Hamel-Smith FORUM
ATTORNEYS-AT-LAW, TRADEMARK & PATENT AGENTS

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ARE YOU LURKING IN THE SHADOWS?

Balancing a Lender's Exposure to a Distressed Borrower Against the Risk of Being Deemed a Shadow Director

Sen. Timothy Hamel-Smith & Keomi Lourenço

The current global and local economic climate increases the risk that companies will reach the brink or very close to the brink of collapse. Such companies will likely approach their lenders to negotiate a solution. When a lender gives instructions or directions to a company in financial distress over whose assets he might hold a charge, he could expose himself to potential liability as a "Shadow Director" of the company. The recent Australian case of *Buzzle Operations Pty (in Liquidation) v Apple Computer Australia Pty Ltd [2010] NSWSC 233* has shed some light on the principles of 'shadow' directorship, and provides clear guidelines for both lenders and the directors of the companies with whom they deal.

While our current local legislation does not specifically provide for informal work outs and corporate rescue of a distressed company, nothing precludes a lender from negotiating informal work outs rather than winding up such a company. In negotiating workouts, lenders may influence the decisions that distressed companies make. A lender might even provide options to the company which its directors may feel compelled to accept, since the alternative might likely be receivership and/or winding up. This potential 'influence' by a lender increases the risk of it being deemed a 'shadow' director of the distressed company.

The office of director or 'shadow' director not only carries the statutory duties of care to act in good faith in the best interests of the company, and with reasonable care and diligence, but also all statutory liabilities for which a director would be held responsible. In particular, it carries the threat of legal liability for a company's insolvent trading debts in the event that the company is eventually wound up.

While the term 'shadow director' does not appear in the Companies Act, 'director' is defined as "a person occupying the position of a director by whatever title he is called". The issue as to whether any person is a director will turn on the degree of control such person might exert over the decision making processes of the company.

In the Buzzle case, Buzzle was the distressed company over which Apple had a floating charge. In order to protect its own interests, Apple, was to a certain extent involved in Buzzle's decision making processes. The issue arose as to whether Apple was a 'shadow' director or officer of Buzzle. It was held that Apple did not participate in the decision making process to the extent required to make it an officer or 'shadow' director of Buzzle.

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SENATORIAL APPOINTMENT

The firm extends warmest congratulations to our Timothy Hamel-Smith on his appointment as President of the Senate of Trinidad and Tobago earlier this month. We are confident that he will bring to the new position his impartiality and his extraordinary insight.

ARE YOU LURKING IN THE SHADOWS? *(cont'd)*

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Mitigating the Risk of Becoming a Shadow Director

The law of 'shadow' directors means that a person who effectively controls a board of a company, even though that person is not a director, may be legally classified as a director. A 'shadow' director may thus be defined as a person in accordance with whose instructions or wishes the directors are accustomed to act.

The judgement in the Buzzle case sets the following guidelines for establishing whether a lender is a 'shadow' director:

- *The director's choice*: A lender who applies commercial pressure or imposes conditions for its ongoing financial support will not necessarily be deemed to be a 'shadow' director, **if**, the directors remain free to decide whether or not to comply (even if they may feel like they have 'no choice'). Unless something more intrudes, the directors are free, and are expected to, exercise their own judgement as to whether it is in the company's best interest to accept or reject the lender's conditions. If the directors accept the lender's demands this does not necessarily mean that the lender participates in the company decision making.

- C*ause and effect*: There must be a causal connection between the lender's instructions and wishes and the directors' decisions or actions. A person is not a 'shadow' director merely because he and the directors have the same ideas. Thus where the directors were going to act in a certain manner in any event for their own reasons and that manner reflects the instructions of the lender, this is not sufficient to establish that the lender was a 'shadow' director.

- *Habitual Compliance of Majority of Directors*: There must be habitual compliance with the lender's wishes and instructions over a period of time. The directors must collectively *be accustomed to act* on the lender's instructions. For this condition to be established it is sufficient if the majority, as opposed to all the directors, have habitually acted in accordance with the lender's instructions.

- C*ontrol over an aspect of the business of the company*: A lender can be deemed a 'shadow director' even if its control only applies to certain aspects of the business of the company. There is no inconsistency with a person being a 'shadow' director and on the other hand the board exercising some discretion or judgement in areas in respect of which the 'shadow' director does not give instructions or express a wish.

Mitigation

It is interesting to note that in the Buzzle case Apple sent a carefully crafted letter to the Buzzle CEO stating that it disavowed any involvement in any corporate decision making, either at a managerial or directorship level and further stated that if it is invited to attend any meetings at which corporate decisions are made, it will only do so as an observer or advisor.

Although the judge acknowledged that the letter would not have helped Apple if it had otherwise proven to act as a 'shadow' director, he also stated that the letter was a very clear statement of Apple's intentions and position that it was not purporting to give any directions to the directors with which they were expected to comply.

Where lenders opt to negotiate options and conditions with a distressed company to whom it has been providing financial support, in the context of an informal work out arrangement, a clear written statement (which is not later contradicted by the lender's conduct) will assist in minimising the risk of being deemed to be a 'shadow' director.

Food for thought

Although not directly related to the factual scenario which gives rise to the question of a lender being deemed a 'shadow' director, the concept may be extended to a lender extending project financing. It has become more regular and commonplace for a lender as a part of the security package, to request direct step in agreements with third party service providers to the Borrower.

Direct agreements are made among the lender, the borrower and the borrower's contractor/s (or service providers) wherein the borrower and the contractor /service provider agrees to allow the lender to "step into" the shoes of the borrower at the point where the contractor/service provider might have a right to terminate the service contract between itself and the borrower.

Usually the lender is granted the right to "step in" and "step out". During the "step in" period the lender enjoys all the rights of the borrower under the relevant service contracts and is jointly and severally liable with the borrower for the performance by the borrower of the obligations of the relevant service contract/s. Further, during this period the borrower is not authorised to deal with the contractor/ service provider or to exercise any of the powers or discretions available to the borrower under the relevant service contract.

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INSIDER TRADING

Jonathan Walker & Catherine Ramnarine

The phrase 'Insider Trading' conjures up images of shady deals by greedy corporate bigwigs, clandestine meetings, secret telephone calls and cash being surreptitiously spirited away to secret bank accounts. But is the reality the thrilling manuscript of a John Grisham novel?

What exactly is Insider Trading?
Insider Trading occurs when certain individuals (Insiders) use price sensitive information that is not available to the general public to buy or sell shares or other securities in order to make a profit or avoid a loss.

Who is an 'Insider'?
In Trinidad and Tobago, Insider Trading is prohibited under both the Companies Act and the Securities Industries Act ('SIA'). The definition under each Act is slightly different; however, both Acts target individuals (such as directors, officers and certain employees) who by virtue of their relationship or connection with a company are likely to have access to confidential, price sensitive information.

The director of an energy company learns that it has discovered a huge oil deposit. He knows that the company's share price is likely to increase once this information goes public, so he buys several shares at the existing (lower) price, thereby enabling him to make a profit when the share price increases. This is the classic example of Insider Trading.

This does not mean that a company 'Insider' is automatically guilty of Insider Trading every time he buys or sells its shares. The prohibition against Insider Trading is intended to prevent an Insider from taking advantage of confidential company information in order to gain an unfair advantage over other investors in the market.

What is 'Inside Information'?
Inside information is specific, confidential information that would materially affect the price of a company's shares if it were generally known. Once information goes public, it is no longer considered 'Inside Information'. Once the investing public has access to the information, the Insider has no unfair advantage and there is a level playing field.

What is prohibited?
The basic form of Insider Trading involves an Insider of Company A using confidential, price sensitive information about Company A to trade in its shares - much like the director of the energy company in the example used above.

Being an Insider of one company may provide access to inside information about *other* companies, for example, Company A's Insider may learn that it intends to award a significant contract to Company B. Under the SIA, insiders of one company are barred from trading in the shares of another if they have Inside Information relating to any transaction involving both companies, including a takeover bid.

The SIA prohibits an Insider from 'tipping' or procuring someone else to buy or sell shares based on Inside Information and also targets the recipients of such information.

Suppose, for example, that you find yourself sitting at a lunch table behind some researchers working for a pharmaceutical company and overhear them discussing the fact that it has discovered a cure for the common cold. Are you free to use this information to buy shares in the company? Under the SIA, someone who has information that he knowingly obtains, directly or indirectly from an Insider of a company, and that he knows is confidential and price sensitive, is prohibited from buying, selling or participating in any transactions involving the shares of that company. It is not a defence that this information came to his knowledge without having been solicited by him.

Is there anything that is not prohibited?
There are several exceptions under the SIA. Among the more notable ones are employee profit sharing and stock ownership plans, sales or purchases by employees or directors not exceeding one half of one percent of the issued share capital of the company over a period of one year and transactions entered into by a receiver, liquidator or trustee in bankruptcy in the good faith exercise of his functions.

Someone who has inside information is not prohibited from trading if he does so otherwise than with a view to making a profit or avoiding a loss by the use of that inside information.

What are the penalties for Insider Trading?
Under the SIA a person who is found guilty of Insider Trading is liable to fine of $50,000. to $200,000. and imprisonment for six months to two years.

Whether you are an Insider or you just happen to overhear something that an Insider says – it is important to be very careful about what you do with inside information.

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PAYING FOR CRIME NOT TO PAY

Amendments to the Proceeds of Crime Act and The Financial Obligations Regulations, 2009 Have Created Increased Compliance Requirements for Financial Institutions, Professionals and Individuals in Specified Areas of Business

M. Glenn Hamel-Smith & Nadia Henriques

Introduction

There is grave concern about the level of crime in the country and how it impacts our lives. One key strategy in the war against crime is to ensure that "crime does not pay" by confiscating the proceeds of crime and punishing those involved in attempting to conceal those proceeds. The Proceeds of Crime Act, 2005 (the 'Act') makes such attempts illegal and permits the State to confiscate the proceeds when detected. Compliance with the record-keeping and reporting requirements under the Act is the price we must pay to reduce crime and to comply with the country's obligations under the Forty Recommendations of the Financial Action Task Force at (http://www.fatf-gafi.org/dataoecd/7/40/34849567.pdf)

This is the first of a three part series on recent amendments made to the Act and the Regulations in the fight to combat money laundering.

Amendment to the Act and the Regulations

Close attention should be paid to the Proceeds of Crime (Amendment) Act, 2009, (the 'Amendment Act') which came into force in October 2009. Financial institutions and certain persons involved in specified types of businesses including: Real Estate, Motor Vehicle Sales, Money or Value Transfer Services, Gaming Houses, Pool Betting, National Lottery on Line Betting Games, Jewellers, Private Members' Clubs, Accountants, Attorneys-at-law and other Independent Legal Professionals, (referred to as 'Reporting Entities') are particularly impacted.

In addition, Reporting Entities should be aware of their responsibilities and potential liabilities under the Financial Obligations Regulations, 2009 (the 'Regulations'). Both of these legislative enactments impose significant obligations and penalties for failure to comply.

The Act as amended requires certain persons to report to the authorities anyone whom they reasonably suspect of money-laundering and permits the State to confiscate ill-gotten gains or assets including funds being laundered.

Some of the amendments to the Act include, among others:

- an expansion of the persons and types of businesses that are required to comply;
- shifting of the focus on drug trafficking (without removing it from one of the specified offences) particularly in the money laundering section;
- replacing the Designated Authority (to whom reporting is required) with the Financial Investigations Unit (the 'FIU') — a new entity established under separate legislation;
- expansion of the penalties and punishment under the Act;
- changes to the record keeping and reporting requirements; and
- expansion of the types of regulations that may be made and the manner in which they may be brought into effect.

The new Regulations contain provisions for Reporting Entities relating to, among others:

- Training Obligations and Compliance Programme;
- Customer Due Diligence;

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ARE YOU LURKING IN THE SHADOWS? *(cont'd)*

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A project financier may wish to carefully consider the extent to which it may control the decisions of a borrower during the 'step in' period or otherwise since the concept of the lender having a right to step into the shoes of the borrower appears to place the lender in total control of the decisions of the borrower vis a vis the relevant service contracts for the duration of the step in period.

Conclusion

Although the concept of a 'shadow' director is not yet a popular local issue, the current economic climate warrants that lenders should at all times carefully consider their actions when dealing with or instructing a distressed company to which they have been providing financial support. If a lender is deemed a director, this carries the burden of adhering to a statutory duty of care together with the potential personal liability for the company's debt in appropriate circumstances. As such the guidelines as suggested by the Buzzle case should be adhered to in order to mitigate against the risk of a lender becoming a 'shadow' director.

PAYING FOR CRIME NOT TO PAY *(cont'd)*

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- Due Diligence Required by Insurance Companies;
- Record Keeping Requirements;
- The Role of Supervisory Authorities; and
- Offences and Penalties.

Challenges Arising from Expanded Legal Obligations

Increased Costs to the Reporting Entities
There will be a significant cost attached to training relevant personnel and establishing systems and procedures to ensure that the legal obligations of the Reporting Entities are complied with at all times. This is an on-going task which involves periodic reviews to verify that adherence to systems and procedures is consistently maintained.

On a more basic level, there will be a cost in both time and money regarding the completion of the prescribed forms/reports, and submission of these to the FIU.

Repercussions from Failure to Ensure Employee Training and Compliance
Pursuant to Section 52(5) of the Act, an employee can assert in defence to a charge of committing an offence under this section that he disclosed the information to the appropriate person in accordance with the stated procedure. If such a defence is successfully raised, the Reporting Entities could then be in breach of their obligations to disclose and report to the FIU under s. 55 (3) and be liable to conviction and relevant fine. The Reporting Entities could also be found in breach of their obligations under the Amended Act to ensure the implementation of a compliance programme and be subject to the FIU obtaining an order to enter, inspect, interrogate and remove copies of documentary evidence.

Lack of Cooperation
The Reporting Entities should also be wary of resistance from clients and customers, regarding the provision of the information that it requires pursuant to the due diligence and record keeping requirements under the Amended Act. This would be in respect of persons whom they reasonably suspect of money-laundering or related offences, and those from whom the Reporting Entities are requesting the information as a matter of standard compliance procedure.

Lengthy Ongoing Obligations
Once the Reporting Entity makes the relevant disclosure and report, it may have ongoing obligations to provide information to the FIU. After the FIU has concluded that the circumstances warrant further investigation, it shall report the transaction to the relevant law enforcement authority for appropriate action. This next step may also involve the Reporting Entity which would then be required to provide information to the law enforcement authority.

Conclusion
Given the extensive record keeping, training, compliance and reporting requirements specified under the Amended Act and the new Regulations, as well as the significant penalties that may be imposed on companies and their directors, officers and agents, Reporting Entities should take great care to familiarise themselves with the provisions in the legislation, and to develop and implement detailed compliance programmes as required under the legislation. While the development of and compliance with these procedures and programmes are likely to be costly; if they succeed in reducing money laundering and other forms of crime, the cost will hopefully be well worth paying.

In the next two issues, we will take a close look at some of the important changes and requirements under the Amended Act and the Regulations identified above.

INSIDER TRADING *(cont'd)*

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If you are not sure whether something qualifies as inside information, you should consider:

- whether the nature of the information or the circumstances in which it was obtained suggest that it would be reasonable for it not to be disclosed to the general public; and

- the likely effect on the price of the company's shares if the information were to be disclosed.

If you think that the information is confidential and price sensitive, it may be better to err on the side of caution and wait until it goes public before buying or selling shares in the company.

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