of the partnership prior to any change are assigned and novated, respectively, to the partnership as constituted after the change, so that mutuality between the parties is maintained.

It is now possible for Bermuda partnerships to register a declaration upon formation to elect 'legal personality'. A Bermuda partnership (general or limited) that registers such a declaration is a legal person separate from its partners with power to own and deal with its separate property in accordance with the partnership agreement and has unlimited capacity at law. Once made the 'legal personality' election is irrevocable. In addition, and subject to any agreement between the partners, such a partnership is not dissolved by a change in the constitution of the partnership. Thus, the complications set out above in relation to Transactions with Bermuda partnerships regarding mutuality are obviated.

- **Unit Trusts**

Investment funds are regularly seen in Bermuda as counterparties to derivatives transactions. Many investment funds are constituted as Unit trusts. These are trusts in which the beneficial interest is sub-divided into marketable units.

Trusts are constituted by a trust deed. A trust has no separate legal capacity; it acts through its trustee or trustees, typically a Bermuda company in the case of a Bermuda trust. Bermuda trusts cannot become insolvent nor can they commit “acts of bankruptcy”; however, the trustee or the beneficiaries of a trust may become insolvent.

The basic problem in applying the termination and closeout provisions of the ISDA Master Agreement in relation to the trustee is the requirement of mutuality in relation to debits and credits sought to be netted. Where the trustee of a Bermuda trust is a Bermuda company, the commercial result of the netting and set-off provisions contained in the ISDA Master Agreement will only be achievable in an insolvency of the Bermuda company if (i) the Bermuda company is the ultimate beneficial owner of the claims against the other party thereto that arise pursuant to the ISDA Master Agreement and is the party ultimately liable to the other party in respect of each Transaction entered into pursuant thereto; and (ii) in entering into each Transaction under such ISDA Master Agreement, each party is acting in the same right and capacity. In other words, the law of insolvency set-off under the law of Bermuda looks through agencies and trusts and analyses set-off as between parties having the relevant beneficial entitlements under the relevant ISDA Master Agreement. Generally, a trustee, as a fiduciary for underlying beneficiaries, is not personally liable and accordingly acts in a different capacity from a person acting for its own account.

The insolvency of the trustee, however, may not substantially affect the rights of the parties under an ISDA Master Agreement. A liquidator would likely be appointed to administer the ISDA Master Agreement or to transfer the obligations of the trustee to a third party. To avoid or reduce complications in this regard, the trustee should be required to transfer his functions to a new trustee nominated by the non-Bermuda counterparty, to transfer all documents and assets to the new trustee and to take all other steps as may be necessary to accomplish this.

Aside from the solvency of the trustee, there is the question of the solvency of the Bermuda trust itself (though, as indicated, a Bermuda trust does not have legal personality under the law of Bermuda).

In these circumstances, an additional trigger for termination can be introduced in the ISDA Master Agreement, by reference to the financial position of the trust. The provision would entitle the counterparty to Early Termination in the event that the liabilities of the trust exceeded its realisable assets (or some such test). To the extent that the beneficiaries themselves are solvent, this would enable netting to occur on a solvent basis, which is not problematic. Even if the beneficiaries are not solvent, Bermuda insolvency set-off should not be implicated unless the beneficiaries are domiciled in Bermuda.

Save as mentioned above the enforceability of the ISDA Master Agreements relating to a Bermuda trust where a party to the ISDA Master Agreement is a Bermuda company and acts in its capacity as trustee of the relevant Bermuda trust is as described above in relation to a Bermuda company. That is to say, the provisions of the ISDA Master Agreements providing for the netting of termination values in determining a single lump-sum termination amount upon the insolvency of the Bermuda trust or the Bermuda company acting as trustee of a Bermuda trust are enforceable under the law of Bermuda.

- **Banks**

Generally, Bermuda banks have the capacity to enter into derivatives transactions on the terms of an ISDA Master Agreement. All four of Bermuda's banks were established by private statutory charter, but the relevant Acts of the Bermuda Parliament are all permissive of such transactions. Nevertheless, regard must be had to any specific terms of those Acts, as well as the banks' own capital and the surplus compliance requirements. In respect of the enforceability of an ISDA Master Agreement with a Bermuda bank, both pre- and post-insolvency, the position is as described above for a Bermuda company (at the date of this publication). Certain special considerations may arise where the Bermuda bank is part of a group of foreign affiliates, entering into a multi-branch ISDA Master Agreement.

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