Corporate Law Reform Update

In its efforts to clean up after the corporate collapses of the 80s, the federal Government has been looking at a variety of regulatory measures to raise the probity of Australian corporate life. The ALRC has been sent in to bat.

A critical symposium

When the federal Attorney-General calls a symposium of lawyers to discuss an exposure draft of a corporate law reform Bill, you might imagine a civilised group of chaps (mostly) swapping *bon mots* over the chardonnay. Forget it. For some participants at a public debate in April last year, the grapes turned distinctly sour and the talk grew almost Parliamentary. They were discussing the first of 1992's two Corporate Law Reform Bills — the one that included provisions dealing with directors' duties and related party transactions (such as loans to directors). The Bill had been published by the Companies and Securities Advisory Committee (CASAC) in their July 1991 *Report on Reform of the Law Governing Corporate Financial Transactions.* The businessmen hadn't liked the provisions when they saw them in the report, and they liked them even less as the discussion flowed on.

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'Virtuous vomit,' declared one critic. 'The trouble with vomit is that there are very good bits in it — often — but you don't actually want to wade in and find them.' This criticism may have said more about its author, John Green of Freehill Hollingdale and Page, than about the Bill. But it does convey something of the quality of the debate and the degree of heat it generated.

Robust *badinage* is a tradition in law reform and it was inevitable that it would occur in corporate law reform consultations too, even in consultations under the aegis of the federal Attorney-General. Amendments to the Corporations Law must be negotiated by the federal Attorney-General with State and Territory Attorneys-General. When the Commonwealth and two of the States agree, an amendment can go ahead. As part of the negotiating process, the Attorneys publish a draft to gauge what support there is for proposed amendments.

Leave loans alone

The bits of the draft Bill that Mr Green — and many others — found so unpalatable gave effect to CASAC's recommendations to tighten the regulation of loans to directors. The basic idea was to require shareholder approval and mandatory disclosure of many of the transactions that occur between companies, on the one hand, and parties that are 'interested' or 'related', on the other.

'Unintelligible gibberish'

The bulk of the criticism was that the Bill's provisions were just too complicated and difficult to follow. 'Unintelligible gibberish' was the charge, again from Mr Green. Other members of the business community wanted to know why Australia needed a 65-page Bill when the United Kingdom had managed to get by on a mere 11 pages. John Story, of Corrs Chambers Westgarth in Brisbane, was reported in the *Financial Review* on 24 February 1992 as being 'overwhelmed by the sheer volume and complexity' of this flood of legislation. He wondered why one section of the Corporations Law (section 1002), dealing with insider trading, needed to be replaced by 20 separate sections. In fact, that one section has only succeeded once in bringing an insider trader to book — and even then, the offender was an officer of the Australian Securities Commission (ASC).

A redraft

In response to these and similar criticisms, the Government referred the related party transactions provisions of the draft Bill to a special committee for redrafting in April last year. The committee was headed by Phillip Noonan, of the federal Attorney-General's Department, and included Tom Reid, a senior officer from the federal Parliamentary Counsel's Office, Reg

Barrett, General Counsel at Westpac, and two members of CASAC, Wayne Lonergan of Coopers and Lybrand and David Crawford of KPMG Peat Marwick.

What the Attorney said

The redraft was successful. The Bill as redrafted was introduced into the House of Representatives on 3 November 1992. In his second reading speech the Attorney-General, Mr Duffy said

> . . . the Government has arranged for the provisions to be redrafted in a simpler form — one which focuses much more directly on the general principles involved, supports those principles by examples where appropriate, and eschews any attempt to provide, by long black letter formulations, a precise description of how the law should apply in every particular case.

Insolvency reforms

One of the Bill's 'good bits' was its implementation of the Harmer report, *General Insolvency*, produced in 1988 by the ALRC. This was the first time that anyone had comprehensively examined the Australian law of individual and corporate insolvency. The report particularly stressed the importance of giving individuals and companies some real alternatives to bankruptcy or being wound up. It recommended new procedures to encourage those in financial difficulty 'to adopt a more positive approach to their financial problems' — a sort of New Age, 'I like my debt' philosophy. A number of the reports recommendations about individual insolvency have already been enacted. The Insolvency and Trustee Service of Australia (ITSA), which administers the *Bankruptcy Act 1966* (Cth), reported recently in its Annual Report that the substantial changes to the bankruptcy law which came into effect from 1 July 1992 have made it more difficult for bankrupts to hide behind trusts and companies in order to avoid paying creditors. The changes also offer an incentive for bankrupts who have the means to discharge their debts to be clear of bankruptcy at the end of the normal three years. But for those who can repay their debts and do not, the bankruptcy can be prolonged so that they are still liable to pay up after the discharge of the bankrupt.

The Attorney-General's second reading speech drew particular attention to the Government's acceptance of the Harmer report's approach:

> In relation to companies in difficulty, the Bill makes it plain that there are ways to deal with a company which is facing solvency difficulties that are more constructive and efficient than current remedies. It will ensure that receivers are accountable to shareholders and creditors for what they are doing while controlling a company.

Civil penalties for errant but honest directors

The Bill restates, in the Corporations Law itself, the duty that a director owes to the company. It also removes the threat of criminal action against a director who breaches this duty but acts honestly and without fraud.

No doubt much to such a director's relief, the only penalty will be under civil law. The maximum will be a pecuniary penalty (a fine) of $200 000 and disqualification — but the pecuniary penalty is to be imposed only if the contravention is 'serious'. The Bill passed in mid-December.

The No 2 Bill

The second Corporate Law Reform Bill was introduced into the House of Representatives in late November 1992. It is now open for public comment and the Senate Standing Committee on Legal and Constitutional Affairs (the Cooney committee) is examining it too. The Bill introduces an 'enhanced disclosure' regime for companies, changes the prospectus rules and sets out requirements for more frequent reporting to shareholders, the Stock Exchange and the ASC. Finally, the Bill clarifies and reforms the provisions of the Corporations Law dealing with directors' indemnification insurance. Many of these changes flow from CASAC reports, in particular, the March 1992 report by the Lonergan committee (a subcommittee of CASAC *Prospectus Law Reform Report*.

Trade Practices Act beefed up

The Corporate Law Reform Bills are not the only movement on the corporate law reform front. The federal Government fired another salvo during last year's Budget sittings when it introduced legislation

- to increase massively the penalties for breaches of the Trade Practices Act (TPA) and
- to make undertakings given by companies to the Trade Practices Commission (TPC) enforceable.

Flowing from recommendations of the Cooney Committee in its December 1991 report — *Mergers, Monopolies and Acquisitions — Adequacy of Existing Legislative Controls* — these changes are designed to allow the TPC more flexibility in administering and enforcing the TPA. As the Attorney explained in his second reading speech on 3 November 1992:

> It has proved efficient in some cases for the Commission to avoid prolonged litigation by accepting undertakings from businesses to cease particular conduct or to take action which will lessen the otherwise undesirable effects of their conduct. . . Recognising the importance and desirability of affording the Commission a flexible approach to the resolution of trade practices matters, the Government has decided to provide legislative recognition of this practice. . . . By providing for the enforceability of undertakings, the scheme will remove the need to rely on means outside the Act to enforce undertakings that people have given, should this prove necessary.

ALRC reference on TPA enforcement

A system of enforceable undertakings is only the first step. The Government also took note of the Cooney Committee's recommendations on the need to provide better mechanisms to enforce compliance with key provisions of the TPA. When ALRC members and staffers returned to work after a well deserved Christmas break, they found a reference from the federal Attorney-General telling them to carry out an exhaustive inquiry into the best ways to enforce the TPA's consumer affairs and restrictive trades practices rules. The range of issues that will have to be covered in the inquiry include

- whether there are ways of ensuring compliance with the Act by appropriate orders, in particular, by orders that a person cease and desist action that is or may be in contravention of the Act
- whether the law adequately provides for redress for those who suffer loss or damage because of contraventions of the Act or of these sorts of orders
- what kinds of sanctions and penalties should be available in respect of such contraventions including:
  — what penalty options other than pecuniary penalties are appropriate;
  — what levels of penalties are appropriate to reflect the community's disapproval of such contraventions
- how those whose interests are or may be prejudiced by such contraventions can get access to quick, cost effective and fair remedies, including what courts and tribunals should have jurisdiction in relation to such matters.

And, of course, to ensure that the ALRC does not have too narrow a focus, its report must cover 'any related matter' as well.

The ALRC's report must be delivered by 30 June 1994.

A compliance environment

Those issues are central to ensuring that the law provides an up-to-date mechanism for enforcing the TPA, one that encourages companies to comply while at the same time taking account of the realities of modern commercial life. It is understood that the TPC hopes to see the ALRC inquiry come up with compliance techniques that will allow the TPC to create a 'compliance environment', backed up by more sophisticated enforcement mechanisms, and more imaginative penalty options, for corporations.

This idea is nothing new. The Taxation Commissioner, for example, surrendered to the inevitable some time ago and pursued a similar approach, of promoting an environment where compliance with the tax laws is nothing out of the ordinary, when it adopted self-assessment as the major technique for tax collections.

Compliance and the ALRC — administrative penalties for underpayments of customs and excise duty

The ALRC has reported recently in this area. The House of Representatives Standing Committee on Finance and Public Administration (now the House of Representatives Standing Committee on Banking, Finance and Public Administration) (the Martin Committee) in 1990 published a report as part of its inquiry into aspects of the Australian Customs Service (ACS) administration. The report, *A Tour of Duties — The Final Report on an Inquiry into Aspects of the Australian Customs Service*, drew attention to the widespread dissatisfaction among ACS 'clients' at the recently introduced 'administrative penalty' regime for underpayments of import duty. 'Draconian' and 'unjust' were among the kinder descriptions of the scheme given to the Committee.

In November 1991 the Government accepted the Committee's recommendation that an independent body like the ALRC review the scheme and asked the ALRC to produce a report by 31 July 1992. The ALRC report, *Administrative Penalties in Customs and Excise*, (ALRC 61) tackled the problem of developing a sophisticated mechanism for penalising underpayment of duty in the context of a general approach towards self-assessment which the ACS, like other revenue agencies, is adopting.

After publishing a discussion paper in April 1991, the Commission consulted closely with customs agents, excise producers and the ACS in drawing up its report. It was able to get all parties to agree that there is a level of unavoidable error in entries and the payment of import duties. Because it is unavoidable, there is no point penalising it. A penalty would not have a deterrent effect. The ALRC therefore recommended that no administrative penalty should be imposed for error if reasonable care is exercised. But penalties should be imposed for errors that the system should have picked up.

Like import duty, excise duty is self assessed. Errors can occur, but there is far less scope for them. Import entries require importers to make technical judgements about the description of the goods, their customs value and their classification. Excise entries essentially rely on sound arithmetic. But the dollars are huge. Almost $9.5 billion was paid in excise revenue in 1991-92; about 90% of this is paid by only 10 organisations. Because there are so few producers, the ACS can monitor them closely. The ALRC therefore took a slightly different approach to excise. It recommended that Parliament approve a level of unavoidable error, above which excise producers pay penalties. As part of their excise licences, producers would have to comply with performance standards specifying acceptable losses. If they exceed those levels, they would incur a penalty. This approach appropriately divides the responsibility for dealing with error between the Parliament and the producers.

Compliance and the ALRC — Collective Investments Review

The ALRC has also confronted compliance issues in its work on the Collective Investments Review. That Review, which the ALRC and CASAC are conducting jointly, published a substantial discussion paper, *Collective Investments* (ALRC DP 53) in October 1992. The DP raised over 100 separate proposals and issues for comment.

One of the more controversial proposals was to abolish the current requirement that unit trusts and other 'prescribed interests' have, not only a manager or promoter, but also a trustee or investor representative (usually a statutory trustee company). Instead, there would be a single 'responsible entity'. The DP proposed that this responsible entity, which would run the scheme, have roughly the same duties to investors in the scheme as the trustees presently have. Investors would be able to remove the responsible entity, terminate the scheme and even take action against the entity and its directors or board members if there was a loss resulting from a breach of these duties. The DP also proposed rules to ensure better information for investors, including more extensive annual reports and half yearly financial reports.

Support me, I'm a trustee!

The proposal to abolish the requirement for a trustee or investor representative provoked a public outcry from trustee companies. Mr Don Blyth, national director of the Trustee Companies Association and a consultant to the Review, told the *Sydney Morning Herald* of 21 October 1992 that billions of dollars of small investor funds would be left unprotected as a result.

> To swap such a high level of monitoring [as trustees presently provide] for more manager disclosure, audit reviews and regulator supervision and say that investor protection is increased is unrealistic . . . The experience of corporate trustees in collective investment schemes over many years has clearly demonstrated an indispensable need for daily, hands-on supervision by an independent trustee.

Other commentators, while a tad less emphatic, echoed similar concerns. Michael Walsh, of research house ASSIRT, was quoted in *Money Management* as saying

> For instance, who is going to watch the fund manager give instructions to a valuer? . . . It is unrealistic to kill the role of the trustee and then have to pick up the pieces.

On the other hand, BT's Ian Martin was reported as cautiously welcoming the move. He drew attention to the role that imposing a capital requirement on responsible entities might play in offsetting the need for an independent party to protect investors:

> What the responsible entity does is take one of the layers of regulation out and replace it with other checks and balances. I believe minimum capital should be one of those checks and balances. . . . If an organisation has minimum capital then it can become a responsible entity. If it doesn't have the minimum capital then it should have an external trustee or custodian.

The Review's final report, which has to include draft legislation, is due at the end of January 1993. It seems likely that one of the focuses of the report will be ways of ensuring that responsible entities follow the rules — particularly as, in many cases, they will write the rules themselves when they establish the schemes. Here again, mechanisms to encourage compliance with the rules must be found.

When does a company commit an offence?

Making it an offence to breach the rules is the traditional way of 'encouraging' compliance. But when does a company commit an offence, that is, do the prohibited act with the relevant state of mind? A company has 'no body to be kicked, nor soul to be damned', but neither does it have arms to strike the blow, or a mind of its own to form an intention. Everything it does or thinks is by proxy — through its directors, servants or agents. Two recent papers have focussed on the difficult question when the acts or thoughts of a director, servant or agent of a company can be attributed to the company so as to make the company guilty of an offence.

The CLOC draft

The Criminal Law Officers Committee of the Standing Committee of Attorneys-General recently released, a discussion paper, *Model Criminal Code.* The paper included a draft Chapter of a proposed Australia wide uniform criminal code. The draft dealt with the principles of criminal responsibility and in particular with attributing criminal responsibility to corporations.

The draft attributes the physical element of an offence to a corporation if the relevant act is done by a servant, agent, employee or officer acting within the scope of his or her employment or within his or her actual or apparent authority.

Intention or knowledge, if that is an element of the offence, is to be attributed to the body corporate if it

> expressly, tacitly or impliedly authorised or permitted the commission of the offence.

This can be proved by showing

- that the board of directors or a high managerial agent of the body corporate did the act or authorised or permitted it (but

there is a 'due diligence' defence)
- that a corporate culture existed within the body corporate that directed, encouraged, tolerated or led to the non-compliance
- that the body corporate failed to create and maintain a corporate culture that required compliance.

The novel legislative notion of 'corporate culture' is defined as

> an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or within the area of the body corporate in which the relevant activities take place.

Where recklessness is the fault element of the offence, it *may* be attributed to the body corporate if the

> servant, agent, employee or officer of the body corporate acting within the scope of his or her employment or his or her actual or apparent authority has that fault element.

However, there will be a defence if the body took appropriate measures to reduce to a justifiable level the risk of the offence being committed.

Negligence as an element of an offence *may* exist

> if the conduct of its servants, agents, employees and officers is negligent when viewed collectively.

This can be shown by, for example, inadequate corporate management, control or supervision, or the lack of proper reporting systems.

ALRC and customs offences

The ideas behind much of the CLOC draft draw on the work of, among others, Professor Brent Fisse of the Sydney Law School. The ALRC's 1991 report on customs and excise law also shows this influence. That report, *Customs and excise* (ALRC 60, 1991), includes similar provisions to those in the CLOC draft.
However, there are some differences.

- Directors, servants, agents etc of a body corporate who act within their actual or apparent authority from the body corporate will have their acts attributed to the body corporate unless acting only for their own benefit.
- Directors, servants and agents of a body corporate who do an act with a particular state of mind, intention or belief will have that state of mind, intention or belief attributed to the body corporate.
- Directors, servants and agents of a body corporate who
  - within their actual or apparent authority from the body corporate, authorise another director, servant or agent to do an act and
  - have a particular state of mind, intention or belief

  will have that state of mind, intention or belief attributed to the body corporate.

Again, the ALRC report would allow a 'due diligence' defence to the attribution of responsibility for the *act* to the body corporate:

> . . . it is a defence if it is established that the body corporate had taken all reasonable precautions, and had exercised due diligence, to prevent its officers, including its directors and employees, and its agents from doing the act.

However, the ALRC report expressly negates this defence if the person who did the act believed on reasonable grounds that reporting the matter to the board of directors or in accordance with the body corporate's reporting system would not have led to the body corporate taking effective measures to prevent the offence or would have led to the person being prejudiced.

Corporate regulation — a civil or a criminal focus?

But what happens when compliance breaks down? In late 1992, a media row broke out between the ASC and its high profile Chairman, Mr Tony Hartnell, on the one hand, and Mr Michael Rozenes, the Director of Public Prosecutions (Cth), on the other. Mr Hartnell's ASC was charged in that it did, in one way and another and at diverse times, neglect the prosecution of serious corporate criminal conduct in favour of civil approaches. The financial and other media were able to report that eventually the federal Attorney-General, Mr Duffy, stepped in and arranged for a clarification of the emphasis that would be placed on each of these elements of enforcement.

The question is by no means an easy one, as the ASC itself has acknowledged. Criminal charges take much longer than civil cases to come to trial. The standard of proof is higher, and the defence likely to be fiercer. The criminal trial is — as it should be — weighted in favour of the accused. Preparing and running a criminal case chews up scare regulatory resources at an alarming rate. But still the regulator must act proactively, to prevent loss to investors, and must act to recover, where possible, investors' funds that have been lost or wasted. The tensions that this creates for a regulator with finite resources were summarised in Mr Hartnell's last annual report as Chairman of the ASC. In his foreword to the 1992 report he said

> . . . the ASC throughout its existence has constantly faced the dilemma caused by the demands for retribution against those participating in the excesses of the 1980s and, on the other hand, dealing with the difficult corporate regulatory problems of

the 1990s. Prioritising work effort in these two areas will for some time be difficult, because the nature of the problems are so different. Accordingly, the type of response needed will also be different.

Despite the media brouhaha, Mr Hartnell has acknowledged the sound working relationship between the ASC and the DPP. At a public dinner on 2 December 1992, to farewell him as ASC Chairman, he was quick to acknowledge the assistance and support that the ASC has received from the DPP, and to stress that the working relationship remains fundamentally sound. It will need to be. In the short term, there may need to be a concerted effort to clear the backlog of criminal prosecutions left over from the 80s. After that we should be able to see the ASC put into place a balanced civil and criminal enforcement strategy.

Greed is gone?

That may be too late to collect the scalps of some of the high flying 80s entrepreneurs. But what is being done now should go a long way to reassuring markets here and abroad that the 'greed is good' decade is over.