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Review of Sanctions for Breaches of Corporate Law
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Review of sanctions in corporate law

CSA is the peak professional body delivering accredited education and the most practical and authoritative training and information on governance, as well as thought leadership in the field. We are an independent, widely-respected influencer of governance thinking and behaviour in Australia and represent over 8,000 governance professionals working in public and private companies. Our members are all involved in governance, corporate administration and compliance with the *Corporations Act* (the Act). Many are officers as defined under the Act. We have drawn on their experience in the formulation of each submission on the matters contained in the Consultation Paper.

General comments

CSA believes that there needs to be a balance between discouraging undesirable behaviour and encouraging directors, and other officers, to take risks. Our comments on all issues raised in the Consultation Paper are offered in this context.

CSA notes that the Consultation Paper focuses on directors as officers under the *Corporations Act*. However, CSA notes that the issues that are raised in the Consultation Paper apply, for the most part, to all officers, including company secretaries, not only to directors.

CSA recommends that any further consultation or exposure draft of legislative reform on these issues clarify that the matters apply to directors *and other officers*, as appropriate.

Responsive regulation and responsible risk taking

In September 2006, when the Federal Treasurer announced that a wide-ranging review of legal sanctions against corporate wrongdoing would be conducted, CSA surveyed its members on whether the prospect of potential sanctions under corporate law had unduly influenced business decision-making.[1]

[1] Chartered Secretaries, Australia, *Penalties for corporate wrongdoing,* at http://www.csaust.com/Content/NavigationMenu/NewsAdvocacy/Surveys/RapidResponseSurvey/Survey23/Survey_23.htm

More than half of the respondents (58 per cent) noted that the current levels of personal liability were inhibiting corporate Australia's appetite for risk. More than half (56 per cent) also believed that excessive penalties were discouraging suitably qualified people from accepting board positions.

However, when asked if respondents knew of a situation where a suitably qualified director or potential director had declined to be appointed a director of the respondent's company, due to onerous penalties and their personal exposure to risk, only a very small minority (13 per cent) could point to one. An overwhelming 87 per cent of respondents were not aware of any case where a suitably qualified director had declined to take up an offer of a directorship in their organisation for these reasons.

When asked if a reduction in personal legal liabilities would result in a heightened appetite for risk, leading to a more effective and prosperous corporate Australia, 59 per cent of respondents agreed that it would, However, they expressed caution, noting that there is considered risk and foolhardy risk, and that any reduction in personal legal liabilities should not suggest that directors and other officers could feel the need to be less diligent than they should be. CSA members also noted that reduced liabilities might lead to increased risk, but that there was no guarantee that this would lead to a more prosperous economy, as confidence in corporate Australia could also be reduced.

On the question of whether the regime for corporate regulation in Australia deters responsible risk-taking more or less than in other comparable jurisdictions, CSA points to the need in Australia for a general defence for directors and other officers that does not seek to 'second-guess' decisions by boards and companies. Currently, no such general defence exists. CSA comments on this issue later in our submission on the issue of 'General protection for directors'.

Criminal sanctions

CSA strongly believes that criminal consequences should only flow from egregious behaviour, that is, behaviour which meets the elements of intentionality, recklessness or fraudulence.

CSA notes that the application of criminal sanctions to types of wrongdoing go to the heart of achieving a balance between undesirable behaviour and encouraging a willingness to take sensible commercial risks. CSA believes that directors and other officers, as appropriate, should be able to 'make mistakes' without risking going to gaol. For example, directors may be required to compensate those who suffer loss by reason of the directors' negligent conduct but should not face criminal sanctions unless the behaviour involves intentional, reckless or fraudulent misconduct.

CSA strongly recommends that breaches of low level record keeping and reporting provisions in corporate law that are currently subject to criminal sanctions have insufficient moral wrongdoing to warrant criminal or civil proceedings. Such breaches of low level record keeping should be subject to administrative penalties and not to criminal sanctions.

CSA notes that if intentional, reckless or fraudulent misconduct is involved, such as document destruction which precludes compliance with provisions in the Act relating to record keeping and reporting, a breach of directors' duties in ss 180 – 185 is likely to apply. In such instances, the civil and criminal sanctions attached to directors' duties would take effect and thus no carve-out is required for types of misconduct where administrative sanctions for low-level offences should not apply.

CSA notes that the Consultation Paper focuses strongly on what sort of conduct should be subject to criminal, civil or administrative sanctions, with the discussion centring on the gravity of the conduct and the damage caused as the motivating factor for which particular sanction to

apply. However, CSA notes that, currently, the regulator has wide discretion to decide if criminal or civil sanctions will be applied and that the Australian Securities and Investments Commission (ASIC) has brought civil proceedings where criminal sanctions may have been more appropriate, given the gravity of the conduct in question. In CSA's view, these decisions tended to be driven by the evidence available to bring proceedings, rather than by the magnitude of the breach.

CSA has concerns with the higher burden of proof attached to criminal proceedings, rather than the gravity of the breach, motivating the decision by the regulator as to what sanction to apply. CSA notes that ASIC attracted considerable criticism over the Vizard case, for example, on this issue. A further concern is that individuals may suffer reputational damage of a kind associated with criminal conviction, without having had the benefit of the higher standard of proof required in criminal actions. CSA also notes that a regulator may take civil action after criminal action has failed.

If sanctions in corporate law are to reflect the magnitude of the breach and the gravity of any misconduct, CSA believes that the regulator needs to articulate more clearly how it approaches the decision to seek either civil or criminal sanctions, recognising that each case will be decided on its specific facts.

CSA strongly recommends that the regulator clearly state its reasoning in choosing to apply either criminal or civil sanctions, and that the basis for the regulator's decision be that criminal proceedings should generally be commenced in the case of serious breaches involving intentional, reckless or fraudulent behaviour.

General protection for directors

CSA notes that, currently, the business judgment rule is available to directors and other officers. The Consultation Paper focuses on directors as officers under the *Corporations Act* and **CSA strongly recommends** that any further consultation or exposure draft of legislative reform on any proposed general defence clarify that it would apply to directors *and other officers*, as appropriate.

CSA firmly supports the introduction of a consistent defence covering a range of provisions. However, **CSA does not support** the general defence as formulated in the Consultation Paper. CSA believes that it is too broad and might permit directors and officers to escape sanctions contrary to the expectations of investors and the broader community.

Support for a general defence

CSA firmly supports the introduction of a consistent defence covering a range of provisions. Currently multiple defences are attached to separate provisions in the Act (for example, s 180(2) provides the business judgement rule for breaches of care and diligence in s 180(1) and s 588H provides the defence against insolvent trading under s 588G). CSA believes that multiple defences in the Act do not bring certainty to directors and other officers seeking to understand their duties and the defences available to them when making decisions involving responsible risk-taking.

CSA notes that the concept of a 'safe harbour' exists in corporate law in the United States. This provision applies to all decisions and stops the courts from 'second-guessing' commercial decisions by boards of directors and companies. CSA fully supports a general defence that operates in this manner. CSA also supports a general defence that clarifies that, if a director or other officer has 'done the right thing', they will be protected.

CSA also notes that consistent defences were introduced in the Criminal Code and that this model has attracted strong support for its clarity and certainty.

CSA concerns with the formulation of a general defence in the Consultation Paper

CSA understands and supports the rationale behind a general defence but for the reasons stated below cannot support the formulation of the proposed general defence as set out in the Consultation Paper.

CSA is aware that the business judgment rule, as currently defined in the Act, has a narrow focus and believes it could be broadened in scope. CSA believes that there are elements in the current business judgment rule that could be included in any proposed general defence. Those elements are discussed below.

Informing oneself
CSA believes that the concept of informing oneself about a matter is critical to the maintenance of a fiduciary duty. CSA could only support a general defence that included an element pointing to the need to inform oneself, similar to the existing s 180(2)(c).

Reasonably and incidentally to the corporation's business
CSA believes that the formulation in the Consultation Paper of 'reasonably and incidentally to the corporation's business' is so broad that any business decision, whether responsible or not, or whether in the best interests of the corporation or not, could fit the definition. The other problem with this element of the proposed general defence is that a decision could be taken that is not incidental to the corporation's business that is a responsible business decision and the defence would not be available.

In the best interests of the corporation
CSA notes that the element of being 'for the corporation's benefit' as formulated in the proposed general defence is not necessarily the same as being 'in the best interests of the corporation', which exists in the current law. CSA notes that there is a considerable body of law on 'in the best interests of the corporation' and that changes to drafting should not be undertaken unless a change in outcomes is sought.

Material personal interest
CSA believes that any general defence needs to have a material interest test similar to the existing s 180(2)(b), as the materiality of the decision-making is the issue in relation to maintaining fiduciary duties. CSA believes that it is appropriate that directors and officers be held to a more stringent standard in respect of decisions and transactions in which they have a material personal interest (other than an interest arising merely by reason of being a shareholder in the entity).

Application of general defence to insolvency provisions

CSA believes that it is appropriate that a general defence also apply in cases of insolvent trading, so long as in these cases the general defence recognises the additional duties owed to creditors and the general policy under the *Corporations Act* of encouraging directors to appoint an administrator early when they consider the company is or is likely to become insolvent and not to seek to continue to trade in the hope that they can trade their way out of difficulty.

CSA notes that entrepreneurship which puts creditor protection at risk would be difficult to defend.

As noted earlier, CSA understands and supports the rationale behind a general defence and notes that any drafting of proposed legislative change needs careful work and analysis to avoid unintended consequences. The defences in s 588H currently operate well to ensure that there is a balance between taking sensible commercial risks and the protection of creditors, and any general defence that is applied to directors' duties in regard to insolvent trading should not be at the expense of creditor protection.

CSA notes that the insolvency provisions, in earlier versions of corporate law, applied not only to directors but also to other officers. However, following the Harmer Report, personal liability for breaches of the insolvency provisions attached to directors only. This was a deliberate policy decision, based on the fact that it is directors who make the decision in respect of continuing to trade or declare insolvency. **CSA recommends** that this policy decision be upheld and that personal liability and any general defence in relation to insolvency provisions apply only to directors and not to other officers should legislative reform occur.

Review of section 189: reliance on information or advice provided by others

CSA does not believe that the requirement to make an independent assessment of information or advice received places too high a burden on directors.

Currently, this section applies only to directors, and not to other officers. **CSA strongly recommends** that officers who are not directors should also be able to rely on s 189.

The obligation to keep financial records

CSA recommends that the penalty for breach of this provision remain unchanged.

CSA notes that if serious misconduct is involved, such as document destruction which precludes complying with provisions in the Act relating to record keeping and reporting, a breach of directors' duties in ss 180 – 185 is likely to apply. In such instances, the civil and criminal sanctions attached to directors' duties would take effect.

CSA does not support a defence for the company as a company only operates through its directors and officers. Providing a defence to directors and officers is sufficient.

Drafting of offence provisions

CSA recommends repealing Schedule 3 and moving the maximum penalties for offences into the provision in the Act. CSA believes this will bring improved understanding and clarity concerning offence provisions.

Interaction with other proposed legislative reforms

CSA notes that the government is currently undertaking or has completed consultation on a range of proposed legislative reforms that interact with sanctions in corporate law. For example, currently a consultation paper is available for comment on issues relating to insider trading.

Of most concern to CSA is the report released by CAMAC in April 2006, *Corporate Duties Below Board Level*. **CSA strongly recommends** that if corporate duties are extended below board level that a general defence be extended accordingly.

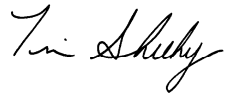
CSA would also like to point to the need to ensure that any general defence introduced in the Act be considered in light of the issues raised in the CAMAC report released in September 2006, *Personal Liability for Corporate Fault*.

Conclusion and recommendation

CSA has given careful consideration to the issues raised by the Consultation Paper on sanctions in corporate law. CSA strongly supports moving away from the operation of criminal sanctions as the 'default' sanction for breaches of corporate law and the introduction of a single, consistent defence that applies to multiple provisions. CSA, however, does not support the current formulation of any such proposed general defence.

CSA would welcome further contact during the consultation process and the opportunity to be involved in further deliberations.

Yours sincerely



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