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DIRECTORS' PERSONAL LIABILITY FOR CORPORATE FAULT: AN ALTERNATIVE MODEL

ABSTRACT

The issue of directors' personal liability for corporate fault is examined in the Corporations and Markets Advisory Committee (CAMAC) Discussion Paper that was released in May 2005. This discussion paper considers directors liability under various statutory provisions and suggests that a standard directors' liability template should be adopted. One of the issues raised in the discussion paper is the nature of the criminal liability to be imposed under the standard liability template and whether that liability should be direct, accessorial or derivative.

This article argues that the imposition of criminal liability on directors for corporate fault should not depend on classification as direct, accessorial or derivative. Instead, liability should depend on fault, and the degree of fault which attracts criminal liability should be determined as a question of public policy. An alternative scheme of liability, which matches the degree of fault with an appropriate measure of punishment, is proposed. This is achieved by the use of both criminal and civil penalties. A template that includes both criminal and civil penalties is preferable because it complies with strategic regulation theory. In addition, civil penalties overcome many of the difficulties that are associated with the enforcement of traditional criminal regimes.

I INTRODUCTION

In May, 2005, the Corporations and Markets Advisory Committee (CAMAC) released a Discussion Paper examining the personal liability of directors for corporate fault.[1] It is based on a reference to the Committee from Senator Ian Campbell, who was 'concerned that duties being imposed on directors by various pieces of legislation may result in inconsistent compliance burdens and increased costs for business.'[2]

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1 Corporations and Markets Advisory Committee, Parliament of Australia, *Personal Liability for Corporate Fault* (2005).

2 Reference from Senator the Hon Ian Campbell, Parliamentary Secretary to the Treasurer to the Corporations and Markets Advisory Committee, 9 July 2002. See

The statutes that are considered in the CAMAC Discussion Paper are various State and Territory environmental protection, occupational health and safety, hazardous goods and fair trading statutes. The issue raised is whether or not the compliance burdens and costs imposed on businesses could be reduced by the adoption across all of these pieces of legislation of a standard directors' liability template. It is argued that the adoption of a standard template would 'assist corporations and their directors and other managers in implementing effective and cost effective compliance and risk management strategies aimed at achieving the regulatory goals of the legislation.'[3] The adoption of a standardised liability template would provide individuals concerned with 'greater legal certainty and predictability'.[4]

The Discussion Paper concentrates largely,[5] although not solely, on the nature of the criminal liability to be imposed on directors by the standard template, specifically whether that liability should be direct, accessorial or derivative. Two issues raised by the Discussion Paper will be discussed in this article. The first is Issue 3.4, namely '[t]he rationale for derivative liability, including in what circumstances, if any, is it necessary as a matter of public policy to go beyond accessorial liability and impose individual derivative liability.' The second is Issue 9.8, which asks '[s]hould some other general derivative liability template be adopted?'

The article will make two points on Issue 3.4. The first is that the imposition of criminal liability on directors should not depend on classification as direct, accessorial or derivative. Instead, liability should depend on fault, and the degree of fault that attracts criminal liability should be determined as a question of public policy. The second is that where the aim of the imposition of liability is to provide incentives to obey the law, the place of a civil penalty regime as a deterrent where appropriate also needs to be considered. In relation to Issue 9.8 the article will outline an alternative scheme of liability which matches the degree of fault with an appropriate measure of punishment.

This article will first examine the reasons why it is necessary to impose liability on directors, and its advantages and disadvantages. Next it will examine the type of

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<http://www.camac.gov.au/camac/camac.nsf/print/Directors%27+Duties+and+Personal+Liability+%28July+2002%29?opendocument>.

3 *Personal Liability for Corporate Fault*, above n 1, [1.3].

4 Ibid.

5 While CAMAC recommends a template for attributing liability to directors under both civil and criminal regimes, the bulk of its discussion considers criminal liability. *Personal Liability for Corporate Fault,* above n 1, [2.5].This paper concentrates on that aspect and the place of derivative liability for directors in the criminal liability regime context.

liability that is most appropriate. Finally, the article will consider the place of a civil penalty regime in the context of strategic regulation theory, and will recommend a three-tiered system of liability.

II Ensuring Compliance

The provisions that are the subject of the CAMAC review were chosen because they are considered to be significant in the commercial operations of many enterprises and because the method employed by these statutes to impose personal liability on directors and other corporate managers was seen to be typical.[6] As a matter of public policy it is of vital importance that companies comply with the legislative provisions that are the subject of this review. The issue is whether or not corporate compliance can be secured by placing liability on the corporation alone or whether it is necessary to impose liability also on the directors and managers of those corporations.

This article will argue that the best way to ensure that companies comply with these provisions is to impose liability on the directors and managers personally as well as on the company. The following section will discuss why corporate liability alone will not be sufficient.

III The Need for Directorial Liability

Corporate criminal liability alone will not always provide a sufficient incentive for directors to implement adequate strategies to ensure that their corporation avoids breaching the provisions that are the subject of the CAMAC review. Commentators have argued that corporate criminal liability alone may not be the best way to influence corporate behaviour and deter future contraventions.[7] Khanna identified deterrence as the aim of corporate criminal liability. However, 'corporate liability may appear incompatible with the aim of deterrence because a corporation is a fictional legal entity and thus cannot itself be 'deterred.' In reality, the law aims to deter the unlawful acts or omissions of a corporation's agents.'[8] It is the culpable actions of individuals within a corporation that leads to the culpability of a corporation. Any moral condemnation that may arise from a corporate criminal

6 *Personal Liability for Corporate Fault*, above n 1.

7 V S Khanna, 'Corporate Criminal Liability: What Purpose Does it Serve?' (1996) 109 *Harvard Law Review* 1477, 1478.

8 Ibid 1494.

conviction will have little rehabilitative impact on the organisation itself. The company is an inanimate object that is incapable of feeling shame or remorse.[9]

The limited nature of the sanctions that can be imposed on corporations is another reason why corporate criminal liability may not be sufficient. A corporation cannot be incarcerated. In many cases the criminal penalty that is imposed when a corporation has been convicted of an offence is a fine.[10] However, the imposition of a fine on the company may not necessarily lead to a change in offending behaviour. Fisse argued that '[f]ines, no matter how large, do not guarantee that corporate offenders will respond by revising their internal operating procedures or physical protection devices in such a way as adequately to guard against repetition of the offence.'[11]

In addition, fines may be passed readily by the company on to other parties either by reducing dividends payable to shareholders or by increasing prices to consumers. This reduces the effectiveness of the penalty because it is not felt by the party on whom it is imposed.[12]

Fisse argued that the imposition of a fine on a corporation can 'convey the impression that offences are purchasable commodities whereas the conventional understanding of serious offences is that they are unwanted even if a given offender is prepared to pay for them in cash.'[13] Fisse and Braithwaite argued that:

> The impact of enforcement can easily stop with a corporate pay-out of a fine or monetary penalty, not because of any socially justified departure from the traditional value of individual accountability, but rather because that is the cheapest or most self-protective course for a corporate defendant to adopt.[14]

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9 New South Wales Law Reform Commission, *Sentencing: Corporate Offenders*, Report No 102 (2003), [2.39].

10 Australian Law Reform Commission, *Sentencing of Federal Offenders,* Issue Paper 29, (2005) [15.61] and Australian Law Reform Commission, *Securing Compliance: Civil and Administrative Penalties in Australian Regulation*, Discussion Paper No 65 (2002) [18.74].

11 Brent Fisse, 'Recent Developments in Corporate Criminal Law and Corporate Liability to Monetary Penalties' (1990) 13 *University of New South Wales Law Journal* 1, 8.

12 Ibid. See also *Personal Liability for Corporate Fault*, above n 1, [3.2].

13 Fisse, above n 11, 8.

14 Brent Fisse and John Braithwaite, 'The Allocation of Responsibility for Corporate Crime: Individualism, Collectivism and Accountability' (1988) 11 *Sydney Law Review* 468, 469.

There is also the possibility that corporations may engage in asset stripping and other evasion techniques if fines are imposed on them.[15]

Further problems arise where the company on whom the fine is imposed is undercapitalised. A monetary fine imposed on such a corporation will not be an adequate deterrent especially if it is the undercapitalised subsidiary of a larger company, deliberately set up to engage in a dangerous activity. In addition, punishing undercapitalised corporations can place a court in an unpalatable position. The contravention may warrant the imposition of a large monetary penalty but this may not be a viable option if the imposition of that penalty would force the corporation into liquidation. This would have adverse consequences for unintended victims such as creditors and employees. A court may be forced to impose a fine that does not reflect adequately the gravity of the contravention that has been committed in order to avoid imposing an adequate fine that would lead to the corporation's insolvency.[16]

Fisse and Braithwaite argued that enforcement action taken against the corporation rather than the individual responsible for the contravention is a major problem confronting modern industrial societies in their attempts to control corporate wrongdoing.[17] This is a problem for two reasons. First, it provides prosecutors with a short cut whereby they can proceed against the corporations rather than the more elusive personnel. 'Secondly, where corporations are sanctioned for offences, in theory they are supposed to react by using their internal disciplinary systems to sheet home individual accountability.'[18] However, the law makes no attempt to ensure that this occurs.[19]

Deterring future contraventions will be problematic where liability for the contravention is not directed towards the individual who is responsible for it. Fisse argued that

> [f]ines, no matter how large, do not guarantee that corporate offenders will respond by taking internal disciplinary action against those responsible. The cheapest and least embarrassing response may be simply to write a cheque in payment of the fine and continue with business as usual. It is readily apparent that companies have incentives not to undertake extensive disciplinary action.[20]

15 Fisse, above n 11, 8.
16 Ibid. See also Celia Wells, *Corporations and Criminal Responsibility* (2nd ed, 2001) 32–4.
17 Fisse and Braithwiate, above n 14, 468–9.
18 Ibid 469.
19 Ibid.
20 Fisse, above n 11, 7–8.

A disciplinary program may be embarrassing and disruptive to the company. It may have undesirable consequences if later civil action is taken against the company or its officers.[21]

Commentators have referred to the advantages of imposing personal liability for corporate fault on directors and other managers. According to Cowan,

> [o]ne obvious way to deter corporations without incurring the undesirable externalities associated with fines is to prosecute the culpable individuals within the organization. From the perspective of the individual wrongdoer, the prospect of a criminal conviction would deter far more than sanctions levied on the organization.[22]

Fisse and Braithwaite argued that 'individual accountability has long been regarded as indispensable to social control.'[23] Directors would be more accountable and more inclined to ensure that their corporation complied with the relevant provisions if personal liability for the contravention was imposed on them directly.[24] If a director believes that he may be subject to personal liability this should provide a strong incentive for him to monitor the corporation's activities and implement preventative programs to avoid future breaches.[25] This incentive should be applicable to all directors of all corporations.

While this article recognises the difficulties associated with corporate criminal liability it does not advocate the abandonment of that form of liability in preference to individual liability. A system that allows for both corporate and individual liability is the preferred option because it gives the regulator greater flexibility.[26] There may be situations where it is not possible to proceed against individuals and corporate liability may be the only option.[27] In other situations individual rather than corporate liability will be the most appropriate choice.

While the benefits of imposing any form of liability on company directors and managers are obvious, the disadvantages are more subtle. The fear that liability would 'result in a disincentive for persons to accept or continue to hold

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21 Ibid 8. See also Fisse and Braithwaite, above n 14, 469–72.

22 Andrew Cowan, 'Scarlet Letters for Corporations? Punishment by Publicity Under the New Sentencing Guidelines' (1992) 65 *Southern California Law Review* 2387, 2393 (footnotes omitted).

23 Fisse and Braithwaite, above n 14, 473.

24 *Personal Liability for Corporate Fault*, above n 1, [3.2].

25 Ibid. See also Khanna, above n 7, 1495.

26 Khanna, above n 7, 1494-1496 and Fisse and Braithwaite, above n 14, 489 and 494.

27 Fisse and Braithwaite, above n 14, 489, 494.

directorships or engage in entrepreneurial but responsible risk taking' was noted in the terms of reference from Senator Campbell to CAMAC.[28]

Bostock is one of a number of commentators concerned with the statutory imposition of liability on directors.

> Developments in statute law, however, in its ever burgeoning quantity, are of increasing concern, not only [to] company directors but also to the community at large. The imposition on directors of strict statutory liability for the acts or omissions of others is both inherently unfair and demonstrates a misapprehension of the role of directors in relation to the business operations of their companies. It will also inevitably make people of ability, achievement, integrity and wisdom all the less willing to assume the risks now inherent in the office of director, some of which are not insurable. It must also be remembered that the general level of fees paid by listed Australian companies to their non-executive directors is, to say the least, by no means extravagant.
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> Recent tendencies in statute law in relation to company directors, involving as they do the imposition of strict liability, reversed onus of proof, imputed knowledge and other forms of what one could call legislative amorality, can perhaps be seen as reflecting the distinction between the process of the common law and the process of legislation in laying down duties and standards of conduct.
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> The process of the common law is an evolutionary one, developments occurring by the decisions of judges on the basis of underlying accepted principles of law to known facts in the light of forensic argument. Law, as the product of legislation, can be – and has been – seen as the attempt to design rules to govern conduct in an infinite variety of future, and hence unknowable, circumstances. It tends to be the product of prejudice, as opposed to knowledge and experience. It can thus be seen as being more revolutionary than evolutionary.[29]

If an unacceptable degree of liability is imposed on directors, experienced, well-qualified business people may be reluctant to take up directorships,[30] thus depriving companies of a valuable resource. Oesterle remarked that

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28 Senator Ian Campbell, above n 2.

29 Tom Bostock, 'To Whom Are the Duties of a Company Director Owed ?' (Speech delivered at the Australian Institute of Company Directors and the Centre for Corporate Law and Securities Regulation, University of Melbourne, 8 November 2000), 18–19.

30 See Justin Dabner, 'Trading Whilst Insolvent – A Case for Individual Creditor Rights Against Directors' (1994) 17 *University of New South Wales Law Journal* 546, 561; also Dale Oesterle, 'Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders' in Ian Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (2000) 19, 29. The American experience following *Smith v Van Gorkom,*

> executives on boards will be more likely to resign at the first sign of trouble. Firms may find themselves looking for directors to fill vacancies and to make critical decisions just when good business people will slam the door on inquiries.[31]

Moreover, imposing liability on directors may be detrimental to a large company's ability to attract non-executive directors.[32] Finch commented:

> The outsider faces severe obstacles in monitoring board activity and the prospect of being held liable for failing in such monitoring functions may prove an excessive deterrent to non-executive direction, notably when the economic benefits of non-executive direction are seen to be dwarfed by potential liabilities for damages.
> Alternatively, companies when selecting outside directors may seek to avoid such problems by choosing directors who are either non-risk averse or uncritical of risk taking. An incentive to select on such a basis would run counter to notions of the outside director as a check on corporate folly.[33]

Finch also observed that the imposition of liability may lead to inappropriate delegation to subordinates or outside consultants to avoid directors bearing personal responsibility.[34]

Another difficulty is the cost of imposing liability as the directors may demand compensation for being exposed to it. Like other employees, directors generally are

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488 A 2d 858 (Del, 1985) should be noted here. The Delaware Supreme Court held directors liable for gross negligence and thus the directors were unable to avail themselves of the protection of the business judgment rule. 'The corporate bar responded to the decision with horror…. Stockholders' suits against directors increased at a dramatic rate. With director and officer (D&O) liability insurance premiums increasing to levels that many companies could not afford, a large number of board members in the mid –1980s resigned rather than risk exposure to liability, as their companies "went bare". Even some directors who had insurance resigned because they had too many exclusions in their policies or had inadequate protection.' Ramesh KS Rao, David Sokolow and Derek White, 'Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm' (1996) 22 *Journal of Corporation Law* 53, 58-9. (footnotes omitted).

31 Oesterle, ibid 30.

32 Oesterle said 'Expose (non-executive) directors to personal liability and one will see many resign from all but the healthiest of companies. Firms cannot pay them enough to compensate them for the personal risk. Sadly, outside directors are the least needed in the best running companies and are the most needed in companies that are suffering through difficult times' Ibid 31.

33 Vanessa Finch, 'Personal Accountability and Corporate Control: The Role of Directors and Officers' Liability Insurance' (1994) 57 *Modern Law Review* 880, 885.

34 Ibid 884–5.

unable to minimise their risk by diversification. As Easterbrook and Fischel pointed out:

> The problem with managerial liability is that risk shifting may not work perfectly. … a legal rule of managerial liability creates risks for a group with a comparative disadvantage in bearing that risk. This inefficiency leads to both an increase in the competitive wage for managers and a shift away from risky activities. And there is no guarantee that the social costs of this shift away from risky activities will not exceed the social costs of the excessively risky activities in the absence of managerial liability.[35]

In addition, directors have clear duties to the company already,[36] which are enforceable by the company or, during insolvency, by the company's liquidator.[37] It could be argued that these duties already provide an adequate deterrent to directors acting improperly. However, it should be noted that the vast majority of companies — nearly 99 per cent — are proprietary companies.[38] Where directors are often the dominant or sole shareholders, the fear of removal from office or the commencement of a statutory derivative action by shareholders will not provide a sufficient incentive to directors of proprietary companies to obey the law.

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35 Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991) 62. Byrne agreed that directors 'are extremely poor risk bearers. Directors, particularly when bound in service to one company, are unable to diversify their investment and spread their risk. Their personal liability may be unlimited. It would necessarily follow, in the same way that creditors seek compensation for the increased risks [due to] limited liability, that the directors would need proper compensation for their risk. Given the inability of the director to avoid the potential liability or reduce its impact as an inefficient risk bearer, the compensation would have to be quite high.' Mark Byrne, 'An Economic Analysis of Directors' Duties in Favour of Creditors' (1994) 4 *Australian Journal of Corporate Law* 275, 282. (footnotes omitted).

36 The statutory duties owed by directors to the company are *Corporations Act 2001* (Cth) s 180 (care and diligence), s 181 (good faith), s 182 (use of position) and s 183 (use of information).

37 *Corporations Act 2001* (Cth) ss 1317J(2) gives the corporation standing to apply for a compensation order if one of the statutory duties have been contravened. *Corporations Act 2001* (Cth) ss 477(2)(a) gives the liquidator standing to bring any legal proceeding in the name of the company.

38 As at the 30/6/04 there were approximately 1,309,870 companies in Australia, of which approximately 1,291,110 were proprietary companies and 18,670 were public companies. Approximately 1,400 public companies are listed on the Stock Exchange. Email from Debbie Cowley, Product Team, ASIC, to Helen Anderson 6 December, 2004.

The most commonly cited objection to a personal liability regime is that directors' fear of liability may make them overly cautious.[39] This risk-averse behaviour[40] on behalf of directors could be detrimental to the achievement of the company's profit and wealth maximisation objectives[41] although Keay reasoned that the additional care taken by directors under conditions of potential liability is, in fact, beneficial to the shareholders. He contended:

> The argument that monitoring activity is costly and reduces efficiency masks the fact that monitoring is a necessary element of responsible corporate governance and a natural part of directors' functions, whether or not a duty to creditors exists … Rather than inhibiting efficiency, it might well lead to improvements that could be made in the company's procedures and profit-making processes … [42]

In 1989 the Senate Standing Committee on Legal and Constitutional Affairs[43] ('the Cooney Committee') considered the directors duty provisions that were contained in the *Corporations* Law. The Cooney Committee acknowledged the fear that liability may affect directors' behaviour adversely and lead to unfavourable economic consequences. The Cooney Committee noted that

> [t]he more productive the corporate sector, the more secure the economic well-being of Australia. Directors are crucial to its success. To restrict unnecessarily the operation of their skills, their industry, their enterprise, is to threaten unnecessarily a factor vital to economic growth. Any regulation of

39 Coase argued that it is wrong to simply impose restraints upon director behaviour without weighing up the total cost of that intervention. Ronald Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1, 2. See also Jonathan Lipson, 'Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation' (2003) 50 *UCLA Law Review* 1189, 1244.

40 Eugene Fama and Michael Jensen, 'Agency Problems and Residual Claims' (1983) 26 *Journal of Law and Economics* 327, 327.

41 Note however, that Modigliani and Miller contended that while the recognition of a duty to creditors causes costs to the company, directors and shareholders, the costs are offset by a correlative reduction in the cost of the credit, so that the position of the parties remains unchanged, in a state of economic equilibrium. Franco Modigliani and Merton Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48 *American Economic Review* 261, 267–70. This statement, however, is only true with respect of those creditors with the capacity to pass on the cost of bearing the risk, and who therefore charge less when their position is more protected. This is not the case with all creditors.

42 Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *Modern Law Review* 665, 686.

43 Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989).

> directors' activities must be warranted and a sensible balance must be found between measures necessary to promote corporate activity in a way which will be of benefit to all, and measures necessary to protect the bona fide shareholder, worker, consumer, financier, and the public at large. Profitability is but one basis for good corporate citizenship. [44]

Whether or not risk deterrence is ultimately of benefit or detriment to shareholder wealth maximisation, the law must ensure that a director liability regime meets the appropriate needs of the law without stifling the entrepreneurial spirit of directors unduly. Individual liability is necessary because corporate criminal liability alone may be an insufficient incentive for directors to implement adequate strategies for the avoidance of a contravention of the provisions that are the subject of the CAMAC review.

However this article recognises that the imposition of personal liability on directors and managers may discourage suitable persons from accepting or continuing to hold directorships. In addition the imposition of this liability may discourage directors from engaging in entrepreneurial but responsible risk taking. This article will consider the types of liability suggested in the CAMAC Discussion Paper and will recommend that in order to give due consideration to the arguments discussed above, criminal liability should be imposed only when certain fault elements can be established. The fault elements that will be considered are intention or knowledge, recklessness and negligence.[45]

IV APPROPRIATE TYPES OF LIABILITY

As the company is an inanimate artificial entity, its liability derives, either by statute or common law rule, from the actions or omissions of its directors, servants

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44 Ibid [2.39].

45 Intention, knowledge, recklessness and negligence are concepts of fault that are contained in the *Commonwealth Criminal Code* ('the code'). Since 15 December 2001 the code has applied to all Commonwealth criminal offences. The code recognises that criminal liability may be imposed where intention, knowledge, recklessness, or negligence can be established. These fault elements are defined in Chapter 2 of the code. For an explanation of the fault elements contained in the code see Attorney General's Department in association with the Australian Institute of Judicial Administration *The Commonwealth Criminal Code: A Guide for Practitioners (2002),* Ian Leader-Elliott 'The Commonwealth Criminal Code: An Introduction to the General Principles' (2001) 5 *The Judicial Review* 297 and Ian Leader-Elliott 'Elements of Liability in the Commonwealth Criminal Code' (2002) 26 *Criminal Law Journal* 28.

or agents.[46] However, it is somewhat artificial to say that a director or agent's liability is attributed to the company, because generally the company is found to have breached the particular piece of legislation and then the inquiry becomes whose actions or omissions brought about the liability.

The types of liability which can be imposed at the present time are: the direct or accessorial liability of the person whose actions or omissions are to be attributed to the company, the company itself either vicariously or via the identification doctrine, and finally the director or manager who bears responsibility derivatively.

The main issue of concern in the CAMAC Discussion Paper is whether the criminal liability imposed on directors as a result of the corporation's contravention of certain provisions should be direct, accessorial or derivative. The meaning of the terms 'direct', 'accessorial' and 'derivative', which are used in the Discussion Paper, need to be established. Direct liability refers to situations where the director is held liable because of his or her own conduct. Examples of direct criminal liability are many and include the statutory directors' duties,[47] and the duty to prevent insolvent trading[48] under the *Corporations Act 2001* (Cth)[49] and duties under other legislation set out in Appendix 1 of the Discussion Paper.

Accessorial liability is a form of direct liability, in that it relates to the conduct of the directors themselves. Usually it occurs where a director has aided or abetted a contravention, been knowingly concerned in a contravention, or has conspired with others to effect a contravention. The Discussion Paper states that

> [u]nder general common law principles, accessorial liability focuses on the actual level of awareness and involvement of an individual in a contravention, not simply whether that person is a director or other officer of a corporation. The prosecution must prove beyond reasonable doubt that the person was an intentional participant, who knew the essential facts that constitute the offence

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46 The purpose of the organic theory of the company, which originated in *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705, 713-4 is to attribute to the company liability for actions and intentions which might otherwise fall solely on the particular actor. In *HL Bolton (Engineering) Co Ltd v TJ Graham & Sons Ltd* [1957] 1 QB 159, 172, Lord Denning explained that the managers of a company who control what it does can be its directing mind and will so that their intentions can be attributed to the company to make it liable. This is known as the identification doctrine. See Neil Campbell and John Armour, 'Demystifying the Civil Liability of Corporate Agents' (2003) 62 Cambridge Law Journal 290, 297.

47 *Corporations Act 2001* (Cth) s 184.

48 *Corporations Act 2001* (Cth) s 588G(3).

49 Hereinafter referred to as the *Corporations Act.*

> or was wilfully blind to them and was implicated or involved in the contravention.[50]

Derivative liability, by definition, derives from the company's own liability, hence the need to establish first that the corporation is liable and cannot avail itself of defences, before looking at the director's own liability.[51] Directors' derivative liability arises as a

> consequence of the positions they hold or the functions they perform in their corporation. This derivative form of liability arises without the need to establish that these persons either breached the law through their own misconduct or were accessories to the misconduct of their corporation.[52]

The Discussion Paper outlines four different types of derivative liability — positional liability, managerial liability, liability arising from a designated responsibility and participatory liability. The first three depend upon the person holding a certain position of responsibility in the company, in a formal capacity, as a manager or as an officer responsible for a particular area of compliance. Only the final category considers the actions or omissions of the person, and therefore overlaps with accessorial liability.[53]

As the Corporate Law Economic Reform Program (CLERP) *Directors' Duties and Corporate Governance* 1997 paper noted,[54] the purpose of liability is 'to provide a significant incentive for directors to put in place effective risk-management arrangements to ensure the corporation complies with its obligations'. Therefore liability should not be imposed on directors and managers who do the right thing — who put in place adequate safeguards to ensure that the companies they control comply with their obligations. Liability should be placed only on those directors who do not put in place these safeguards.

It is submitted that in situations where potential derivative liability arises, ie where the liability arises simply because person holds a certain position of responsibility in the company, criminal liability should not arise in the absence of proof of a fault element.

Although the CAMAC Discussion Paper discusses derivative liability it does not advocate derivative liability that that is not connected to fault. When the various forms of derivative liability outlined in the Discussion Paper are examined and

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50 *Personal Liability for Corporate Fault*, above n 1, [3.2].

51 Prior conviction of the corporation is usually not necessary in order for derivative liability to arise. See *Personal Liability for Corporate Fault*, above n 1 [4].

52 Ibid [1].

53 Ibid [6.2.1].

54 CLERP *Directors' Duties and Corporate Governance* 1997, [6.6].

examples are given,[55] it is clear that the form of liability proposed depends on the culpability of the actions or omissions of the particular person on whom the law, for policy reasons, considers it appropriate to impose liability. CAMAC appears to recognise that liability should be connected to fault. For example, 'positional/managerial liability' might appear to denote a strict liability provision; however, the example of positional liability given, at [6.3.2], speaks of knowledge, recklessness or negligence as to contravention of the law, as well as the requirement that the person failed to take all reasonable steps to prevent the contravention despite being in a position of influence in relation to the contravention.

Each of the templates put forward by CAMAC contains some fault element. For example the template recommended by the Australian Law Reform Commission[56] includes elements of positional liability as well as knowing or being reckless as to whether the contravention would occur, *and* failing to take steps to prevent the contravening conduct.[57]

The State template presumes liability on the part of the person unless he or she is able to prove one of a number of defences, such as that he or she was not in a position to influence the relevant conduct, or that he or she exercised all due diligence to prevent the conduct or took all reasonable steps to prevent the relevant conduct. Again, this defence is based on the faulty conduct of the person.

The emphasis needs to be on the degree of fault that attracts personal liability rather than being concerned with the categorisation of liability as direct, accessorial or derivative and within derivative, as positional liability, managerial liability, liability arising from a designated responsibility or participatory. A template that is concerned with the more fundamental question of whether fault can be attributed to the director should be adopted. If the aim of the imposition of liability is the modification of directors' behaviour, liability should always be related to fault. The issue then becomes how that fault is defined. It is submitted that the relevant consideration should be whether the behaviour of the director was criminal or civil.

It should be made clear that CAMAC's terms of reference[58] did not include a discussion of the relationship between directors' civil and criminal liability. Its main brief was to consider standardisation of the means of attributing liability for the purpose of regulatory efficiency. However, this article recommends a template

55 *Personal Liability for Corporate Fault,* above n 1, [6.2.1].

56 Ibid [9.2].

57 The ALRC template also required that the individual be in a position to influence the conduct of the body corporate in relation to the contravening conduct. This will excuse non-executive directors from liability for breaches occurring in the day to day business of the corporation.

58 *Personal Liability for Corporate Fault,* above n 1, [1.1].

that includes criminal as well as civil liability imposed pursuant to a civil penalty regime. According to the recommended template liability should not be assessed on the basis of whether or not it is direct, accessorial or derivative but rather on the basis of whether the behaviour of the director is more correctly classified as criminal or civil. The question then becomes the degree of fault that should attract personal criminal liability for the directors of companies and the degree of fault that should attract liability to a civil penalty.

The templates recommended here are not concerned with direct or accessorial liability. They are concerned with derivative liability. It is submitted that where derivative liability is in issue directors should not be subject to criminal sanctions unless they knew or were reckless to the fact that the corporation would commit the contravention. If directors are negligent to this possibility civil liability should apply.

The civil liability proposed in this submission is similar to duty of care contained in s 180(1) *Corporations Act* and common law negligence, both of which give rise to civil not criminal liability. However, this was not always the case. Prior to the *Corporate Law Economic Reform Act* 1999 (Cth),[59] the directors duty of care was contained in s 232 (4) *Corporations Law*. This section provided that 'an officer of a corporation must exercise a degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances'. This section was a civil penalty provision but a breach of the duty of care and diligence undertaken with dishonest intent amounted to a criminal offence.[60] Although the duty contained in s 232 (4) embodied the concept of negligence the law allowed for the imposition of a criminal penalty where a director had been 'dishonestly negligent'.

In 1989 the Cooney Committee considered these provisions.[61] In a submission to the Cooney Committee Professor Fisse referred the fact that the director's duty of care was a criminal provision. Fisse stated that

> [t]he main trouble with the offence under s. 229(2) as it now stands is that it is defined in terms of negligence rather than in terms of subjective blameworthiness. Generally speaking, the approach adopted in our system of criminal justice is to require proof of guilty intention, knowledge or recklessness, especially where the offence carries the possibility of a jail sentence.[62]

59 Hereinafter referred to as *CLERP Act.*
60 *Corporations Law* s 1317FA(1).
61 Senate Standing Committee on Legal and Constitutional Affairs, above n 43, [13.2].
62 Ibid [13.11].

The Cooney Committee recommended that criminal penalties apply only where the conduct in question is genuinely criminal in nature but that

> civil penalties be provided in the companies legislation for breaches by directors where no criminality is involved, and, in appropriate circumstances, people suffering a loss as a result of a breach be enabled to bring a claim for damages in the proceeding taken to recover the penalty. [63]

These provisions were amended by the *CLERP Act.* The explanatory memorandum to the *CLERP Bill* argued that the availability of criminal penalties for the directors' duty of care was not satisfactory as the concepts of negligence and dishonesty were inconsistent. 'Dishonesty suggests an active awareness of wrong doing, rather than a failure to exercise sufficient care and diligence.'[64] As a result of this reasoning the *CLERP Act* amended the law so that the current duty of care and diligence owed by directors attracts civil but not criminal penalties.[65]

The *Commonwealth Criminal Code* allows criminal liability to be imposed in certain situations where negligence has been established. However, Leader-Elliott states that although

> the Commonwealth *Criminal Code* concedes the possibility that criminal liability might be imposed for negligence, the concession was grudging and liability for negligence was accepted, at best, as an expedient compromise of fundamental principle.[66]

It is submitted that directors or managers who are not involved in, and are not accessories to, the corporation's commission of a relevant offence and who do not have knowledge of, or, are not reckless to the possibility of the commission of the offence should not be subject to criminal penalties. Rather, a director who negligently fails to prevent the commission of the offence should face civil liability. A director or manager in this situation should be treated in the same way as one who has contravened s 180(1) of the *Corporations Act* or has breached the duty of care under common law negligence. The relevant liability should be civil, not criminal.

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63 Ibid [13.15].

64 Explanatory memorandum to the Corporate Law Economic Reform Bill 1999 (Cth) [6.6].

65 *Corporate Law Economic Reform Act 1999* (Cth) s 180.

66 Leader-Elliott, 'Elements of Liability in the Commonwealth Criminal Code', above n 45, 28.

V The Proposed Liability Template

Issue 9.8 of the Discussion Paper asked whether some other general derivative liability template should be adopted. The following contains a recommendation as to the enforcement template that should be adopted, given the arguments outlined in this article. The proposed regime provides that directors will be criminally liable where they directly participate in or are accessories to the corporation's contravention. In addition directors will be criminally liable if derivative liability exists and the director had knowledge of, or, was reckless to the corporation's contravention. This ensures that criminal liability is imposed where criminal conduct has occurred.

The template provides for civil liability in situations where a director negligently fails to prevent the company committing the relevant criminal contravention. Directors will not be civilly liable if they can satisfy certain defences. Civil liability recognises the importance of ensuring that directors comply with these provisions and allows for non-criminal liability to be imposed in situations where criminal behaviour does not exist.

A *Criminal Liability*

Two forms of criminal liability are proposed. The first form of proposed criminal liability will be a form of direct liability and will relate to the conduct of the directors themselves. Criminal liability will arise where a director has aided or abetted a corporate contravention, been knowingly concerned in a corporate contravention, or has conspired with others to effect a corporate contravention. Under the proposed liability template the prosecution would be required to prove beyond a reasonable doubt that the director or manager 'was an intentional participant, who knew the essential facts that constitute the offence or was wilfully blind to them and was implicated or involved in the contravention.'[67]

The second proposed form of criminal liability is derivative liability. Directors will be liable when a corporation commits a contravention of a relevant provision and a director of that corporation while not being involved in or an accessory to that contravention

- was in a position to influence the conduct of the corporation in relation to the contravening conduct,
- knew that or was reckless as to whether the contravening conduct would occur and
- failed to take all reasonable steps to prevent the intervening conduct.

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67 *Personal Liability for Corporate Fault*, above n 1, [3.4].

B *Civil Penalty Provisions*

A second tier of liability should be introduced. The proposed second tier would provide civil liability which would be enforced by a civil penalty regime. The proposed regime is similar to the civil penalty regime contained in Part 9.4B of the *Corporations Act*. The civil penalty regime would provide for a form of derivative liability but the consequences flowing from that liability would be civil, not criminal.

It is submitted that a duty should be imposed on directors and managers to ensure that the corporations they control do not commit an offence under the relevant Act. Therefore, by definition, if the corporation is convicted of an offence, the director or manager must have breached his or her duty to prevent the company from committing that offence. However, to ensure that liability is not unfairly harsh with resultant risk aversion and the other adverse consequences outlined above from the imposition of liability, the proposed regime would provide defences. The proposed defences would include a due diligence defence and a reasonable director or manager defence.

The proposed civil template is similar to the State and Territory representative template detailed in the Discussion Paper.[68] The main difference between that template and the template proposed here is that the liability flowing from the template in the Discussion Paper is criminal whereas the liability flowing from the template proposed here is civil.

The template proposed here provides that

> any director or other person who is concerned, or takes part, in the management of the corporation is under a duty to prevent the corporation contravening the relevant legislation;
>
> where a corporation contravenes the relevant legislation any director or other person who is concerned, or takes part, in the management of the corporation has breached his or her duty and is liable to a civil penalty order unless the person proves:
>
> - that they were not in a position to influence the relevant conduct,
> - or that they
>
>   i. exercised all due diligence to prevent the relevant conduct, or
>   ii. took all reasonable steps to prevent the relevant conduct.

68 Ibid [9.3].

The first of these defences — that they were not in a position to influence the relevant conduct — is important in safeguarding the position of non-executive directors. As noted above, such non-executive directors serve an important oversight function in companies and should not be deterred from accepting such positions by the fear of excessive liability.

The standard of proof proposed is the civil standard. The civil penalty orders available under the proposed regime would be those orders that are available under Part 9.4B of the *Corporations Act*. They are pecuniary penalties, banning orders and compensation orders. Pecuniary penalties would allow the courts to impose a punitive order on directors and managers who fail to prevent the company committing the contravention. Banning orders would protect third parties from future contraventions as well as being punitive. Compensation orders would be appropriate in situations where there is no other compensatory scheme available.

These orders, while containing a punitive element, fall short of criminal penalties. Directors and managers who breach the proposed duty would not face the stigma that is associated with the conviction of a criminal offence, nor would they face the possibility of incarceration. It is submitted that this is an appropriate outcome when the behaviour of the director or manager concerned could not be described truly as criminal. [69]

C *Third Tier – Lesser Penalties, Education and Persuasion*

It is proposed that a third tier of liability should be introduced. Where corporations commit relatively minor contraventions, directors and managers should face this type of personal liability. It could involve the director or manager being warned, minor pecuniary penalties being imposed or orders being made that the director or manager undertake a relevant education program or implement a relevant compliance program.

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[69] *Corporations Act 2001* (Cth) s 1317P allows a criminal prosecution to be issued against a person for conduct that is substantially the same as conduct that constitutes a contravention of a civil penalty provisions, even if the prior civil penalty proceedings have been finalized and orders made. Civil penalty proceedings have been finalised and orders made against Rodney Adler and other directors of HIH Ltd. *ASIC v Adler No 6* (2002) 20 ACLC 1,183. Later criminal proceedings arising out of conduct that was substantially the same as the conduct that was found to have constituted the contraventions of the civil penalty provisions were issued against Rodney Adler. *R v Adler* (2005) 23 ACLC 590.

VI ADVANTAGES OF THE PROPOSED LIABILITY TEMPLATE

Adoption of a template that includes both criminal and civil penalties provides various advantages. The first advantage, that it allows consideration to be given to the degree of fault displayed by the director or manager of the offending corporation, has been discussed in detail above.[70] The second advantage that flows from the adoption of a regime that includes both criminal and civil penalties is that the availability of civil penalties could overcome many of the difficulties that are associated with the obtaining of corporate criminal prosecutions. Thirdly, the adoption of the alternative template would comply with strategic regulation theory. Finally, the adoption of a civil penalty regime will increase the range of orders that are available by allowing the courts to issue banning, pecuniary penalty and in appropriate circumstances, compensation orders. The following section of the article considers some of these advantages in detail.

A *The Template Overcomes Many of the Difficulties Associated With Traditional Criminal Enforcement Regimes*

Commentators have recognised the difficulties that can arise with the application of criminal enforcement regimes in the corporate context. A template that contains both criminal and civil penalties can overcome many of the difficulties that are associated with a regime that relies exclusively on criminal penalties.

For many reasons convictions for corporate criminal offences are difficult to obtain.[71] Often corporate criminal offences are difficult to detect. In 1994 Alan Cameron, the then Chairman of the Australian Securities Commission referred to the Commission's responsibility to

> take proactive steps to discover, investigate and prosecute or refer to the DPP for prosecution circumstances constituting a crime. However, such offences in

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70 The Cooney Committee recognised the importance of ensuring that criminal penalties apply only where the conduct in question is genuinely criminal in nature, and that civil penalties be provided for breaches by directors where no criminality is involved. See Senate Standing Committee on Legal and Constitutional Affairs, above n 43, [13.12 and 13.14].

71 See Henry Bosch, 'Bosch on Business' (1992) *Information Australia* 1, 1; Seumas Miller, 'Corporate Crime, the Excesses of the 80's and Collective Responsibility: an Ethical Perspective' (1995) 5 *Australian Journal of Corporate Law* 139, 162; Roman Tomasic, 'Corporations Law Enforcement Strategies in Australia: The Influence of Professional, Corporate and Bureaucratic Cultures' (1993) 3(2) *Australian Journal of Corporate Law* 192; Roman Tomasic, 'Corporate Crime' in Duncan Chappell and Paul Wilson (eds), *The Australian Criminal Justice System The Mid l990* (1994) 263 and Roman Tomasic, 'Corporate Crime in a Civil Law Culture' (1994) 5 *Current Issues In Criminal Justice* 244, 251.

> the corporate arena often escape early identification despite the best endeavours of …surveillance programs… There is rarely to be found a freshly broken window, recent blood stain or a still warm body to suggest immediately that a crime may have recently been committed. Even when it has become apparent that there may have been a crime committed, the form the crime took, those involved and the gathering of evidence is an arduous task.[72]

Even if a corporate crime is detected it can be very difficult to prove. Henry Bosch stated that

> the evidentiary requirements of the criminal law and the need to prove complex cases beyond reasonable doubt have greatly reduced the effectiveness of regulation and policing of the companies and securities area. They have reduced the likelihood that malefactors will be punished and have acted as a protection for the unscrupulous.[73]

In many cases offenders are powerful and well resourced and are able to take advantage of the vagaries of the criminal law. According to Tomasic there is a 'widespread view that the criminal justice systems [is] a poor mechanism for dealing with corporate law offences. One reason for this [is] the proposed reluctance of the courts to convict white collar or corporate offenders.'[74] It has been argued that in the unlikely event that an offender is prosecuted and convicted, the sanction imposed often bears little relation to the harm inflicted or the profits made by the corporation in breaching the particular law.[75]

If these same difficulties arise in relation to the criminal enforcement regimes proposed in the CAMAC derivative liability templates, compliance with the relevant legislative provisions will not be assured. A criminal enforcement regime will not provide a significant level of deterrence if there is limited prospect of a criminal conviction being obtained. The use of civil penalties in the proposed liability template will overcome many of these difficulties.

The civil penalties contained in the proposed regime would overcome many of the difficulties associated with the enforcement of corporate criminal offences. Civil penalty provisions provide an alternative to traditional criminal enforcement regimes.

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72 Alan Cameron, 'Getting the Regulatory Mix Right' (1994) 4 *Australian Journal of Corporate Law* 121, 122.

73 Ibid.

74 Tomasic, 'Corporations Law Enforcement Strategies in Australia' above n 71, 217. See also Tomasic, 'Corporate Crime above n 71.

75 Tomasic, 'Corporate Crime', above n 71, 263.

They are

> punitive sanctions that are imposed otherwise than through the normal criminal process. These sanctions are often financial in nature, and closely resemble fines and other punishments imposed on criminal offenders. However, the process by which these penalties is imposed is decidedly non-criminal.[76]

In 1994 Michael Gillooly and Nii Lante Wallace-Bruce examined the civil penalty provisions contained in the *Industrial Relations Act 1988* (Cth), the *Trade Practices Act 1974* (Cth), the *Corporations Law* and the uniform consumer credit legislation. Gillooly and Wallace-Bruce noted that

> [c]ivil penalty provisions are an increasingly common feature of both State and Federal legislation in Australia. Such provisions authorise the imposition of penal sanctions upon persons who contravene the legislation notwithstanding that their liability need only be established on the civil standard of proof and in proceedings that employ the civil rules of practice and procedure. In this way the Legislature seeks to ensure compliance with the key provisions of its statutes.[77]
>
> Civil penalties have a defined function. They play a crucial role in ensuring compliance with specific provisions of the legislation. In all the Acts examined, it is plain that the provisions which may attract a civil penalty are regarded as 'key provisions' by the legislature. If these provisions are not complied with, there is a real risk that the aims of the legislation in each case will be defeated… The Legislature therefore finds it necessary to particularly encourage compliance with those provisions, not by turning persons who contravene them into criminals nor merely by rendering such persons liable to pay compensation, but rather by employing the convenient 'half way house' of civil penalties.[78]

Civil penalties are attractive enforcement mechanisms because they allow the relevant regulator to obtain an enforcement order on the civil standard of proof. [79] The increased likelihood of a civil penalty order being made against directors and

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76 Michael Gillooly and Nii Lante Wallace-Bruce, 'Civil Penalties in Australian Legislation' (1994) 13 (2) *University of Tasmania Law Review* 269, 269. For a discussion of the reasons for the introduction of the civil penalty regime into the *Corporations Act*, see Vicki Comino, 'National Regulation of Corporate Crime' (1997) 5 *Current Commercial Law* 84 and Explanatory Memorandum, Corporate Law Reform Bill 1992.

77 Gillooly and Wallace-Bruce, above n 76, 269.

78 Ibid 288.

79 See for example *Corporations Act 2001* (Cth) s 1317L.

managers should provide an increased deterrent to encourage them to ensure that the corporation complies with the relevant legislation.

An example of a civil penalty regime is the regime contained in Part 9.4B of the *Corporations Act.* Although the number of civil penalty applications issued by ASIC pursuant to Part 9.4B is not large, ASIC has been making increasing use of the civil penalty regime in high profile cases. For example, since 2000, civil penalty applications have been issued against directors involved in high profile corporate collapses including the directors of the HIH group of companies, the Water Wheel groups of companies and One.Tel Ltd.

ASIC has achieved a successful outcome in most of the civil penalty applications it has issued. For example, from March 1993 to May 2004, 19 applications for civil penalty orders issued by ASIC were finalised. In all but one of these 19 cases, ASIC obtained a declaration that a contravention of a civil penalty provision had been committed and civil penalty orders were imposed on the defendant.[80]

B *The Template Complies with Strategic Regulation Theory*

Another advantage that flows from a proposed template that includes criminal sanctions, civil penalties and lesser penalties is that it complies with strategic regulation theory.[81] Strategic regulation theory 'offers insights into how regulatory compliance can be most effectively secured.'[82]

Strategic regulation theory relies on the premise that the actions of different persons will be motivated by different factors and that a successful regulatory agency will need to have a range of enforcement options available to it to enable it to deal with actors who are subject to those different motivational factors. A regulatory regime could not operate effectively if it was based solely on a strategy of persuasion and self-regulation nor could it operate successfully if it was based solely on a strategy of punishment.[83] Some business actors will be motivated purely by economic factors while others will be motivated by a sense of social responsibility. Some will

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80 See Michelle Welsh, 'Eleven Years On – An Examination of ASIC's Use of an Expanding Civil Penalty Regime' (2004) 17 *Australian Journal of Corporate Law* 175, 190.

81 For a discussion of the application of Strategic Regulation Theory see George Gilligan, Helen Bird and Ian Ramsay, 'Civil Penalties and the Enforcement of Directors' Duties' (1999) 22(2) *University of New South Wales Law Review* 417; Helen Bird et al, 'Strategic Regulation and ASIC Enforcement Patterns: Results of an Empirical Study' (2005) 5(1) *Journal of Corporate Law Studies* 191.

82 Gilligan, Bird and Ramsay, above n 81, 419.

83 Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992) 24.

be motivated by a combination of these and other factors. The motivational factors influencing the behaviour of individual actors will change over time.[84]

Because of these different motivational factors, different enforcement strategies are required to ensure compliance with the law. Those who are motivated by a sense of social responsibility could be regulated effectively by a regime that relied on persuasion or self-regulation. A regime based on punishment would be required to regulate those who are influenced solely by economic considerations. However such a regulatory regime could undermine the good will of business actors within the group who were motivated by a sense of responsibility.[85]

The need for a range of enforcement options was highlighted by Ayres and Braithwaite in situations where the regulator is armed with a single enforcement option. This is especially true when the single enforcement option is severe. If a regulator has only one single severe enforcement option it is politically impossible to use it except with the most serious of offences. When less serious offences occur regulators have no enforcement mechanisms at their disposal. When only one drastic enforcement mechanism is available, regulators 'often find themselves in the situation where their implied plea to co-operate or else has little credibility. This is one case of how we can get the paradox of extremely stringent regulatory laws causing under-regulation.'[86]

Ayres and Braithwaite reasoned that 'the trick of successful regulation is to establish a synergy between punishment and persuasion'.[87] They argue that

> compliance is most likely when regulators (1) have access to an armoury of deterrent and incapacitative weapons and (2) when they avoid the mistake of selecting a sledge hammer to swat a fly and selecting a fly swat to stop a charging bull. Compliance is predicted by the existence of an awesome armoury and by the avoidance of clumsy deployment of it.[88]

The proposed templates provide regulators with a variety of enforcement mechanisms. They are minor penalties, education orders and persuasive measures, civil penalties and criminal sanctions.

Not only do regulatory agencies require a variety of enforcement mechanisms but those enforcement mechanisms must be ordered correctly. According to Ayres and Braithwaite if the enforcement mechanisms are ordered correctly 'every escalation

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84 Ibid.
85 Ibid.
86 Ibid 36.
87 Ibid 25.
88 Ibid 52.

of non-compliance by the firm can be matched with a corresponding escalation in punitiveness by the state.'[89]

Usually strategic regulation theory is represented graphically by the pyramid model.[90] The pyramid model was developed and expanded by John Braithwaite, Brent Fisse and Ian Ayres. It requires the regulator to be armed with a range of sanctions with education and persuasion at the base, various other stages in the middle and incapacitation at the apex.

Is it vital that the pyramid should contain a variety of enforcement measures that can escalate in severity in proportion to the nature of the contravention that has been committed. Ayres and Braithwaite argued that

> [r]egulatory agencies have maximum capacity to lever co-operation when they can escalate deterrence in a way that is responsive to the degree of uncooperativeness of the firm, and to the moral and political acceptability of the response. [91]

The regulatory agency should move from one level to another, commencing at the lowest level in the majority of cases. Gilligan, Bird and Ramsay contended that

> [t]he goal of the pyramid enforcement model is to stimulate maximum levels of regulatory compliance. Regulators start by assuming that the regulated are willing to comply voluntarily (whether in a self-regulated or public agency environment). In an ideal world the regulated would not need any inducement or threat from the regulator. However, the regulator must accept the reality of non-compliance and be prepared to move 'up' the enforcement pyramid. The rationale of strategic regulation theory and the pyramid model is that the regulated will comply sooner or later through a combination of normative desires and instrumental deterrence.[92]

The economic premise that underpins strategic regulation theory is that regulation is best secured through persuasion because it is the least costly of the enforcement measures. However for persuasion to be effective there must be a real threat of punishment underpinning the regulators conciliatory actions or gestures. If persuasion fails the regulator must be able to rely on an integrated set of sanctions. These sanctions should escalate in severity in comparison with the nature of the contravention that has been committed.[93]

89 Ibid 37.
90 Gilligan, Bird and Ramsay, above n 81, 425.
91 Ayres and Braithwaite, above n 83, 36.
92 Gilligan, Bird and Ramsay, above n 81, 426.
93 Ibid 425.

Fisse and Braithwaite stated that

> [a] central idea behind pyramidal enforcement is the game theory postulate that actors, individuals or corporate, are most likely to comply if they know the enforcement is backed by sanctions which can escalate in response to any given level of non-compliance, whether minor or egregious. The pyramid proposed is tall rather than squat, the theory being that the taller the enforcement pyramid, the more the levels of possible escalation, then the greater the pressure that can be exerted to motivate 'voluntary' compliance at the base of the pyramid. Compliance is thus understood within a dynamic enforcement game where enforcers try to get commitment from corporations to comply with the law and can back up their negotiations with credible threats about the dangers faced by defendants if they choose to go down the path of non-compliance.[94]

Ayres and Braithwaite reasoned that a successful enforcement pyramid should have persuasion as a strategy of first choice. In the case of the provisions that are the subject of the CAMAC review punishment as a strategy of first choice would be unworkable and unaffordable due to the large number of corporations and corporate actors. Punishment as a strategy of first choice would also be counterproductive because it would undermine the goodwill of those actors who are motivated by a sense of social responsibility. Braithwaite argued that usually actors who are motivated by a sense of social responsibility will be committed to compliance. He argues further that if actors who are committed to compliance are faced with a regulator who, through the behaviour of one of its enforcement officers, communicates to the actor that the regulator assumes that they are untrustworthy, this can destroy the virtue of the actor. Braithwaite stated that:

> Common sense and a wealth of experimental psychological research instructs us that when human beings are compelled to do something their commitment to doing it erodes. More precisely, commitment erodes in comparison with a situation where they voluntarily choose to do a thing because they are persuaded that it is the right thing to do.[95]

Therefore a successful enforcement regime must allow virtuous actors the chance to be virtuous and to comply voluntarily with the law. However, in situations where corporate actors do not respond to persuasion or self regulation a successful regulatory regime would be required to have at its disposal some form of punishment to force the actors to comply.[96] Fisse and Braithwaite maintained that

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94 Brent Fisse and John Braithwaite, *Corporate Crime and Accountability* (1993) 143. See also Ayres and Braithwaite, above n 83, 38–46.

95 John Braithwaite, 'Responsive Business Regulatory Institutions' in C A J Coady and Charles Sampford (eds) *Business Ethics and the Law* (1993) 83, 85.

96 Ayres and Braithwaite, above n 83, 26.

> [w]hen regulatory persuasion and advice fail, warnings escalate to civil monetary penalties, to negotiation of voluntary accountability agreements, to accountability orders mandated by the courts to corporate criminal sanctions escalating from fines to community service to punitive injunctions and, if necessary, corporate capital punishment (for example, licence revocation).
> The exact form of the pyramid may well vary from jurisdiction to jurisdiction, depending on such factors as the particular modes of regulation to which locals are accustomed, and the extent to which lawmakers are prepared to exercise their imagination.[97]

The enforcement mechanisms included in the proposed templates are ordered from the least to the most severe. This allows the regulator to respond in proportion to the nature of the contravention that has been committed. It also allows virtuous directors and managers to comply voluntarily with the law. Lesser penalties, education and persuasive measures are available as a first resort. If the use of these enforcement mechanisms does not secure compliance the regulator can escalate its response to a civil penalty application and, if necessary, to an application for criminal sanctions.

VII Conclusion

In order to ensure that corporations comply with the statutes that are the subject of the CAMAC review, personal liability must be imposed on directors and managers. The Discussion Paper concentrates on the nature of the criminal liability to be imposed on directors, specifically whether that liability should be direct, accessorial or derivative.

The article argues that the imposition of criminal liability on directors should not depend on classification as direct, accessorial or derivative. Instead, liability should depend on fault, and the degree of fault which attracts criminal liability should be determined as a question of public policy. An alternative scheme of liability which matches the degree of fault with an appropriate measure of punishment is proposed. This is achieved by the use of both criminal as well as civil penalties.

The proposed liability templates provide that directors will be criminally liable where they directly participate in or are accessories to the corporation's contravention. In addition directors will be criminally liable if derivative liability exists and the director had knowledge of, or, was reckless to the corporation's contravention. In addition, the templates provide for civil liability in situations

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97 Fisse and Braithwaite, *Corporate Crime and Accountability,* above n 94, 143. See also Ayres and Braithwaite, above n 83, 35–6.

where a director negligently fails to prevent the commission of the criminal act by the company.

A template that includes civil penalties is preferable because it allows consideration to be given to the degree of fault displayed by the director or manager of the offending corporation. Civil penalties overcome many of the difficulties that are associated with the enforcement of traditional criminal regimes. In addition, the proposed liability templates are preferable because they comply with strategic regulation theory and allow for a greater range of sanctions to be imposed.