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THE 60/40 RULE IN RESPECT OF LOCAL COMPANIES

Local Companies: Required To Be Controlled By Bermudians

The (Bermuda) Companies Act 1981 (the “Companies Act”) provides, inter alia, that no local company shall carry on business of any sort in Bermuda unless:

- a. it is a company which, at the relevant time, complies with Part 1 of the Third Schedule or is a wholly-owned subsidiary of such a company; or
- b. it is a company mentioned in Part II of the Third Schedule; or
- c. it is licensed under Section 114B and, at the relevant time is carrying on such business in accordance with the terms and conditions imposed in such licence, and not otherwise.

Part 1 of the Third Schedule to the Companies Act 1981 (the “Third Schedule”) further provides that:

1. (1) The Company shall be controlled by Bermudians.
(2) Without prejudice to the generality of sub-paragraph (1), at least sixty per centum of the total voting rights in the company shall be exercisable by Bermudians.
2. (1) The percentage of Bermudian directors and the percentage of shares beneficially owned by Bermudians, in the company shall

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**Reasons For Incorporating
In Bermuda**

- Respected International Business jurisdiction (built on the principle of “know your customer”);
- Tax Neutral Business

not be less than sixty per centum in each case.

Provided that the Company shall not be deemed to be in breach of this paragraph in so far as, and so long as, it is acting in accordance with sub-paragraph (2).

(2) The company shall act in accordance with this subparagraph if the percentage of shares beneficially owned by Bermudians in it falls below sixty per centum by virtue of factors which are beyond its control and it gives notice in writing to the person who is not Bermudian and whose ownership of shares results in the percentage so falling, as soon as the directors become aware of that fact.

The rule embodied in the Third Schedule is commonly referred to as “the 60/40 rule”. The rule, so expressed, is somewhat misleading because the Companies Act does not refer to any prescribed percentage; it simply mandates control by Bermudians. The origin of the 60/40 rule may be traced back to the (Bermuda) Companies Act 1923 which required that British Subjects hold at least 3/5 of the shares in a local company.

The (Bermuda) Companies Act 1969 introduced provisions similar to those found in the Third Schedule to the Companies Act. More significantly it introduced the general concept of Bermudian control in addition to the specific requirements pertaining to voting rights, directors and beneficial ownership.

The key provision in the Third Schedule is the general requirement that a local company, in order to carry on business in Bermuda, “shall be controlled by Bermudians”. What follows the general requirement is a group of particular requirements dealing with aspects of control and the minimum percentages of Bermudian participation by way of beneficial ownership (60%). These relate to shareholder control through the exercise of voting rights; director control through a majority on the Board; and ownership control through equity participation. Both the general and the specific requirements are couched in imperative terms. The fulfilment of those requirements is therefore obligatory and cannot be avoided if there is to be compliance with the Companies Act. While the particulars enumerated above may not cover all aspects of control, the general provision in paragraph 1(1) which is unrestricted by definition is sufficiently broad to include all relevant aspects of control.

Environment (no income, capital gains, transfer or withholding taxes);

◦ Business sensitive and well established Legal System (based upon English common law);

◦ Minimal Government Annual Reporting except for Restricted Businesses;

◦ Access to Capital Markets (through Bermuda Stock Exchange listings);

◦ Access to one of the most successful Insurance/Reinsurance Markets in the world;

◦ Reliable Banking System;

◦ Efficient Support Services (legal, accounting, management, corporate and trust services);

◦ State-of-the-Art Global Internet Services and Telecommunications (connecting Bermuda to the world); and

◦ Friendly yet efficient business environment for holding Company Meetings.

Control by Bermudians

In addition to the Third Schedule requirements some other regulatory aspects of Bermuda company law will also be helpful in understanding the Schedule's intent and purpose. Examples of other regulatory aspects of Bermuda company law may be found in the licensing provisions for local companies that do not meet Third Schedule requirements ; in the special provisions applicable to hotel companies ; in the safeguards for the avoidance of "fronting" arrangements connected with equity participation ; and in the supervisory authority vested in the Minister to scrutinize and ascertain whether local companies are in fact Bermudian controlled .

The (British) Privy Council, Bermuda's highest court, has ruled that "controlled by Bermudians" is to be given its ordinary meaning, unencumbered by any technical restrictions which are often imposed by canons of statutory interpretation. 'The purpose of the requirement is plainly to ensure that Bermudian resources remain Bermudian. And [the Third Schedule] must have been intended to make an effective provision to this end. Giving the words in paragraph 1(1) their ordinary meaning achieves this legislative purpose.'

In illustrating what is meant by the concept of the "ordinary meaning", the Privy Council rejected the restrictive meaning suggested in a number of previous decisions in different contexts and pointed out that 'Indeed a study of the reasoning in those [previous] decisions shows that expressions such as "control" and "controlling interest" take their colour from the context in which they appear. There is no general rule as to what the word "controlled" means. Contrary to the submissions of counsel for the appellants, the expression "controlled by Bermudians" in paragraph 1(1) is not a term of art. The expression must be given the meaning which the context requires.'

By way of illustration, the concept of control has been put thus : '... I think that the analogy is to be found in control, an idea which, if not very familiar in law, is of capital importance and is very well understood in commerce and finance. The acts of a company's organs, its directors, managers, secretary, and so forth, functioning within the scope of their authority, are the company's acts and may invest it definitively with enemy character. It seems to me that similarly the character of those who can make and

unmake those officers, dictate their conduct mediately or immediately, prescribe their duties and call them to account, may also be material in a question of the enemy character of the company. If not definite and conclusive, it must at least be prima facie relevant, as raising a presumption that those who are purporting to act in the name of the company are, in fact, under the control of those whom it is their interest to satisfy.'

Control and Election of Directors

In the case of local companies in Bermuda, the provision contained in the Companies Act for the election of directors must be read with Part I of the Third Schedule, unless, of course, the local company is a licensed company or falls within a permitted exception. If a local company does not fall within any such exception, it is a company that is required to comply with Part I of the Third Schedule.

The Companies Act also deals with the election of the first Board of Directors and with the election of the Board of Directors annually thereafter . The statutory requirement is that such elections must take place at annual general meetings of the members (shareholders) of the company . The reference to members here is an obvious reference to all members who have the right to vote for the election of Directors.

The significance lies in the fact that these provisions of the Companies Act contemplate a combined meeting of the entire qualified membership, not one meeting divided into separate meetings of separated groups or classes with exclusionary rights. Put another way, the Companies Act contemplates that each and every member who has a vote for the purpose shall participate in the election of each and every director to the Board; not that only some members shall vote for and elect some of the directors and be excluded from voting for other directors.

Voting rights for the election of directors is therefore intended to be exercised in a total voting context and not in several distinct units. The ability to exercise voting rights in an all-inclusive context is that which is required for compliance with the Companies Act.

Any local company's bye-laws that are not in compliance with the above-mentioned principles are ultra vires the Companies Act, 1981 .

In order to determine if there is compliance with paragraphs 1(1) and 1(2) of the Third Schedule, three questions need to be answered: first, do the Bermudians have sufficient shares with a voting majority (minimum 60%); secondly, whether their voting rights are exercisable in the context of total voting on a material issue such as election of directors; and, thirdly, if so exercised, would the result help to establish that the Bermudians have control of the company as required ?

The foregoing discussion has stressed the importance of the shareholders' ability to elect a majority of the Board of Directors as a requisite ingredient for asserting control over the company. Total voting rights in the context of the Third Schedule does not mean the divisible exercise of total voting rights. It must necessarily mean voting rights of all the shareholders which are exercised together. It is only then that the Bermudians could have had the opportunity of using their majority vote (at least 60% as contemplated by the Companies Act) to attain the result intended by law, which is control over the company, and control would have been possible only if the Bermudian shareholders were able to elect a majority of the Board of Directors.

Who can own a 60/40 Local Company?

Given the fact that a local company must be controlled by Bermudians, the question is who is a Bermudian? Section 113(1) of the Companies Act, 1981 specifically sets out who "shall be deemed to be Bermudian", which includes:

- (a) The Government or any corporation of which the majority of the directors, managers or trustees are subject to the appointment by the Governor or a Minister;
- (b) Any person who has Bermudian status by virtue of the law relating to immigration from time to time in force;
- (c) A local company in which the percentage of shares beneficially owned by Bermudians is not less than 80% of the total issued share capital of that company ...

When a holding company owns sixty per cent of a subsidiary, which in turn is a 60/40 local company, then the holding company must meet the requirements of Section 113(1)(c) which requires the holding company to have at least 80% of the issued share capital held by Bermudians if the provisions of the Companies Act

is to be complied with.

BERMUDA BASED SELF-INSURANCE ALTERNATIVES

There are several self-insurance alternatives available in Bermuda for those seeking to minimize the cost of insurance or reinsurance while providing added advantages of building up reserves in a tax neutral environment with commercially sensitive regulations.

Bermuda has seen the development and proliferation of five (5) types of captives, all of which serve a different clientele and purpose.

Single Parent Captive

Often described as pure captives, these are the companies with a single owner, usually the Parent Company. The Single Parent Captive writes the risks of its Parent Company and its affiliates. Generally, these Captives are managed by professional managers who provide management and underwriting capability from a Bermuda base.

Association Captive

Association Captives are insurance companies formed or supported by the pre-existing trade or professional associations to provide insurance coverage for the association members. Ownership of such Association Captives could be structured in several different ways – either with the association holding all of the shares in the Captive or each member that is also an insured, holding shares in the Captive or a combination of both.

They too usually have a financial expert at the association level with prime responsibility for the business of the Captive. However, not all associations have actual insurance specialists on their payroll. When they do not, much more responsibility is given to the Bermuda management company, broker and other consultants. There is usually some form of surplus allocation method agreed upon by members.

Agency Captive

The Agency Captive was very popular in the insurance days of the mid 1980's. Brokers or intermediaries formed these captives either singly or along with their clients. The Agency Captive continues to give advantages to insureds that have difficulty in obtaining adequate coverage in the open market. It is also a strong marketing tool to Reinsurers as it demonstrates that the Broker/Agent is prepared to join them on the risk insured by the Agency Captive.

Industry Captive

Industry Captives are insurance companies that are owned by the companies within the same industry, which have come together solely to solve an insurance coverage problem. The stockholders appoint a Board of Directors to whom the Bermuda management company reports. This type of Captive usually places a substantial responsibility on the management company, which makes the important decisions. Industry Captives are usually work-intensive due to the need for detailed and regular reporting to stockholders. There is usually some form of surplus allocation method agreed upon by members. When Captive's boards of directors invoke this, it can be the single most time-consuming duty performed by the management company.

Rent-a-Captive

Certain companies 'rent' their surplus to entities wishing to establish a self-insurance program but do not wish to own a captive at the outset. However, a number of policy-holders of 'rent-a-captives' do eventually form their own captives, because of all of the clear advantages mentioned above.

Not all Bermuda management companies have in-house 'rent-a-captive' facilities. Those that do have rent-a-captive facilities can provide insureds with the advantages of accepting their risks through segregated cells so that the losses and gains are segregated on the basis of each cell.

Some rent-a-captive programs provide fronting coverage for captives; therefore will participate on the first level of risk and reinsure risk in excess of certain limits. Under this type of arrangement the fronting carrier could provide all of the claims processing services, the regulatory filing, product design for the

program and the participant would only agree to share the risk. The provider would not be responsible for the day-to-day processing and/or management of the rent-a-captive.

There are many different types of arrangements under a rent-a-captive situation, ranging from strictly renting the insurance license to some level of participation by the fronting carrier in the plan. Under either scenario the fronting carrier usually charges 5% of the premium for use of its license and then charges additional fees for whatever services it has agreed to provide.

Setting up a rent-a-captive program for a group of participants provides a cohesive base of opportunity for a sponsoring organization to sell additional goods and services to its target population under the same umbrella as the captive. Alternatively, a group of participants could band together to form a rent-a-captive program and typically save anywhere from 15-25% on their insurance. Although this is, in and of itself, a significant saving, it provides the opportunity to now sell the same group of providers other programs, general liability programs, health insurance programs and other types of programs that collectively could save these organizations a significant amount of money and provide capital for a sponsor organization. Profits of the captive can be used to sponsor risk management programs, continuing education programs and other types of programs, which could only enhance a participant's value.

The following represent some of the advantages associated with the operation of a rent-a-captive facility from Bermuda:

- Typically requires less capital to form and operate than a captive.
- Provides the flexibility of pricing and dividend programs based on your insured membership.
- Does not require the development of infrastructure for claims processing, billing and/or enrolment.
- Can usually be set up within a matter of weeks.
- Least expensive of the self-insured type programs.

not be used as a substitute for legal advice in specific fact situations. If you require more detailed information or advice concerning a specific fact or situation, you are invited to contact one of the above named for that purpose. Lynda Milligan-Whyte & Associates cannot accept any liability or responsibility for loss occurring as a result of anyone acting or refraining from acting in reliance on any material contained in this newsletter.