

## Directors Beware: Corporate Sanctions and Defences, a Matter for Review?

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The current global economic crisis appears to have brought about the desire to review sanctions, and possibly defences, with regard to company officers. In Australia the Ministerial Council for Corporations (MINCO) has been entrusted with the task of reviewing corporate laws relating to directors' liabilities. Evidence suggests that although criminal prosecution may be instigated following civil penalty proceedings, the Australian Securities and Investment Commission (ASIC) has not been forthcoming in taking such action due to the unlikelihood of successful prosecution. The thrust in potentially revising personal criminal liability of directors could herald a new phase in Australian corporate law.

### 1. Introduction

The financial collapses of banks, financial institutions and corporations world wide draw attention once again to the issues of corporate accountability and responsibility of those at the helm. The current global state of play highlights a number of pertinent flaws in the regulation of corporate entities. Namely, that in general, such entities have not been subjected to, nor burdened by, desirable external scrutiny from appropriate bodies. Further, there is often little in the way of direct personal ramifications for those in control of such entities, particularly where they have made poor business judgments founded on self-interest. In the context of Australia, we have in more recent times witnessed the collapse of corporate bodies such as Westpoint, Fincorp, Australian Capital Reserve, Opes Prime, and ABC Learning to name a few, which begs the question as to whether the time is rife for sanctions and defences relating to officers of corporations to be seriously reviewed.

### 2. Processes of Review

Within the framework of the corporations legislation lies the imposition of accountability<sup>1</sup> on 'officers'<sup>2</sup> of a corporation. In March 2007, Federal Treasury had sought public submissions about the efficacy of the existing civil and criminal sanctions for breaches of the *Corporations Act 2001* (Cth) and *Australian Securities and Investment Commission Act 2001* (Cth) by officers of corporations. An integral part of the exercise, was the consideration of whether existing sanctions be reviewed along with the possibility of extending defences available to officers of a corporation, in particular directors, for breaches of duties and other statutory provisions. A consultative paper,

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<sup>1</sup> See for example, *Corporations Act 2001* (Cth) ss 182-183 that impose respectively prohibitions on the misuse of position and information to gain an advantage or cause detriment to the corporation not merely on directors but other officers also.

<sup>2</sup> *Corporations Act 2001* (Cth) s9 defines the term 'officer' to include directors, company secretaries, persons who are involved in the management of the company or have the capacity to affect its financial standing, amongst others.

*Review of Sanctions in Corporate Law*,<sup>3</sup> ('consultation paper') was released in an attempt to open public debate on the matter.

Recommendations by Federal Treasury were expected to be released in November 2007, however a change in government brought this to an abrupt end. Attempts were made in the early part of 2008 to re-ignite the discussion on the review of sanctions and defences, but more pressing needs such as the focus on tax reform, petrol pricing strategies and the world wide financial crisis resulted in the postponement of the matter once again. It would appear however, that consideration for reform is now back on the agenda. A media release from Federal Treasury on 18 December, 2008<sup>4</sup> ('the media release'), announced that the Council of Australian Governments (COAG) was in agreement on the matter of harmonising laws on company director liability. The Ministerial Council for Corporations (MINCO) has been entrusted with the task of reviewing corporate laws relating to directors' liabilities. It is expected MINCO will submit to COAG its recommendations for harmonisation and reform in the latter part of 2009.

Without a doubt, a broad sweeping review of current corporate sanctions and defences has been some time in the making. Significant changes introducing civil sanctions for breaches of directors' duties were made to the *Corporations Law 1991* (Cth) in 1993. Prior to the introduction of civil sanctions for breaches of directors' duties, breaches were addressed exclusively by the imposition of criminal sanctions. In the lead up to the changes there had been concerns raised as to the appropriateness of harsh criminal sanctions, such as imprisonment, for breaches generally by directors. Also at the time, the courts demonstrated a great reluctance to impose harsher criminal sanctions on directors, opting instead for menial fines and thereby creating the appearance of the law being somewhat ineffectual and weak.<sup>5</sup> Subsequently, quite apart from a trickle of amendments introducing civil sanctions for other related matters, such as share capital transactions, management of managed investment schemes and market misconduct provisions,<sup>6</sup> a significant review of corporate sanctions has not been forthcoming. The Federal Treasury's media release could ultimately result in significant changes to current laws relating to directors' liabilities.

### 3. Matters for Consideration

Underlying the consideration of any proposed changes is concern over the impact that revised corporate sanctioning may have on the commercial viability of a corporation. The question is whether the threat of sanctions significantly impacts on directors' business judgments. In other words, is it possible to balance the issue of regulatory compliance (coupled with the threat of sanctions for non-compliance) with the desired capability of directors to take commercial risks unhindered? In particular, discussion regarding reviewing current corporate sanctions appears to reflect the associated concerns

<sup>3</sup> Australia. Treasury, *Review of Sanctions in Corporate Law*, (Canberra: Australia. Treasury, 2007).

<sup>4</sup> Australia. Treasury, 'Minister Welcomes COAG Decision on Directors' Liabilities' (Press Release, 18 December 2008).

<sup>5</sup> Such concerns were noted in the 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) [5.57].

<sup>6</sup> Australia. Treasury, above n 3, Table 1: Timeline of amendments to the system of civil sanctions, [2.32].

that such sanctions may unduly influence business decisions and engender an overly conservative approach by some directors to the detriment of business development.<sup>7</sup>

The concerns arise as existing corporate sanctions are perceived to be restrictive, particularly as they discourage responsible risk taking. The restrictive nature of the sanctions purportedly cause economic and commercial drawbacks such as reduced entrepreneurship with the flow on effect of reduced product development, investment potential, performance outcomes, profit margins and returns to shareholders. As cautioned by the Taskforce on Reducing Regulatory Burdens on Business, a 'risk-averse approach to business may limit their [directors'] willingness to adopt innovative approaches in developing products and meeting new challenges. It would also be reflected in an overly cautious approach to compliance such as in product disclosure statements. This would undermine the overall efficiency and dynamism of the economy.'<sup>8</sup> Ironically, promoting such risk taking may explain in part the essence of the current global financial crisis, and within Australia our own corporate collapses, possibly rendering such concerns of undue hindrance upon the entrepreneurial activities of officers as somewhat short sighted.

On this issue, recommendations were made suggesting that the 'Australian Government should review the penalties for breaches of directors' duties to ensure that they strike an appropriate balance between promoting good behaviour and ensuring business is willing to take sensible commercial risks.'<sup>9</sup> Such sentiments were also reflected in the media release by Senator Nick Sherry, the then Minister for Superannuation and Corporate Law where he stated:

We need corporate laws that create strong incentives for directors to act honestly, carefully and diligently. As part of this, we need a balance in our corporate laws between promoting accountability and ensuring suitable people are willing to serve as directors and take appropriate business risks.<sup>10</sup>

However a review of sanctions must be careful not to indirectly encourage foolhardy risks.

Strictly from a director's perspective, corporate sanctions, of a civil and criminal nature, may arguably act as a deterrent for some seeking to assume the role of director within a corporation. On this very point, the submission made by the Chartered Secretaries Australia (CSA) relating to the consultation paper is of some interest.<sup>11</sup> The results of a survey conducted by the CSA in 2006 suggests the ramifications of corporate sanctions have in reality little, if any, impact on influencing whether a person would take up the

<sup>7</sup> Australia. Treasury, above n 3, [1.39].

<sup>8</sup> Taskforce on Reducing Regulatory Burdens on Business, *Taskforce on Reducing Regulatory Burdens on Business* (Belconnen: Productivity Commission, Regulation Taskforce, 2006) 90.

<sup>9</sup> Australia. Treasury, above n 3, 45.

<sup>10</sup> Australia. Treasury, above n 4.

<sup>11</sup> Chartered Secretaries Australia, *Submission to the Treasury on the Review of Sanctions for Breaches of Corporate Law* (2007)

<<http://www.csaust.com/AM/Template.cfm?Section=Submissions&Template=/CM/ContentDisplay.cfm&ContentID=8750>> at 23 August 2009.

office of director. As part of the survey, CSA members were asked whether they were aware of any situation where a suitably qualified director or potential director had declined to be appointed due to existing onerous penalties and exposure to personal risk. The results of the survey regarding this question indicated that ‘... [an] overwhelming 87per cent of respondents were not aware of any case where a suitably qualified director had declined to take up an offer of a directorship ...’ due to the potential of onerous sanctions being imposed.<sup>12</sup> Despite this, the CSA survey did support the perception that potential personal liability related to corporate sanctions inhibited corporate risk taking. It found that ‘more than half of the respondents (58 per cent) noted that the current levels of personal liability were inhibiting corporate Australia’s appetite for risk.’<sup>13</sup>

In May 2008, Federal Treasury conducted a survey of company directors, in conjunction with the Australian Institute of Company Directors, to assess the impact corporate laws impose on personal liability of directors.<sup>14</sup> Approximately 100 directors of S&P/ASX – 200 companies participated in the survey. The results of the survey of company directors were announced by Federal Treasury in the December 2008 media release.<sup>15</sup> Of note, the results of the survey of company directors do not support the CSA survey findings regarding the uptake of directorships. A number of questions were posed relating to the general issue of whether potential risk of personal liability acted as a deterrent to potential or suitable directors declining to sit on boards. The results of the survey of company directors indicate that the risk of potential liability has acted as a significant deterrent and resulted in a high proportion of persons declining the offer of a company directorship or retiring from such positions.<sup>16</sup>

#### 4. Reform of Corporate Laws

What direction will possible reform take? Will the focus turn exclusively to the consideration of imposing criminal liability on corporate officers for statutory breaches? Or is it there still a potential to broaden the types of sanctions that could be imposed for breaches of corporate law and introduce a general defence, as outlined in the consultation paper?

With the exception of ss 180, 184, *the Corporations Act 2001 (Cth)* recognises the possibility of criminal penalties being imposed where breaches of statutory duties are reckless or intentionally dishonest. As the law currently stands, s184 establishes the test for determining the criminality of the conduct of an officer, and has to date dispensed with the need for reform regarding criminal breaches of the statutory duties. However, if the indication of the media release is anything to go by, changes to aspects of directors’ criminal liability will be imminent. MINCO has been handed the task of examining the possibility of imposing personal criminal liability on an officer of a corporation for corporate misconduct where the officer encourages or assists in the misconduct.

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<sup>12</sup> Chartered Secretaries Australia, above n 11.

<sup>13</sup> Chartered Secretaries Australia, above n 11.

<sup>14</sup> Australia. Treasury, *Survey of Company Directors* (2008) The Treasury <<http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1387>> at 23 August 2009.

<sup>15</sup> Australia. Treasury, above n 4.

<sup>16</sup> Chartered Secretaries Australia, above n 11.

What of other considerations, such as breaches of corporate law not related to the statutory duties? Such breaches appear to raise different concerns when it comes to imposing criminal sanctions, particularly where the gravity of the wrong doing does not warrant a criminal sanction. Of note are the low level record keeping obligations which currently attract criminal sanctions, a breach of which would not logically be labeled as a serious wrong doing. Prior consideration of these matters had suggested such breaches would be more equitably resolved via the imposition of administrative sanctions, such as a prescribed penalty. The imposition of administrative sanctions should be more effective in deterring or punishing breaches, given the unlikelihood of criminal prosecutions in such cases.<sup>17</sup> It is now probable that these matters will also be reviewed by MINCO as part of the reform process.

Further, past discussion has tended to focus on the fact that any proposed review of sanctions would be directed to considering the appropriateness of extending the use of civil sanctions for breaches of the statutory duties. As noted by Welsh, 'civil penalties were introduced to provide an enforcement mechanism for breaches of statutory duty where no criminality was involved.'<sup>18</sup> The critical factor has traditionally been determining whether existing civil penalties<sup>19</sup> are adequate or whether harsher penalties would be more desirable. There have been other considerations that supported the desirability of extending the use of civil sanctions for breaches of corporate law. Evidence suggests that, although criminal prosecution may be instigated following civil penalty proceedings, ASIC has not been forthcoming in taking such action due to the unlikelihood of successful prosecution.<sup>20</sup> ASIC has preferentially and successfully pursued civil penalty orders, due to a lower standard of proof that applies to breaches of civil penalty provisions.<sup>21</sup> ASIC may now have to face new challenges, and the need to change its practices, following the recommendations that could be made by MINCO regarding reform of personal criminal liability of directors. The future discussion may no longer focus on whether the use of civil sanctions should be expanded for breaches of corporate law, but the implications of personal criminal liability being imposed for such breaches and whether the likelihood of prosecution will ensue.

The introduction of a general defence, or the expansion of the business judgment rule, as discussed in the consultation paper, may resurface if due consideration is given to the survey of company directors responses. The consultation paper contemplated the application of a general defence not merely to the duty of care contained in *Corporations Act 2001* (Cth) s180(1), but other core statutory duties of ss181-183 and 588G, along with the provisions relating to account keeping and financial reporting obligations. The sampling of responses from the survey of company directors reflected desirability, on the

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<sup>17</sup> Australia. Treasury, above n 3, [2.54].

<sup>18</sup> Michelle Welsh, 'The Corporations Law Civil Penalty Provisions and the Lessons that can be Learned from the Trade Practices Act 1974' (2000) 11(3) *Australian Journal of Corporate Law* 298, 304.

<sup>19</sup> See *Corporations Act 2001*(Cth) civil penalties provisions ss206C, 1317G, 1317H.

<sup>20</sup> Michelle Welsh, 'The Use of Civil Sanctions for Breaches of Corporate Law' (Working Paper No 7, Corporate Law and Accountability Research Group, Faculty of Business and Economics, Monash University, 2007) 6.

<sup>21</sup> Welsh, above n 20, 7-9.

part of directors, for the reworking of the business judgment rule to afford better protection against liability for breaches of statutory duties.<sup>22</sup> Needless to say, the introduction of a general defence would need to be carefully considered to safeguard against leniency in the case of directors' breaches of statutory duties.

The business judgment rule of s180(2) *Corporations Act 2001*(Cth) operates as a defence for breaches of s180(1) and common law and equitable duties of care. The defence enables directors to make a business judgment without consequence, provided directors have acted in good faith and for a proper purpose, have no material personal interest in the judgment and believe the judgment is in the best interests of the corporation.

The business judgment rule currently affords protection to the company and its creditors on the one hand and appears to function satisfactorily in the context of directors exercising care and diligence on the other. If the defence was extended to other statutory duties under the *Corporations Act 2001*(Cth), namely ss181-183 and 588G would it be appropriate, or would it result in adverse consequences for the company and shareholders by alleviating liability of directors?

Further, there are defences under s588H available to directors who find themselves in breach of s588G.<sup>23</sup> How would the application of a general defence to s588G interact with the existing defences of s588H? Another concern is whether the application of a general defence to s588G would encourage insolvent trading and whether this would ultimately be to the detriment of creditors.

The introduction of a general defence, although thought provoking, highlights the difficult task for directors of acting bona fide while being required to act reasonably in circumstances of insolvency. The dilemma here clearly is demonstrated by the fact that s588G requires directors to show reasonable grounds for their actions. Whereas the business judgment rule of s180(2) instead provides a defence to company officers provided a rational belief is held that the judgment is in the best interests of the corporation. To act bona fide cannot be substantiated when a director undertakes a risky course of action, particularly in the context of insolvent trading. The application of a general defence could also prove difficult in the case of the statutory duties in ss181-183 if the rational belief concept was applied.

Despite the concerns about the appropriateness of extending the business judgment rule to statutory duties other than s180(1), the survey of company directors<sup>24</sup> has drawn commentary on the matter.

## 5. Conclusion

The consultation paper released in 2007 had stimulated discussion on the topic of reviewing corporate sanctions and defences, relating in particular to directors, although without consequence due to a change in the federal government. The current global

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<sup>22</sup> Australia. Treasury, above n 14.

<sup>23</sup> See s588H(2)-(6) *Corporations Act 2001*(Cth).

<sup>24</sup> Australia. Treasury, above n 14.

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economic crisis appears once again to have brought about the desire to review sanctions, and possibly defences, with reference to company officers. Undeniably, what has emerged on the Australian home front is evidence of corporate collapses linked to the pressing need for accountability and close scrutiny of corporate behaviour. To this end, law reform may be justified, albeit with the likelihood of revised criminal liability for directors. The thrust in potentially revising personal criminal liability of directors could herald a new phase in Australian corporate law.