LEGAL UPDATE

Privy Council decision on 60:40 rule and its potential impact on the interpretation of "Caymanian controlled" under the Cayman Islands' Local Companies Control Law

In Brief

The Privy Council judgment in Bermuda Bar Council v Walkers (Bermuda) Ltd delivered on 10 June 2019 recently clarified the longstanding "60:40 rule" in respect of local companies in Bermuda, which could also have a wider economic impact on local companies in the Cayman Islands and their ability to access foreign capital. The principal question in the Privy Council appeal was the nature of foreign control over a local company, Walkers (Bermuda) Ltd ("**WBL**"), which would prevent it from being "controlled by Bermudians" and would therefore require it to be licensed by the Minister of Finance in Bermuda.

The local company 60:40 rule is enshrined in Part I of the Third Schedule of The Companies Act 1981 in Bermuda ("**Companies Act**"), which provides that a local company must be (i) controlled by Bermudians (ii) at least 60% of the total voting rights to be exercisable by Bermudians and (iii) the board of directors to comprise at least 60% Bermudians. This mirrors the local company requirements in the Cayman Islands set out in section 5(1) of the Local Companies (Control) Law (2019 Revision), which requires a local company or an exempted company that is carrying on business in the Cayman Islands to be (i) Caymanian controlled (ii) at least 60% of its shares are beneficially owned by Caymanians and (iii) at least 60% of its directors are Caymanians. The principal purpose of the 60:40 rule in both Bermuda and the Cayman Islands is to aim to ensure local control over local companies and the economy.

What happened in the Bermuda Bar Council v Walkers (Bermuda) Ltd case?

i. In May 2015, Walkers Global, a partnership established in the Cayman Islands determined to set up a local presence in Bermuda and in October 2015 incorporated WBL as a local company in Bermuda under the Companies Act.

ii. All of the issued share capital of WBL is held by Bermudian barristers with valid practicing certificates, with no legal control over or beneficial interest in the shares being exercised by Walkers Global. Kevin Taylor is the sole director.

iii. Two draft agreements were prepared between Walkers Global and WBL, being (i) a licensing and services agreement to allow professional services to be provided in Bermuda under the "Walkers" brand, including access to human resources, marketing and IT support and (ii) a loan agreement for a loan of up to US$5 million to be lent by Walkers Global. If executed, these two agreements would govern the relationship between Walkers Global and WBL.

iv. Kevin Taylor applied to the Bar Council in Bermuda for a certificate of recognition of WBL as a professional company under section 16C of the Bermuda Bar Act 1974. The application was re-

fused on the grounds that the terms on which WBL proposed to operate in Bermuda with respect to Walkers Global, would contravene section 114 of the Companies Act, that requires a local company cannot carry on business in Bermuda unless it complies with Part I of the Third Schedule (as set out above).

v. WBL's appeal against the Bar Council's decision was granted by the Chief Justice, on the basis that the proposed arrangements regulating the operation of WBL as a professional company were not contrary to section 114 of the Companies Act or contrary to public policy.

vi. On appeal to the Court of Appeal of Bermuda, the Court of Appeal disagreed with the decision of the Chief Justice and interpreted the local company provisions of The Companies Act as extending beyond control over the voting power of shareholders, to include the substance and reality of commercial control.

vii. Adopting a practical interpretation of the concept of "control" over a company, the Privy Council held that non-Bermudians may exercise de facto control over a local company by way of commercial arrangements without having to first obtain a licence from the Minister of Finance, provided that the directors and shareholders of such company are free to vote of their own volition. The decision determined that "control" of a company to be exercised over a local company is at board and shareholder level and that influence over a local company's operations does not constitute "control". In restoring the decision of the Chief Justice, the key arguments of the Board of the Privy Council were:

- Lord Hodge stated that "if it were sufficient to establish non-Bermudian control by commercial control alone, a local company might face intolerable uncertainty as to whether it was carrying on business legally or was committing an offence." In support of this determination, he provided an example of a primary producer entering into an exclusive supply agreement with an overseas buyer which made it dependent on the commercial decisions of the buyer – in this case, the buyer would have considerable influence over the supplier's commercial decisions and would have the potential to control the quality and quantity of the supplier's products. In a similar context, if a local company had borrowed a large sum of money from an overseas lender and came into financial difficulty such that it was required to act in the interests of the overseas lender, this would cause uncertainty as to what would constitute "control" and breach of The Companies Act.

- The Board of the Privy Council interpreted Part I of the Third Schedule as preventing agreements or arrangements which confer voting control or constrain the effectiveness of majority votes in director or shareholder meetings.

- Lord Hodge further stated that there is no requirement in the Companies Act (either express or by implication) that a local company must pay or attribute a minimum percentage of its profits to Bermudians in order for it to be controlled by Bermudians.

- Lady Arden determined that "controlled by Bermudians" is that of "board and of the company in the general meeting. Mere influence of any kind on a company's operations does not constitute control in this sense."

What does this mean for the Cayman Islands?

As the Privy Council is the highest court of appeal for the Commonwealth countries and its decisions are binding on all countries in the Commonwealth, the ruling in this case will be binding in the Cayman Islands. Furthermore, the similarity between the 60:40 rule in Bermuda and requirements under Section 3(2) and Section 5 of the Local Companies (Control) Law (2019 Revision) of the Cayman Islands means that the reasoning put forward in the Privy Council decision is equally applicable in determining whether a local company incorporated in the Cayman Islands is "Caymanian controlled". On a practical level, this ruling means that an element of commercial influence may be exercised by non-Caymanians in respect of the day-to-day operations of a local company in the Cayman Islands, provided that the key constitutional documents and any shareholders' agreement do not constrain the voting rights of the board and/or shareholders.

For specific advice on this matter, please contact your usual Loeb Smith attorney or:

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