GUIDE

APPLEBY

GUIDE TO SEGREGATED ACCOUNTS COMPANIES IN BERMUDA

CONTENTS

PREFACE

This Guide is a summary of the law and procedures relating to segregated accounts companies in Bermuda. It will describe various insurance and non-insurance applications of the Segregated Accounts Companies Act 2000 before providing a commentary in relation to the major sections of the Segregated Accounts Companies Act 2000.

We recognise that this Guide will not completely answer detailed questions which clients and their advisers may have; it is not intended to be comprehensive. If any such questions arise in relation to the contents, they may be addressed to any member of the Corporate Department, using the contact information provided at the end of this Guide.

Appleby
Bermuda
May 2016

1. INTRODUCTION

The Segregated Accounts Companies Act 2000 (**SAC Act**) establishes a registration regime whereby a Bermudian company may register as a segregated accounts company thereby establishing, operating and maintaining a company with segregated accounts.

A segregated account (in some jurisdictions described as a "protected cell" or "segregated portfolio") is an account containing assets and liabilities that are legally separated from the assets and liabilities of the company's ordinary account, called its "general account" and also separate from such company's other segregated accounts (if any). Companies having segregated accounts are known as segregated accounts companies and will be referred to in this Guide as a **SAC**.

The SAC Act affirms, however, that a segregated account is not a legal person distinct from the SAC itself. The effect of this statutory division is to protect the assets of one account from the liabilities of other accounts. As a result, the accounts will be self-dependent, such that only the assets of a particular account may be applied to the liabilities of that account.

The statutory divisions between accounts do not create separate bodies corporate, but rather achieve within a single company what could otherwise be achieved, for example, by incorporating subsidiaries or by using complex contractual and trust structures.

The substance of the relationship between a SAC and its assets which the SAC Act imposes is in the nature of a trust, in that the SAC Act describes a segregated account as being a separate fund from within the company's own assets. Such a separate fund is created by way of a mandated agreement between a company and its client. Despite the trusts nature of a segregated account, the SAC Act expressly excludes fiduciary responsibilities and the general law of trusts from applying to the establishment and management of a segregated account.

The SAC Act may be used for a variety of insurance purposes, including rent-a-captives, life and annuity companies, transformer vehicles, as well as financial guarantee, securitisation and derivatives structures and special purpose vehicles, not to mention numerous uses in the mutual and hedge fund industries.

2. APPLICATIONS

2.1 Advantages of the SAC Concept

The SAC Act has several advantages over traditional routes to creating legal divisions between accounts. It is less expensive and less unwieldy than forming numerous subsidiaries. It also avoids issues of time, solvency and perfection in relation to charges. Most importantly, the SAC Act establishes substantive law governing the application of particular assets in favour of particular accounts and their respective liabilities, which enhances the prospects for enforceability of transactions.

2.2 Range of Applications

The SAC Act represents a major opportunity for many international businesses. Insurance applications, mutual fund applications as well as some of the other potential applications are considered below.

Insurance

The SAC Act may be used for a variety of insurance purposes. Among them include rent-a-captives, life and annuity companies, transformer vehicles, as well as financial guarantee, securitisation and derivatives structures, and special purpose vehicles. A company licensed under the Insurance Act 1978 (**Insurance**

Act) may freely establish segregated accounts and register under the SAC Act without specific consent from the Minister of Finance (the **Minister**).

Rent-a-captives

In relation to insurers, a segregated accounts insurance company is typically a variation of a "rent-a-captive". A rent-a-captive is a risk financing solution in which the sponsor (such as a captive manager) establishes and licenses a captive insurance company and "rents" the core capital, licence and corporate capacity of the vehicle to programme participants, thus providing participants with the many benefits of captive risk financing without the attendant administrative and capital costs associated with a pure captive. Rent-a-captive programmes have lowered the cost of establishing one's own captive, opening this solution to smaller corporations and other entities for which ownership of a captive would otherwise be too expensive.

In a rent-a-captive which does not offer legal segregation of accounts, participants agree among themselves to keep the gains and losses of each programme separate from the others. These internal agreements would not generally be effective against third parties such as creditors of the rent-a-captive in the event of liquidation. In a segregated account or protected cell rent-a-captive, each participant's programme is legally segregated from the other, thus making the separation between participants in the rent-a-captive unassailable in the event of a liquidation. This is the principal advantage of the segregated accounts rent-a-captive, offering "fire walls" between programme participants which should withstand the claims of third party creditors of another participant. Participants need not be concerned that the underwriting losses of an imprudent participant may bring the whole facility down.

Life and Annuity Companies

Legal segregation of accounts also has application in the insurance industry outside of the group captive context. Insurers underwriting long-term risks, such as life, disability, pension plan or annuity programmes can take advantage of the legal segregation of reserves among different programmes and products.

Transformer Companies

So-called "transformer" companies are those engaged in the transformation of insurance risk into capital markets products and vice-versa. In cases where a single company enters into multiple arrangements of this kind, it will often be desirable to do this through segregated accounts.

Mutual Funds

In the context of mutual funds, different programmes can be offered to investors under the same corporate structure. Legally segregated accounts are particularly attractive for umbrella or multi-class funds, which would afford each share class the same limited liability that would be obtained if separate bodies corporate were used for each category of investor. (See section 10 of this Guide for a more detailed summary of the provisions of the SAC Act which apply to mutual funds.)

Open Category

In limited exposures under designated derivatives contracts are exempted from regulation as insurance. The types of exposures which may be included in some contracts of this kind may include risks in the nature of insurance risks.

It is likely that it will be desirable to establish segregated accounts under the SAC Act for the purpose of writing multiple contracts of this kind.

Companies Owning Real Estate, Ships, Aircraft or Other Assets

Businesses with multiple assets can organise themselves using a SAC whereby each asset would be owned by a separate account. This is more efficient and economical than using a typical corporate structure where a holding company owns a separate company for each asset.

Temporal Segregation: Business Divisions

When a company operating a core business decides to enter into a new area of business, prudence dictates that in some circumstances the new venture should be isolated from the core business. This would protect the creditors and shareholders of the core business in the event that the new venture fails.

Isolation of the new venture may be accomplished by incorporating a new company or by using the segregated accounts structure; the segregated accounts structure being the more efficient of the two.

The same comments may be made in respect of any company with several discrete businesses in the form of divisions within a single company. In some circumstances it may be desirable to isolate each division from the other divisions. This is particularly so where, as is normally the case, each division operates as a separate profit centre for which separate accounting statements are prepared.

Ring-fencing in Special Cases

SACs can be used in the context of rehabilitation and corporate reorganisation, for example, where it is proposed to reorganise a group of companies (or other entities) which are facing severe financial challenges, it may be appropriate to put into place a financial rescue package through the medium of a segregated accounts entity whose exposure would be limited, rather than contributing assets directly into or entering into unlimited covenants directly with the financially challenged parties. This may be particularly appropriate where there are multiple parties participating in a bail-out on different terms.

Trust Applications

Employee benefit schemes and other arrangements where a trust might otherwise be used lend themselves to the idea of a SAC structure.

Where a trustee operates numerous trusts for unrelated beneficiaries the assets and liabilities of each trust are already legally separated. Nevertheless, at least for administrative purposes, it may be appropriate to reinforce the division between the assets and liabilities of each trust, and between those and the trustee's own assets and liabilities, by using a SAC as the trustee. Separate licensing as a trustee company may also be required in addition to registration as a SAC.

3. REGISTRATION UNDER THE SAC ACT

3.1 Application Procedure

The SAC Act provides that any Bermuda company (i.e. a company to which the Companies Act 1981 (**Companies Act**) applies) may apply to be registered as a SAC. However, only companies engaged in insurance business (as defined in the Insurance Act) may do so without the prior approval of the Minister, which is required for all other companies.

The application for registration requires a notice to be filed with the Registrar of Companies (**Registrar**). The notice must include:

- the name of the company (which in certain cases where the Registrar so directs must include the expression "(SAC)");
- a statement that the company intends to operate segregated accounts;
- the registered office of the company;
- the name and address of the segregated account representative of the company;
- the nature of the business of the company;
- its date of incorporation; and
- a statement that the company has made provision to account for segregated accounts in the manner prescribed by the SAC Act (see 4.2(c) below for details).

Where the company has carried on business prior to registration, the application must be supported by a statutory declaration made by at least two directors setting out a true and accurate statement or description of the assets and liabilities of the company and any pending material transactions. In addition, the statement must describe the segregated accounts the company intends to operate and the assets and liabilities which the company proposes to assign to each of those segregated accounts. The statement must then affirm that the company and each segregated account will be solvent and that no known creditor of the company (having a claim against the company in excess of $1,000) will be prejudiced, or they have consented in writing to the company proceeding to register, or they have been given notice and have not objected. Pursuant to the SAC Act, a statement published in an appointed newspaper that the company intends to register and that a creditor may object to the notice within 28 days is sufficient notice. Where the company has carried on business prior to the application, the application must also attach evidence of the consent in writing to registration of 75% of those who would, on the registration of the company, be the account owners of the segregated accounts of the company and 75% of those who would, on the registration of the company, be creditors. A copy of the notice filed with the Registrar must also be given to all would be account owners and to its known creditors.

A person may object to the registration of the company under the SAC Act by application to the Supreme Court of Bermuda. A percentage threshold of objecting constituents is required in order for an objection to be lodged. The threshold is 20% of all account owners, 20% of all creditors (which by definition includes counterparties who are creditors) or 20% of the combined group of these. The threshold requirement disables an aggrieved individual from frustrating the registration process. Such an application to object must be made within 28 days of registration of the company. The court then has broad powers on the application to object to the registration, including the power to direct that the dissentient's interests be purchased.

3.2 Registration

The Registrar maintains a register of SACs and, when satisfied that the company has paid the prescribed fee and that the company is capable of complying with the SAC Act, the Registrar may register the company as a SAC. Note, however, that in the case of financial institutions, the Registrar must also be satisfied that the Bermuda Monetary Authority (**BMA**) has no objection to the registration.

The Registrar has wide powers in that he may impose such conditions on the registration of the company as he may consider necessary to ensure the reputation of Bermuda. The Registrar may also require the company to take certain steps or refrain from pursuing a particular course of action, including restricting its segregated accounts business.

After registering a company under the SAC Act, the Registrar will issue a certificate showing the date of registration, a copy of which will be available on the public file and therefore available for inspection by members of the public.

The Registrar is empowered to require that a company use the abbreviation "(SAC)" in its name.

The Registrar may, of course, refuse to register a company and where he does so he is not obliged to give reasons and his decision is not subject to appeal or review in any court.

3.3 Converting a Private Act Company to a SAC

A company that has previously operated segregated accounts by virtue of authority conferred on it by a private Act may register under the SAC Act and thereby convert its private regime into the public SAC system. The statutory procedure for a private Act company is the same as it is for any other company, with the addition of a few special provisions.

Where there are inconsistencies between the private Act and the SAC Act, the SAC Act will prevail. In view of this provision, it will be very important in the conversion process to review all of the private Act documentation to ensure that it accords with the requirements of the SAC Act. It will also be important to ensure that there are no problematic inconsistencies between the private Act and the SAC Act.

Contracts entered into prior to registration will be construed in accordance with the private Act and those entered afterwards will be construed in accordance with the SAC Act.

An exception to this is that inter-account transactions, even those entered into prior to registration, will be valid as though they were entered into under the provisions of the SAC Act. This is to assure the validity of inter-account transactions which may already have been entered into in respect of segregated (or separate) accounts of private Act companies which have been registered under the SAC Act.

Private Act provisions pertaining to matters other than the operation of segregated accounts are unaffected by the SAC Act.

4. MANAGEMENT AND ADMINISTRATION

4.1 Segregated Account Representative

A SAC must appoint a segregated account representative in Bermuda who must be approved by the Minister, and whose details must be included in the register of officers and directors of the company. A body corporate, as well as an individual, may be appointed.

4.2 Management Duties

The SAC Act sets out a number of duties that the SAC, an account representative or account manager each have to fulfil. A few of the key duties are outlined below.

(a) Resident Representative

The segregated account representative is required to make a report to the Registrar when he becomes aware of a reasonable likelihood that the general account or a segregated account has become insolvent or that it is in breach of certain provisions of the SAC Act.

(b) **Contracts with Third Parties**

The SAC Act includes several provisions intended to ensure that third parties dealing with segregated accounts companies will be aware of that fact. The primary requirement is that third parties must be informed that they are dealing with a SAC and, where the transaction is with a segregated account, that account must be identified. In addition, all contracts and the letterhead of the company must make mention of the fact that the company is registered under the SAC Act.

(c) **Accounts, Records and Registers**

A SAC must keep proper records in accordance with the standards which apply to ordinary companies, which include records which, to the best of the knowledge, information and belief of the directors and officers of the company, clearly show the share capital, proceeds of rights issues, securities, reserves (including retained earnings, contributed surplus and share premium), assets, liabilities, income and expenses, dividends and distributions that are linked to each account, as well as a record of each transaction entered into by the company. The SAC must also properly record the assets and liabilities in the general account, disclosing any assets intended by the parties to be applied to a risk of any nature, and which therefore exposes such assets to liability or loss.

An account owner of a segregated account may inspect the records maintained with respect to that segregated account, but the SAC Act explicitly states that an account owner does not have the right to inspect the records relating to the general account or another segregated account. A special provision applies to mutual funds, about which see below at 10.

A SAC must prepare financial statements in respect of each segregated account, in accordance with the Companies Act (see also the "Guide to Companies in Bermuda" which is available on the Appleby website). The financial statements of the segregated account must be made available to account owners at intervals of no less than once each year; however, the account owners of a segregated account may indefinitely waive their rights to receive the annual financial statements and audit, provided that the waiver is revocable by the account owner. This provides a commercial treatment of the subject matter while safeguarding the account owner's rights, if he wishes to exercise them.

A register of account owners (other than a mutual fund) must be maintained by a SAC in the same way that an ordinary company must maintain a register of shareholders, but a SAC register of members must also set out the respective interests of the account owners in any segregated account. The register is not open to public inspection and again there are special provisions relating to mutual fund companies (see below at 10).

If records maintained with respect to a segregated account or the financial statements of a segregated account are not made available for inspection by any account owner of that segregated account then, on application by the affected account owner, the court may compel immediate production of the records or financial statements.

(d) **Offences under the SAC Act**

The SAC Act creates several offences. First, the SAC Act makes it an offence to make a false statement for any purpose under the SAC Act. It is also an offence to fail to comply with the conditions imposed upon registration of a company under the SAC Act or to fail to inform third parties that they are dealing with a SAC.

A segregated account representative also commits an offence if he breaches his duty to provide a report in certain circumstances, including his coming to the view that the company is insolvent.

If a SAC fails to comply with certain provisions of the SAC Act in relation to the reduction of share capital by the cancellation of shares, then both the SAC and every officer of the SAC will be liable to a fine. (see also 7.3 below).

(e) **Effect of Infringement of the Act**

The legislation provides that, except where expressly provided to the contrary in the SAC Act, no transaction or interest in a segregated account becomes ineffective by reason only that the SAC fails to comply with, or is in breach of, any provision of the SAC Act.

The section generally corresponds with a similar provision in the Insurance Act. The intention is to ensure that if a breach of the SAC Act occurs the consequences should be as set out in the SAC Act, rather than generally rendering business transactions ineffective, which could sometimes produce absurd results. For example, if a SAC fails to inform a third party that the company is a SAC, the consequence of that is that the company commits an offence and may be subject to sanction. In some circumstances it could cause unfair hardship to the company or the third party if either of them were able to terminate the transaction.

5. GOVERNING INSTRUMENTS AND CONTRACTS

The rights and obligations of an account owner must be set out in a governing instrument, which would correspond with articles or bye-laws of an ordinary company. In contrast, a transaction with a counterparty will be evidenced in the form of a written contract (including by electronic means). These will be discussed in turn below.

5.1 Governing Instruments (Account Owners)

The rights, interests and obligations of account owners in a segregated account must be evidenced in a governing instrument. The SAC Act sets out a few requirements that are thought to be essential in relation to governing instruments namely, that the governing instrument is governed by the laws of Bermuda and the parties submit to the jurisdiction of the courts of Bermuda.

The legislation also outlines a number of provisions which may (but need not) be included. Most of the permissive requirements in relation to governing instruments are self-explanatory and provide for general management powers of a standard and routine character. However, we offer brief comments on some of these provisions below.

A person becomes an account owner by satisfying the conditions, if any, set out in the governing instrument for becoming an account owner, i.e. an account owner takes such interest in a segregated account as may be provided for in the governing instrument. If the governing instrument does not indicate any interest, and there is no other compelling evidence indicating an interest, then the person has no interest in the segregated account. Governing instruments would normally provide that, if no other provision applies, an account owner's interest would include being entitled to receive any dividends declared in respect of the class of interest held by him and to receive a pro rata share of the net assets of the account upon winding down the affairs of the account.

The legislation includes a default provision which applies if the governing instrument does not deal with management of the segregated account. The default position is that the SAC itself manages the affairs of a segregated account and may appoint managers, employees and others appointed to manage the segregated account and enter into financial arrangements for payment for services, such as the charging of fees and disbursements.

In addition, and unless otherwise provided, the SAC may take any action including:

- the amendment of the governing instrument;
- the appointment of one or more managers;
- providing it is for the benefit of the segregated account only, deal with assets of that account or the orderly winding-up of the affairs and termination of the segregated account; or
- provision for the taking of any action to create under the provisions of the governing instrument a class, group or series of account holdings that was not previously outstanding, without the vote or approval of any particular manager or account owner, or class, group or series of managers or account owners.

The governing instrument may set out rules dealing with meetings of account owners.

The company may create new segregated accounts and transfer rights and obligations from a pre-existing account to a new account and convert rights of account owners in the first account to rights in the new account.

The governing instrument may also deal with such things as:

- the governance of the business of the account and the rights, powers and duties of the company, any manager and the account owner and their respective agents;
- the identity of the segregated account to which the transaction and any assets or liabilities are linked; and
- the extent of the interest of the account owners and others (if any) in the account.

5.2 Contracts (Counterparties)

As is the case for governing instruments, the SAC legislation provides for minimal mandatory requirements for contracts. In fact, the only mandatory requirements are that the contract should name the counterparty and be in written form (including by electronic means).

5.3 SAC and Management Duties to a Segregated Account, Account Owner or Counterparty

To the extent that, at law or in equity, a SAC or manager (i.e. the person who, by virtue of a governing instrument or otherwise and with the consent of the SAC and the account owners, has control of the segregated account in question) has duties (including fiduciary duties) to a segregated account, an account owner or counterparty, such duties may be expanded or restricted by provisions in the governing instrument or contract, as the case may be. However, the SAC or manager acting under a governing instrument or contract is not liable to the segregated account or to any account owner or counterparty for the SAC's good faith reliance on the provisions of that governing instrument or contract to which that account owner or counterparty is a party.

It should be noted that the reference to "fiduciary duties" above is merely in the corporate capacity, i.e. no rule of law relating to trusts may be pleaded by any person to modify the operation of the SAC Act. Equitable remedies, including the remedy of tracing, and the creation of trusts may still, however, be applied.

5.4 Contracts – Internal Transactions

There are circumstances in which it is necessary or desirable for segregated accounts to contract with each other or the general account. By way of example, it may be convenient for the general account to provide centralised administrative services to one or more segregated accounts and presumably to charge the accounts on some basis for that service.

A number of specific provisions have been included in the SAC Act to avoid any problematic legal issues in connection with internal transactions. This has been accomplished without compromising the paramount notion that a segregated account does not have separate legal personality.

In addition to providing that segregated accounts may contract with each other and the general account, the SAC Act introduces provisions to protect creditors in the event that preferential or other improper transactions are entered into between accounts and, within limits, protects management (on a consensual basis) from exposure to liability consequent upon inevitable conflicts of interest which will arise in internal transactions. Finally, the SAC Act provides for the resolution of any disputes arising in relation to internal transactions, either by reference to the court or to arbitration.

A related provision enables segregated accounts to own an interest in other segregated accounts.

6. ASSETS AND LIABILITIES

The SAC Act provides that an asset, right, contribution, liability or obligation that belongs or pertains to a segregated account of a SAC must be "linked" to that segregated account by one of the following methods:

- an instrument in writing (which includes a governing instrument or contract);
- an entry or other notation made in respect of a transaction in the records of a SAC; or
- an unwritten but conclusive indication.

6.1 Application of Assets and Liabilities

The SAC Act requires that assets linked to a segregated account must be held by the company as a separate fund which does not comprise an asset of the general account. This fund is to be held exclusively for the benefit of account owners and counterparties and is available to meet the claims of account owners and creditors of the particular segregated account. It is not available to meet the company's obligations to general shareholders or those creditors whose claims are not linked to the same segregated account. Accordingly, under the SAC Act, liabilities linked to a segregated account are liabilities only of that account. Creditors to whom those liabilities are owed have no rights against accounts other than the segregated account to which the liability is linked.

Equally, the assets recorded in the general account will be the only assets of the SAC available to meet liabilities of the SAC that are not linked to a segregated account. Accordingly, a liability to a person that arises or is imposed otherwise than in respect of a particular segregated account can only be satisfied out of the general account.

The legislation contains a default provision in respect of priorities as between different types of claims against a segregated account. Creditors (which would include counterparties who are creditors) rank equally among themselves and above account owners, who also rank equally among themselves.

Subject to the terms of the governing instrument relating to a given segregated account, on dissolution of the SAC or termination of the segregated account and after paying creditors of the segregated account, any property linked to that segregated account must be paid pro rata to the account owners of such segregated account or, if there are no account owners, then the property will fall into the general account.

6.2 Apportionment of Assets and Liabilities

Generally, the intention of the SAC Act is to ensure that assets and liabilities of segregated accounts and the general account will not be intermingled. However, in many cases it will be convenient for commercial purposes for an asset, such as a bank account, to be held to the credit of more than one account. The

same will sometimes be true of liabilities. Accordingly, the SAC Act expressly enables the apportionment of assets and liabilities between segregated accounts and the general account. Provided that the records of the company clearly indicate that this is intended.

6.3 Transfers between Accounts

The legislation also contains provisions dealing with transfers of assets between accounts. The transfer of assets from the general account to a segregated account is not permitted unless the general account is solvent or all shareholders and creditors of the general account consent.

Assets of or pertaining to a segregated account may from time to time be temporarily held within the general account (e.g. reinsurance recoveries or other inbound payments) en route to the particular segregated account for which they may be earmarked. Hence, the section applies only to transfer of assets owned by the general account.

The converse situation is the transfer of assets from a segregated account to the general account. A transfer of assets from a segregated account to the general account is not permitted unless the account owners and counterparties who are creditors consent to the transfer and even then only if the account remains solvent. This latter condition is included for the benefit of those creditors who are not counterparties, since their consent is not required.

In either case, a prohibited transfer is voidable on application to the court by an affected party. The setting aside of such a transaction does not affect the rights of any third parties obtaining their interest in good faith for value and without notice of the illegal transaction.

6.4 The Account Owner's Interest

Unless otherwise agreed, an account owner of a segregated account and any counterparty who is a creditor in respect of a transaction linked to that account will have an undivided beneficial interest in the assets linked to that account. Following satisfaction of the claims of creditors, account owners will share in the profits and losses of the segregated account in such proportions of the residual undivided beneficial interest in the segregated account owned by that account owner as may be specified in any governing instrument relating to such account.

Irrespective of the nature of the property of the segregated account, the SAC Act provides that an account owner's (or counterparty's) beneficial interest in a segregated account is personal property. That said, but subject to the governing instrument or contract, as the case may be, the SAC Act provides that:

- an account owner or counterparty has no interest in specific segregated account property; and
- subject to the Exchange Control Act 1972, an account owner's or counterparty's beneficial interest is freely transferable.

6.5 Creditor Enforcement Rights over Account Assets

Special provisions are included in the SAC Act to reduce the likelihood that creditors in respect of a particular segregated account will be in a position to enforce their claims against assets not linked to that account. First, the SAC Act implies a provision into every contract by which the parties agree that the liability will not be paid out of assets other than assets of the account to which the transaction is linked and that any recoveries in breach of the provision are held in trust by the recipient.

The legislation also enables the company to make appropriate adjustments between accounts in case (a) a creditor, in breach of the SAC Act, enforces its claims against assets not linked to the account with whom the creditor has dealings and (b) the company is unable to recover the sum.

These provisions are particularly useful in cases where assets linked to a segregated account are located outside of Bermuda.

7. SECURITIES

7.1 Issue of Securities Linked to a Segregated Account

The SAC Act expressly provides that a segregated account may issue securities in the same way that an ordinary company may do. They may be issued in classes and the proceeds of issue would of course be included in the assets linked to the account which issues the securities.

The securities must be clearly linked in the records of the company to the account issuing the securities.

Where securities are not linked to any segregated account, the proceeds comprise an asset of the general account.

7.2 Dividends, Distributions and Redemptions

Due to the inherent nature of a segregated account, a SAC may pay a dividend or make a distribution in respect of securities of any class linked to a segregated account irrespective of whether a distribution is declared on any other class of securities linked to that account, any other account or the company itself.

However, the SAC Act contains a number of provisions intended to restrict the improper reduction of the capital of a segregated account, which are consistent with the rules which apply to the capital of an ordinary company. For example, the SAC Act prevents the distribution of dividends on "shares or other account holdings" if the segregated account is insolvent. It is noteworthy that the restriction does not apply to "securities", which would include bonds and other evidence of indebtedness. The restriction applies only to equity interests, as is the case under general company law.

It is also significant that distributions to account owners who are not shareholders are also subject to the restrictions under this section. The reason for this is that account owners are meant to be holders of residual interests rather than ranking with ordinary creditors. Accordingly, it would be inappropriate to enable one type of account owner to receive dividends without restriction, whereas another type of account owner would be subject to this restriction.

When making a distribution on any securities (whether to account owners or counterparties), only the assets of the issuing segregated account are available for distribution. It is worth reiterating that only the assets and liabilities of the segregated account are taken into account for purposes of determining whether the solvency test (if applicable) is passed by the account.

The Companies Act does not apply to a distribution by a segregated account under the SAC Act. This is because the SAC Act itself provides a complete code in relation to the payment of distributions by a SAC in respect of a segregated account.

A SAC may redeem or repurchase a security using the assets linked to the relevant segregated account provided that the relevant segregated account is solvent or any creditors with claims linked to that segregated account agree (in writing) to the redemption or repurchase. This section is said to apply notwithstanding the redemption and repurchase provisions in the Companies Act. The SAC Act therefore

provides an alternative regime, rather than additional requirements, for the redemption or repurchase of shares.

7.3 Reduction of Capital/Capital Transactions

The SAC Act contains provisions dealing with the reduction of share capital. These provisions address the question of reduction of capital of a segregated account and ensure that the share capital of a segregated account may be reduced but only on the same basis as a reduction of the share capital of a general account is possible. The provisions are of course intended to protect the interests of counterparties and creditors and are consistent with the rules that apply to an ordinary company.

Subject to the governing instrument in relation to a segregated account, a SAC in respect of that segregated account may, if authorised in a general meeting of the account owners of that account to which the shares are linked, reduce its capital in any way. However, a SAC is prevented from reducing the amount of its share capital of a segregated account unless:

- the SAC publishes an advert in an appointed newspaper (not more than 30 days and not less than 15 days before the date on which the reduction is to have effect) stating the present amount of share capital, the amount by which the share capital is to be reduced and the date the reduction is to be effected; and
- whether there are reasonable grounds for believing that the segregated account after such a reduction would be solvent.

The SAC must file a memorandum with the Registrar within 30 days of a reduction of capital along with a copy of the advert printed in an appointed newspaper (as stated above) and a statement to the effect that the SAC Act has been complied with.

The SAC Act also provides a mechanism for the cancellation of shares. Where the governing instrument pertaining to the affected segregated account is silent then section 12 provides that where only part of a class of shares is to be cancelled, the shares to be cancelled may be selected by the directors, or proportionally to the number of shares of the class registered in the name of each account holder, or in such other manner as the directors determine with the consent of the majority of the account owners of the class to be cancelled. Where shares are to be cancelled, the shares must be acquired at the lowest price at which, in the director's opinion, the shares are obtainable, which does not exceed any amount stated in the governing instrument.

8. RECEIVERSHIP AND WINDING UP

8.1 Receivership Orders

A receivership order may be made in respect of one or more segregated accounts. The test the court will apply in determining whether to grant such an order in relation to a segregated account will be satisfied if:

- a particular segregated account is not solvent, the general account is not solvent, a liquidation has been commenced in relation to the SAC, or if it appears just and equitable to appoint a receiver; and
- the making of the order would achieve: the orderly management, sale, rehabilitation, run-off or termination of the business of, or attributable to, the segregated account; or the distribution of the assets linked to the segregated account to those entitled thereto.

Accordingly, the case for the appointment of a receiver may be more compelling, for example, when the general account is insolvent and other proper bases are easily conceivable.

The purposes for appointing a receiver have also been broadened to extend beyond merely terminating the business of the account. As detailed above, a receiver is able to sell the business or portfolio of the account, manage it, or rehabilitate it.

8.2 Application Procedure

An application for a receivership order in respect of a segregated account may be made by the company itself, the directors, any creditor or account owner in respect of the relevant segregated account, or the Registrar. Notice of such an application must be served upon the SAC, the Registrar and such other persons (if any) as the court may direct, each of whom will have an opportunity to make representations to the court before any order is made.

The court, on hearing such an application for a receivership order (or for leave for a resolution for the winding up of the SAC) may make an interim order or adjourn the hearing conditionally or unconditionally. If an order is made then the court will not discharge the order until it appears to the court that the purpose for which the order was made has been achieved (or substantially achieved or is incapable of achievement).

8.3 The Receiver

Pursuant to the SAC Act, the receiver of a segregated account has all the powers of the directors and managers of the SAC in respect of the business and assets linked to that account for the purpose of achieving:

- the orderly management, sale, rehabilitation, run-off or termination of the business of, or attributable to, the segregated account; or
- the distribution of the assets linked to the segregated account to those entitled thereto.

Accordingly, and during the operation of a receivership order, the functions and powers of the directors and managers and any liquidator of the SAC cease in respect of the business and assets linked to the account in question. The receiver is therefore the agent of the SAC and the SAC Act provides that the receiver does not incur personal liability except to the extent that his conduct amounts to misfeasance. In addition, the SAC Act stipulates that no legal action may be commenced against the Registrar or Official Receiver or any person acting on their behalf for anything done or omitted in their official capacities in good faith without negligence. This protects these governmental officers from having to defend personal lawsuits, unless they have acted in bad faith or negligently. Further, the Registrar and Official Receiver need not participate in any legal actions outside of the jurisdiction, unless the person wishing the suit to be defended or prosecuted provides an adequate indemnity.

The remuneration of a receiver and any expenses are payable in priority to all other unsecured claims from the assets linked to the account in respect of which the receiver was appointed.

8.4 Stay of Proceedings

The SAC Act also enables the court to order the stay of any legal actions which are pending in respect of the affected segregated account. A stay of proceedings comes into force automatically when the general account goes into a compulsory liquidation and the court may order a stay in a creditor's voluntary winding-up. In those circumstances, the stay of proceedings is meant to give the insolvent company and its liquidator a "breathing space" during which the company and the liquidator may consider their options.

The receivership provisions in the SAC Act may come into operation when a segregated account becomes insolvent whereas the general account is not insolvent or in liquidation. A stay of proceedings might be just as appropriate in the event of the insolvency of a segregated account as it is in the event of the insolvency and liquidation of the general account.

As the court has a discretion to grant a stay of proceedings, the stay would not come into force automatically. This is in part because a receiver may well be appointed when the segregated account is not insolvent, in which case the stay may not be appropriate. In addition, even where the segregated account is insolvent, a stay of proceedings may not always be called for. For example, if the segregated account has only very few creditors or if there is, for some other reason, no risk of the segregated account becoming subject to protracted litigation, a stay may not be needed.

8.5 Winding up

Subject to the special provisions of the SAC Act, a SAC is wound up, as far as possible, just like an ordinary company. For the purposes of determining whether a SAC may be wound up on the ground of insolvency, the tests of insolvency which apply are the same tests which apply to ordinary companies for purposes of winding-up.

Assets and liabilities linked to segregated accounts are not taken into account for the purposes of determining whether a SAC is solvent. This is so that it is clear that one looks only to assets and liabilities associated with the general account to determine whether a SAC is solvent. It would be misleading to include for this purpose assets linked to segregated accounts, since those assets are not available to pay creditors of the general account. Equally, it would be inappropriate to include liabilities of the segregated accounts since those are not to be paid out of the general assets of the company. In this regard, a SAC is like a company which is a trustee of assets. Beneficial entitlement of (and responsibility for) the assets and liabilities connected with the trust do not fall into the estate of the trustee company for liquidation purposes. For this reason, the SAC Act limits the application of Part XIII of the Companies Act with respect to the circumstances in which a company may be wound up by the court.

The shareholders of a SAC cannot pass a resolution to wind up voluntarily without the consent of the Registrar. This is to ensure that such a dramatic step will not take place in relation to a SAC unless the Registrar is aware.

A liquidator must respect the segregation of assets and liabilities under the SAC Act.

The SAC Act also affirms that a liquidator's remuneration may be allocated between segregated accounts and the general account in such proportions as may be approved by the court. This is to reflect the possibility that the activities of a liquidator may in part accrue to the benefit of a segregated account. He may, for example, carry out functions which accrue to the benefit of all segregated accounts, just as the company outside liquidation may perform functions for the benefit of segregated accounts (and may charge a fee for this). As well, a liquidator may perform functions which are specifically for the benefit of a segregated account (such as administering its assets, operating its business, or consulting with the account owners and counterparties regarding the liquidation, rehabilitation or transfer of the business of the account). This is particularly likely to happen if no receiver is appointed in relation to that account.

9. REMOVAL FROM THE REGISTER

A SAC may be removed from the register of SACs maintained by the Registrar, with the effect that the SAC Act would no longer apply to the company. This may be done either at the instance of the company itself or at the instance of the Registrar (either on his own initiative or on the request of an account owner or

counterparty). Given the dramatic effect of removing a company from the register of companies under the SAC Act, and given the mandatory requirements which apply to the application, it is unlikely that this power will be exercised except in extraordinary cases.

The application may be made by the company and must be supported by 75% of account owners and counterparties who are creditors and a statutory declaration from the directors stating that no creditors will be prejudiced or that the known creditors have consented. The declaration must also include a statement of assets and liabilities and describe any material transactions since the date of the statement. The declaration must also enumerate the segregated accounts of the company and indicate the assets and liabilities linked to each. The Registrar may require additional information and documentation.

All account owners and creditors must be notified of the request for removal and may, within 21 days of receipt of such notice, apply to the Registrar to object to it (or to reinstate the company if he has already removed it from the register). The decision of the Registrar may be appealed to the court.

The Registrar's power to remove a company from the Register may be exercised only where the company is in breach of the SAC Act or of a condition imposed by the Registrar. If the company is removed on this basis, accrued rights and obligations in relation to segregated accounts are not affected. Where the Registrar intends to remove a SAC from the Register as such, he must give the SAC notice of that intention and he must take into account any representations made by the SAC before effecting the removal of the SAC from the Register.

The Registrar has produced a procedural table in relation to these procedures.

10. MUTUAL FUND PROVISIONS

A number of specific provisions in the SAC Act facilitate the use of the legislation for mutual funds. These provisions are outlined below.

10.1 Distributions and Redemptions

Special consideration arises in relation to the repurchase or redemption of shares of a mutual fund and to the payment of dividends or other distributions. Under the Companies Act, the restrictions pertaining to this do not apply to mutual funds and special provisions are included for mutual funds. The SAC Act also affords corresponding treatment to SACs which operate mutual funds.

For example, a SAC which is a mutual fund (hereinafter referred to as a **mutual fund SAC**) may redeem or repurchase for cancellation shares using assets linked to the relevant segregated account provided that, on the date of redemption or repurchase, there are reasonable grounds for believing that the relevant segregated account is solvent. The mutual fund SAC may effect the redemption or repurchase out of the assets of the company linked to the relevant segregated account, on such terms and in such manner and at such price as may be determined having regard to the asset value of such shares as ascertained in accordance with the governing instrument. In addition, and on the same basis, on the redemption or repurchase of such shares linked to an account, the mutual fund SAC may repay the capital on such shares out of paid in capital, for example, or pay the premium, if any, out of realised or unrealised profits, additional paid in capital or other reserves of the company linked to the relevant segregated account.

10.2 Application of Assets and Liabilities

Assets and liabilities may be allocated between several different accounts, where the parties provide for this clearly. Very strict and explicit requirements must be satisfied if a mutual fund SAC wishes to allocate assets or liabilities between several accounts, including the general account.

10.3 **Disclosure**

As mentioned above, a register of account owners must be maintained by a SAC, in the same way that an ordinary company must maintain a register of shareholders. However, the register of account owners of a mutual fund SAC is not available to inspection by anyone, though an account owner is entitled to receive a copy of the information in the register pertaining to his interests in the company. This is consistent with the general law in relation to mutual fund companies.

Similarly, the provision of the SAC Act which allows any account owner of a segregated account to inspect the records maintained with respect to that segregated account, does not apply to mutual funds. Ordinarily, a member of a mutual fund which is not a SAC would not be able to demand access to transaction records or even details of the assets and liabilities of the company. The member would have access only to information disclosed in the audited financial statements and such additional information which the company agreed in the prospectus to provide the investors (including details of the net asset value of the shares as at each valuation date). The exception to mutual funds, then, brings the provision into line with the general law.

10.4 **Segregated Account as Account Owner**

The SAC Act can be used by umbrella funds (funds offering several discrete investment portfolios each with its own unique investment objective). It is quite common in these structures to also offer a diversified portfolio which will invest in all the other portfolios. Accordingly, one segregated account can be an account owner of another segregated account.

11. **BERMUDA SAC CASE LAW**

The Bermuda courts have considered the SAC structure and upheld the statutory segregation of accounts established by the SAC Act has been upheld. The following points have been confirmed by Bermuda courts:

- When dealing with segregated account companies that it is imperative, in order to preserve the fundamental segregation concept, that the governing instrument is clear and complete, that the bye-laws are carefully drafted (particularly if it is intended to empower the directors to act without owner consent) and that Bermuda legal advice is sought both at the creation of the segregated account company and in the event of a complex and substantial restructuring.
- Segregated account companies under Bermuda law are typically designed to ensure that third party creditors cannot attack the assets in the segregated account which are intended to be available exclusively to meet the claims of creditors who have entered into transactions linked to that specific account. The Bermuda court further confirmed that only the general assets are available to meet general claims.
- The winding-up regime applicable to Bermuda companies in general is also applied to segregated account companies. The Bermuda court further confirmed that the statutory provisions provided under the SAC Act will also apply providing that each segregated account must be wound up on an individual basis.
- A liquidator must deal with the assets and liabilities of each segregated account in accordance with the SAC Act and in the absence of contractual terms to the contrary, not apply the assets of one segregated account to the liabilities of another segregated account or the general account. The Bermuda court held that it was clear on the evidence presented before the court that there was nothing to support piercing the "iron curtain" which applies to the segregation of accounts.

It should be noted that despite the efforts the Bermuda courts have gone to in order to protect the segregation of assets and liabilities of a SAC, there is a risk that the SAC Act will not be upheld or recognised in jurisdiction where the SAC may operate or have assets, particularly if that jurisdiction does not have corresponding segregated accounts legislation.

12. GENERAL

12.1 Supervisory Direction

The Minister may direct that certain provisions of the SAC Act will not have effect in relation to a particular SAC (or shall have effect but subject to modifications). The provisions of the SAC Act in relation to which a direction may be made are:

- requirements in relation to application to become registered under the SAC Act;
- removal from register;
- requirements in relation to governing instruments and contracts; and
- accounts, records and registers.

The Minister will only make a direction for those special cases where the standard provisions of the SAC Act may be departed from for special commercial reasons, without adversely affecting the interests of parties.

In support of a direction, the company must submit a statutory declaration made by at least two directors affirming that no creditor will be affected or that the creditors have consented.

12.2 Investment Business Act 2003 Considerations

The application to segregated accounts companies of the Investment Business Act 2003 (**IBA**) which establishes a licencing regime for persons who carry on investment business, will depend on whether services constituting investment business (as defined in the IBA) are being provided to a third party.

For example, financing structures which utilise the SAC as a vehicle for alternative risk transfer arrangements must ensure that such a vehicle is exempt under the IBA.

Contracts or arrangements which are entered into by the SAC or the segregated account for their own account or benefit would be excluded activities and therefore outside the scope of the IBA.

12.3 Arbitration

Disputes between the interests of segregated accounts may be resolved by reference to court or to arbitration. The parties may choose whether to refer a dispute to arbitration or to court. However, in the event of a disagreement between the parties as to whether to refer a matter to court or to arbitration, the default position is that the matter will be referred to arbitration. This is provided for simply to avoid protracted disputes over the question of forum. The arbitration process is selected as the default forum on the basis that for nearly all purposes either forum would likely be as appropriate as the other. From a public policy perspective, the arbitration process has the advantage that it does not represent a burden on government resources.

12.4 Insurance Regulatory Issues

Issues arise regarding how to regulate a SAC which is an insurer under the Insurance Act. These include:

- whether a SAC should report its financial position on a consolidated basis or on a per-account basis;

- whether a SAC which has satisfied its solvency and other financial requirements in one account can be said to have satisfied those requirements for all accounts; and
- in the case of a company which carries on long-term business, how to hold and use a long-term business fund.

A detailed discussion of those issues is inappropriate in this Guide. Suffice it to say that there are ways to reconcile the requirements of insurance regulations with the requirements of the SAC Act, thus ensuring that a SAC which is an insurer complies with regulations applying to it as an insurer.

The relevant documentation may provide that claims of creditors of a segregated account extend also to the general account (sometimes described as an "open" account) or the documents may provide that the claims of such creditors do not extend to the general account (sometimes described as a "closed" account). For more advice on this topic, please refer to the contact details below.

13. CONCLUSION

The SAC Act creates an inexpensive and less unwieldy system to the traditional route of forming numerous subsidiaries. The SAC Act establishes substantive law governing the application of particular assets in favour of particular portfolios and their respective liabilities. The substantive provisions significantly enhance the prospects for enforceability of transactions in jurisdictions where the assets of a particular segregated account might be situated, and furthermore, the extent to which procedural as well as substantive law provisions may bind third parties.

For more specific advice on segregated accounts companies in Bermuda, we invite you to contact the following:

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For the convenience of clients in other time zones, a list of contacts available in each of our jurisdictions may be found here.