

STEPPING STONES – FROM CORPORATE FAULT TO DIRECTORS' PERSONAL CIVIL LIABILITY

Abe Herzberg and Helen Anderson***

ABSTRACT

Several recent cases have seen the courts approving ASIC's employment of a 'stepping stone' approach that applies directors' statutory duty of care as well as their other statutory duties in a novel context. The first 'stepping stone' involves an action against a company for contravention of the *Corporations Act 2001 (Cth)*. The establishment of corporate fault may then step stone to a finding that by exposing their company to the risk of criminal prosecution, civil liability or significant reputational damage, directors contravened one or more of their statutory duties in ss 180-2 of the *Corporations Act*, particularly their statutory duty of care, with the attendant civil penalty consequences. The effect of the 'stepping stone' approach is that directors may face a type of derivative civil liability for corporate fault. In this paper we analyse the stepping stone approach and assess the justification for imposing civil liability on directors for their company's misbehaviour. This paper also examines whether an extension of the stepping stone approach could make directors liable for their company's contraventions of non-*Corporations Act* laws as well as open the floodgates to make directors personally liable to shareholders, creditors, employees, or others affected by corporate fault.

I INTRODUCTION

Directors' criminal liability for corporate fault has been the subject of extensive analysis by the Corporations and Markets Advisory Committee ('CAMAC').¹ By way of contrast, this paper considers their civil liability for corporate misbehaviour. Several recent cases² have seen the courts approving ASIC's employment of a 'stepping stone'

* Senior Lecturer, Department of Business Law & Taxation, Monash University.

** Associate Professor, Melbourne Law School, University of Melbourne; Senior Research Fellow, Department of Business Law and Taxation, Monash University. We express our thanks to the anonymous referees for their useful comments and suggestions.

1 Corporations and Markets Advisory Committee, *Personal Liability for Corporate Fault*, Report (2006) ('Personal Liability Report').

2 *ASIC v Elm Financial Services Pty Ltd* (2005) 55 ACSR 533 ('*Elm Financial Services*'); *ASIC v Maxwell* (2006) 59 ACSR 373 ('*Maxwell*'); *ASIC v Warrenmang Ltd* (2007) 63 ACSR 623 ('*Warrenmang*'); *ASIC v Sydney Investment House Equities Pty Ltd* (2008) 69 ACSR 1 ('*Sydney Investment House Equities*'); *ASIC v Macdonald [No 11]* (2009) 256 ALR 199 ('*Macdonald [No 11]*').

approach³ that applies directors' duties in a novel context. The first stepping stone involves an action against a company for contravention of the *Corporations Act 2001* (Cth) ('*Corporations Act*'). The establishment of corporate fault then leads to the second stepping stone: a finding that by exposing their company to the risk of criminal prosecution, civil liability or significant reputational damage, directors contravened their statutory duty of care⁴ with the attendant civil penalty consequences. In some of the cases, the courts also applied the stepping stone approach to directors' contraventions of ss 181 and 182 of the *Corporations Act* as well as contraventions of s 180(1).⁵ The effect of the 'stepping stone' approach is that directors may face a type of derivative civil liability for corporate fault, but one which nonetheless is based on their own inadequate conduct.

There are four parts to this paper. In Part II we consider the various stepping stone cases. In this part we provide an overview of the nature of the various corporate contraventions, the nature of directors' involvement in the corporate contraventions and what conduct triggers their contravention of ss 180(1), 181 and 182. In relation to their statutory duty of care we also discuss whether directors can rely on the business judgment rule⁶ and the delegation and reliance provisions in the *Corporations Act*.⁷

Part III examines the theoretical underpinnings of both directorial criminal and civil liability for corporate fault and the various ways it is imposed. This part also assesses the justification for imposing civil liability on directors for their company's misbehaviour and evaluates whether the stepping stone approach is a superior way to make directors civilly liable for corporate fault.

In Part IV we discuss several possible future extensions of the stepping stone approach. Even though a company's contravention of one or more provisions of the *Corporations Act* was the first stepping stone in the decided cases, this part explores whether the first stepping stone might also include a company's contravention of other laws, such as income tax legislation or occupational health and safety laws. It also explores whether third parties other than ASIC, such as corporate creditors or employees who are affected by the company's contravention of the law, could employ the stepping stone approach to make directors personally liable.

II STEPPING STONE CASES

A The first stepping stone – company's contravention of the law

This part considers the stepping stone cases and highlights the nature of the corporate misconduct that led to the conclusion that directors breached their statutory duties. All the decided cases involved the company's contravention of various provisions of the

11]); *Morley v ASIC* (2010) 274 ALR 205 ('*Morley*'); *ASIC v Citrofresh International Ltd [No 2]* (2010) 77 ACSR 69 ('*Citrofresh [No 2]*'); *ASIC v Fortescue Metals Group Ltd* (2011) 190 FCR 364 ('*Fortescue Metals Group*').

³ The term 'stepping stone' stems from Keane CJ's description of ASIC's proceedings in *Fortescue Metals Group* (2011) 190 FCR 364, 370 [10].

⁴ *Corporations Act* s 180(1).

⁵ *Elm Financial Services* (2005) 55 ACSR 533; *Maxwell* (2006) 59 ACSR 373; *Warrenmang* (2007) 63 ACSR 623; *Sydney Investment House Equities* (2008) 69 ACSR 1.

⁶ *Corporations Act* s 180(2).

⁷ *Ibid* ss 189 and 190 respectively.

Corporations Act that exposed it to criminal fines or civil liability for the loss or damage caused. Some of these cases also involved contraventions of other companies and securities legislation such as the *Australian Securities and Investment Commission Act 2001* ('ASIC Act'). In one case, discussed below, the court held that the company's breach of contract may be the basis of directorial liability, in addition to the *Corporations Act* breach.⁸

Many of the cases dealt with corporate contraventions of various misleading and deceptive conduct provisions in the *Corporations Act* and the *ASIC Act*. For example, in *Sydney Investment House Equities*,⁹ *Maxwell*,¹⁰ *Citrofresh [No 2]*,¹¹ and *Fortescue Metals Group*¹² the court found that the various defendant companies contravened s 1041H of the *Corporations Act* as well as ss 12DA, 12DB and 12DF of the *ASIC Act*. In *James Hardie Industries NV v ASIC*¹³ it was held that the company contravened the former s 995, the predecessor of s 1041H. Similarly, in *Macdonald [No 11]*¹⁴ ASIC linked directors' contraventions of the statutory duty of care in s 180(1) to the James Hardie Industries Ltd's alleged contraventions of the former ss 995 and 999.¹⁵

In some of the stepping stone cases, a listed company's misleading and deceptive conduct was itself a stepping stone to the *company's* contravention of the continuous disclosure provision in s 674(2) of the *Corporations Act*.¹⁶ Some of the cases concerned contraventions of various fundraising provisions of ch 6D of the *Corporations Act*. For example, in both *Elm Financial Services*¹⁷ and *Maxwell*¹⁸ it was held that the companies contravened s 727 by offering securities that needed disclosure to investors without a disclosure document. In *Maxwell* the companies were also held to have breached the advertising and publicity restrictions in contravention of s 734(2). In *Sydney Investment House Equities*¹⁹ the court held that a company committed a criminal offence when it contravened s 1018A, which sets out similar restrictions as s 734(2) in relation to advertising, and publicity of financial products to retail clients. In *Warrenmang*²⁰ the company, whose prospectus envisaged ASX listing, contravened ss 722 and 723 by failing to hold investors' application money in trust and failing to refund the application money when ASX listing was not achieved.

⁸ See *Sydney Investment House Equities* (2008) 69 ACSR 1, 36 [170]-[172]. As well as the contractual breach the company was involved in multiple contraventions of the *Corporations Act*.

⁹ (2008) 69 ACSR 1.

¹⁰ (2006) 59 ACSR 373.

¹¹ (2010) 77 ACSR 69.

¹² (2011) 190 FCR 364.

¹³ (2010) 274 ALR 85 ('*James Hardie Industries NV*').

¹⁴ (2009) 256 ALR 199.

¹⁵ Sections 1043E and 1041H of the *Corporations Act* are current equivalent provisions.

¹⁶ *James Hardie Industries NV* (2010) 274 ALR 85 involved the company's appeal of the first instance decision in *Macdonald [No 11]* (2009) 256 ALR 199; *Citrofresh [No 2]* (2010) 77 ACSR 69; *Fortescue Metals Group* (2011) 190 FCR 364.

¹⁷ (2005) 55 ACSR 533.

¹⁸ (2006) 59 ACSR 373.

¹⁹ (2008) 69 ACSR 1.

²⁰ (2007) 63 ACSR 623.

In other stepping stone cases,²¹ the company was found to have contravened the financial reporting provisions of ch 2M of the *Corporations Act* by failing to provide annual financial reports to members²² and failing to lodge such reports with ASIC.²³ Companies also breached the managed investment scheme provisions of ch 5C of the *Corporations Act* by operating unregistered managed investment schemes.²⁴ In two cases,²⁵ it was held that companies infringed provisions of the financial services licensing provisions of pt 7.6 of the *Corporations Act*, by carrying on financial services businesses without holding an Australian Financial Services Licence that covered the provision of financial services²⁶ and failing to ensure authorised representatives were adequately trained.²⁷

Even though a company's contravention of a provision of the *Corporations Act* was the first stepping stone in all of the cases noted above, *Sydney Investment House Equities*²⁸ is significant because it indicates that a company's *contractual* breach may also be a sufficient stepping stone to a director's breach of ss 180–2 of the *Corporations Act*. As discussed in Part IV below this raises the possibility that the other party to the company's breach of contract may use the stepping stone approach to make the directors liable for damages under s 1324(10) of the *Corporations Act*. In *Sydney Investment House Equities* investors agreed to lend money to Sydney Investment House Equities Pty Ltd on the basis that it would on-lend the money to 'approved development borrowers' consisting of other companies in the group and that a term of the on-lending agreement would specify that the approved development borrowers would use the loan monies only for purposes of 'approved property development projects'. Sydney Investment House Equities Pty Ltd on-lent the money to other entities in the group but, in breach of its agreement with investors, it had not in fact approved any of those entities as an approved development borrower. Further, none of the loan agreements to any of the borrowers imposed a condition restricting the use of the loan monies as required.

B The second stepping stone – directors' breach of duty

In this part we consider the various breaches of directors' duties that may stem from a company's contravention of the law. In all the decided stepping stone cases, ASIC alleged that directors breached s 180(1) by failing to prevent their company from contravening various provisions of the *Corporations Act*. This provision takes into account the position held by the director as well as the corporation's circumstances, and imposes a duty of care and diligence, objectively assessed. Directors may rely on the business judgment rule defence in circumstances specified in s 180(2). In some of

²¹ *Elm Financial Services* (2005) 55 ACSR 533; *Sydney Investment House Equities* (2008) 69 ACSR 1.

²² *Corporations Act* s 314.

²³ *Ibid* s 319.

²⁴ *Ibid* s 601ED.

²⁵ *Elm Financial Services* (2005) 55 ACSR 533; *Sydney Investment House Equities* (2008) 69 ACSR 1.

²⁶ *Corporations Act* s 911A.

²⁷ *Ibid* s 912A(1).

²⁸ (2008) 69 ACSR 1, 36 [170]–[172].

the stepping stone cases, breaches of ss 181 and 182 were also alleged.²⁹ These require directors to exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose, and not to improperly use their position to gain an advantage for themselves or someone else or to cause detriment to the corporation, respectively. However, contraventions of ss 180–2 'do not provide a backdoor method for visiting, on company directors, accessorial civil liability for contraventions of the *Corporations Act* in respect of which provision is not otherwise made.'³⁰ The stepping stone approach does not mean that directors who authorised or permitted their company's contravention automatically breach ss 180–2. The statutory duties do not impose on directors a general obligation 'to conduct the affairs of the company in accordance with law generally or the *Corporations Act* in particular'.³¹ Whether or not directors contravened their duties as a result of their company's breach of the law requires an analysis of the particular duty and an assessment of whether the jeopardy to the company's interests arising from its breach of the law outweighs the potential benefits.³²

Section 180(1) recognises that a corporation's circumstances are one of the factors to be taken into account when deciding whether directors exercised the degree of care and diligence that a reasonable person would exercise in a particular case.³³ The other relevant factor is the particular director's office and responsibilities in the corporation.³⁴ It is well established that one situation in which directors breach their duty of care is where they expose their company to risks without the prospect of producing any benefit for the company.³⁵ This raises two inter-related issues: the nature of the risks to which the company was exposed, and the extent of the directors' involvement or participation in their company's contravention of the law.

It is sufficient for the purposes of a director's breach of the statutory duty of care that the company's contraventions of the *Corporations Act* merely expose it to the risk of criminal prosecution or the prospect of civil liability.³⁶ For directors' liability to arise it is not necessary for a court to impose a fine on the company for its criminal contravention of the *Corporations Act*; a declaration of contravention is sufficient. It is also unnecessary that the company is actually sued for damages as a result of its

²⁹ Sections 180(1), 181(1) and 182(1) of the *Corporations Act* are all civil penalty provisions. However, unlike s 180(1), which only has civil penalty consequences, s 184 specifies that breaches of either ss 181 or 182 are also criminal offences if it is proved that a defendant was intentionally dishonest or reckless.

³⁰ *Maxwell* (2006) 59 ACSR 373, 402 [110]. See also *Citrofresh [No 2]* (2010) 77 ACSR 69.

³¹ *Maxwell* (2006) 59 ACSR 373, 399 [104]. A similar point was made in *Vines v ASIC* (2007) 73 NSWLR 451, 463 [84] and *Warrenmang* (2007) 63 ACSR 623, 628 [22].

³² *Ibid.*

³³ *Corporations Act* s 180(1)(a).

³⁴ *Ibid* s 180(1)(b).

³⁵ *Sydney Investment House Equities* (2008) 69 ACSR 1, 11 [28]. See also *Maxwell* (2006) 59 ACSR 373, 402 [110]; *Macdonald [No 11]* (2009) 256 ALR 199; *Citrofresh [No 2]* (2010) 77 ACSR 69. A similar point arises in non-stepping stone cases such as *ASIC v Adler* (2002) 168 FLR 253; *Circle Petroleum (Qld) Pty Ltd v Greenslade* (1998) 16 ACLC 1577; *Permanent Building Society v Wheeler* (1994) 12 ACLC 674.

³⁶ See, eg, *Maxwell* (2006) 59 ACSR 373; *Sydney Investment House Equities* (2008) 69 ACSR 1; and *Macdonald [No 11]* (2009) 256 ALR 199.

contravention. For a listed company, a contravention of the *Corporations Act* need only affect its reputation and result in adverse market impact on its listed securities.³⁷

In relation to the extent of the directors' involvement or participation in the corporate misconduct, the stepping stone cases indicate that directors breach their statutory duty of care if they cause, authorise or permit corporate conduct that amounts to contraventions of the *Corporations Act*. Provided that the required degree of involvement in corporate misconduct is found, it does not make a difference whether the defendant is an executive or non-executive director or a company officer. For example, in *Fortescue Metals Group*³⁸ the Full Court of the Federal Court held that Forrest, the CEO of a listed company, breached s 180(1) because he was 'intimately and directly' involved in formulating his company's misleading media releases and ASX announcements.³⁹ By virtue of these releases, the company engaged in misleading and deceptive conduct for the purposes of s 1041H. The company's contravention of s 1041H was a stepping stone toward a conclusion that the company also contravened the continuous disclosure obligations in s 674(2) when it failed to correct the misleading statements. Forrest breached s 180(1) because his conduct exposed the company to civil penalty pecuniary orders for contravention of s 674(2).

Significantly, the Court also held that Forrest was not entitled to rely on the business judgment rule.⁴⁰ Keane CJ noted that the Explanatory Memorandum to the Corporate Law Economic Reform Program Bill 1998 (Cth) made it clear that the business judgment rule was not intended to apply to decisions related to compliance or non-compliance with the *Corporations Act*.⁴¹ Further, the courts would not construe s 180(2) 'as affording a ground of exculpation for a breach of s 180(1) where the director's want of diligence results in a contravention of another provision of the Act and where that other provision contains specific exculpatory provisions enacted for the benefit of the director.'⁴² The defendants in *Fortescue Metals Group* appealed the Federal Court's decision to the High Court. While the High Court has heard the appeal, at the time of writing it has not handed down its decision.

The James Hardie litigation provides further examples of breaches of s 180(1) by the company's directors and officers because of their close involvement in their company's contraventions of the *Corporations Act*. In *Macdonald [No 11]*⁴³ the managing director of James Hardie Industries Ltd was held to have contravened s 180(1) in circumstances where he was involved in the drafting, preparation and final dissemination of misleading media releases and ASX announcements that resulted in the company's contravention of the predecessor of s 1041H. These statements indicated that an asbestos victims' compensation fund was 'fully funded' and would adequately cover all current and future claims. He was also held to have been negligent because he

³⁷ Finkelstein J in *Fortescue Metals Group* (2011) 190 FCR 364, 433 [231] onwards discusses the impact the company's misleading statements had on investors.

³⁸ (2011) 190 FCR 364.

³⁹ The media releases and ASX announcements falsely represented that framework agreements with Chinese contractors were contractually binding.

⁴⁰ *Corporations Act* s 180(2).

⁴¹ *Fortescue Metals Group* (2011) 190 FCR 364, 427 [198].

⁴² *Ibid* 427 [199].

⁴³ (2009) 256 ALR 199.

failed to advise the board whether or not a material aspect of the company's restructuring arrangements had to be disclosed to the ASX thus causing the company to contravene its continuous disclosure requirements under the predecessor of s 674.⁴⁴ While ASIC also prosecuted the James Hardie Industries Ltd's non-executive directors alleging they had contravened s 180(1) because they approved the misleading draft ASX announcement at a board meeting, the New South Wales Court of Appeal in *Morley*⁴⁵ decided that there was insufficient admissible evidence of such approval. It held that ASIC failed the *Briginshaw* test⁴⁶ and did not adduce direct evidence that the board approved the draft ASX announcement containing the misleading statements that resulted in the company's contravention of the legislation. However, the Court of Appeal decided that, had this been proved, the non-executive directors – being intelligent people with considerable business skills who were well aware of the importance of the issue of the sufficiency of compensation funding and its communication to stakeholders – would have breached s 180(1) because they ought to have known the ASX announcement was misleading. In *ASIC v Hellicar*⁴⁷ the High Court found that the Court of Appeal was wrong to conclude that ASIC failed to prove that the draft ASX announcement was tabled and approved at the board meeting and remitted the s 180(1) case against the non-executive directors back to the Court of Appeal.⁴⁸

The James Hardie litigation also demonstrates that the stepping stone approach may also be used against officers below board level in appropriate circumstances. For example the New South Wales Court of Appeal in *Morley*⁴⁹ held that because of James Hardie Industries Ltd's chief finance officer's close involvement in the company's restructure proposals and cash flow modelling, he contravened s 180(1) when he failed to advise the board of the limited nature of an external consultant's reviews of the cash flow modelling. Similarly, the Court of Appeal also held that Shafron, the company secretary (who was also its general counsel), contravened s 180(1) by virtue of his participation in the board's deliberations about the company's ASX announcement and the non-disclosure to the ASX of material aspects of the company's restructuring arrangements. In a listed company, part of a secretary's traditional responsibilities included responsibility for filing ASX continuous disclosure announcements as well as the accuracy of the announcement contents.⁵⁰ Since Shafron had also been delegated the task of undertaking cash flow modelling involved in the company's restructure and the establishment of the compensation fund for asbestos victims, he had responsibility in relation to the actuarial modelling undertaken by external consultants, the modelling assumptions and the conclusions about the sufficiency of funding. Shafron

⁴⁴ *James Hardie Industries NV* (2010) 274 ALR 85.

⁴⁵ *Morley* (2010) 274 ALR 205.

⁴⁶ *Briginshaw v Briginshaw* (1938) 60 CLR 336, 361–2 (Dixon CJ).

⁴⁷ *ASIC v Hellicar* (2012) 286 ALR 501.

⁴⁸ The High Court held that the facts indicated that the board minutes, which recorded the tabling of the draft ASX announcement and its approval, were evidence of the truth of the matters recorded: *ibid* 519 [69], 532 [119], [121]. The Court of Appeal was also wrong to hold that ASIC breached a duty of 'fairness' by failing to call a witness: *ibid* 541 [156], 545 [170].

⁴⁹ (2010) 274 ALR 205.

⁵⁰ *Ibid* 382 [921].

was held to have breached his duty of care by failing to draw the board's attention to deficiencies in actuarial reports. In *Shafron v ASIC*⁵¹ the High Court upheld the Court of Appeal's decision in relation to Shafron. The High Court held that Shafron came within the definition of an officer⁵² of James Hardie Industries because the tasks delegated to him in his dual role as company secretary and general counsel indicated that he participated in making decisions that affected the whole or a substantial part of the company's business. According to the High Court, the responsibilities actually assigned to him were of critical importance for the purposes of s 180(1) regardless of how or why those responsibilities came to be imposed on him. As these responsibilities included advising the board about the content of ASX announcements and the actuarial modelling undertaken by external consultants, the High Court agreed with the conclusions of the courts below, that Shafron contravened s 180(1).

In appropriate circumstances a company's contravention of the law may also be the first stepping stone leading to a finding that its directors breached ss 181 and 182.⁵³ Like s 180(1) these statutory duties are owed to the company. Section 181(1) has a subjective element of moral turpitude and is contravened where a director engages deliberately in conduct, knowing that it is not in the interests of the company.⁵⁴ For example, in *Maxwell*⁵⁵ it was held that a director who was 'instrumental and central' to his company's contravening conduct breached s 181 on multiple occasions. He knew that the solicitation of loans from investors were in contravention of the fundraising provisions of the *Corporations Act* and due to his dominant role in the company, and the consequent potential exposure of the company to liability, his conduct was intentional and with knowledge that it placed the corporations in jeopardy, so as to amount to a breach of his duty of good faith, as well as his duty of care and diligence.⁵⁶

Directors breach s 182 as well as ss 180 and 181 if they cause the company to enter into transactions that confer unreasonable personal benefits.⁵⁷ Section 182 seeks to prevent directors abusing their position for their own advantage or the corporation's detriment.⁵⁸ Impropriety for the purposes of that section is to be determined objectively and

does not depend on [the director's] consciousness of impropriety. Impropriety consists in a breach of the standards of conduct that would be expected of a person in the position of

⁵¹ (2012) 286 ALR 612.

⁵² *Corporations Act* s 9 (definition of 'officer of a corporation' paras (a) and (b)).

⁵³ *Corporations Act* s 181(1) requires directors or other officers to exercise their powers and discharge their duties in good faith in the best interests of the corporation. Directors must also exercise their powers for a proper purpose. Section 182(1) specifies that a director, secretary, other officer or employee must not improperly use their position to gain an advantage for themselves, someone else or cause detriment to the corporation.

⁵⁴ *Maxwell* (2006) 59 ACSR 373, 402 [109]. See also *Macdonald [No 11]* (2009) 256 ALR 199. On the other hand in *Sydney Investment House Equities* (2008) 69 ACSR 1, 12 [34] Hamilton J was of the view that s 181 may be breached where the conduct of the director is not in the interests of the company, even if there was no subjective dishonesty.

⁵⁵ (2006) 59 ACSR 373.

⁵⁶ *Ibid* 418 [180].

⁵⁷ *ASIC v Adler* (2002) 168 FLR 253, 365 [458].

⁵⁸ *Warrenmang* (2007) 63 ACSR 623.

the alleged offender by reasonable persons with knowledge of the duties, powers and authority of the position and the circumstances of the case.⁵⁹

*Warrenmang*⁶⁰ and *Maxwell*⁶¹ are examples of directors' contraventions of s 182 in the context of the stepping stone cases. In *Warrenmang*, the director caused his company to breach ss 722 and 723 of the *Corporations Act* when it failed to keep investors' subscription monies for securities in trust until the securities were issued and ensure the monies were returned when the company did not achieve ASX listing as specified in its disclosure document. The director contravened ss 181 and 182 when he deliberately misappropriated a portion of trust monies (the subscription monies) for his personal benefit. In *Maxwell*, a director who was intimately involved in the company soliciting loans from investors in contravention of the fundraising provisions of the *Corporations Act* breached s 182 because he received commissions on each investor loan he introduced.

III SHOULD DIRECTORS BE LIABLE FOR CORPORATE FAULT, AND IF SO HOW?

The previous part looked at the recently evolved stepping stone approach to director liability. This part examines the theoretical underpinnings of directorial liability for corporate fault, first in relation to civil liability and then to criminal liability. Both of these are necessary for the stepping stone approach because directors' liability for breach of their duties is enforced through the civil penalty provisions, allowing for punishment through pecuniary penalties and disqualification, as well as allowing for compensation. Next, the part looks at different types of liability: personal, accessory and derivative. It then considers whether the stepping stone approach imposes liability appropriately and overcomes some of the difficulties with existing forms of liability.

A Civil liability

Companies can only act through human beings, and there is no corporate fault except through the act or omission of some individual. In the context of civil liability, it is sometimes thought that the creation of a company relieves its officers of personal liability for their actions on its behalf. Undoubtedly, a contract made on behalf of a company by a servant or agent, including a director, will bind the company as principal to the outsider, with no separate liability attaching to the agent. In a number of tort cases, a few courts have mistakenly extended the notion of a corporate veil to deny that directors are liable for torts committed in the course of their employment, on the basis of the separate legal entity doctrine and limited liability,⁶² and because

⁵⁹ *R v Byrnes* (1995) 183 CLR 501, 514–15 (Brennan, Deane, Toohey and Gaudron JJ).

⁶⁰ (2007) 63 ACSR 623.

⁶¹ (2006) 59 ACSR 373.

⁶² See, eg, *Mentmore Manufacturing Co Ltd v National Merchandising Manufacturing Co Inc* (1978) 89 DLR (3d) 195, 203; *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517. See further Ross Grantham and Charles Rickett, 'Directors' "Tortious" Liability: Contract, Tort or Company Law?' (1999) 62 *Modern Law Review* 133; Andrew Borrowdale, 'Directors' Liability in Tort' [1999] *New Zealand Law Journal* 51.

persons dealing with companies should realise that they can only look to the company for redress.⁶³

Clearly this is not correct. Limited liability refers to the liability of shareholders on their shares, and not of directors, servants or agents.⁶⁴ The corporate veil does not apply where a person acting on behalf of a company has committed a wrong. Otherwise, the absurd situation would arise that a person could avoid tortious liability by the chance circumstance of committing it on a company's behalf rather than for themselves or another person. The sense that only the company is answerable for the wrongs of its employees committed in the course of their employment may have arisen from the application of the doctrine of *respondeat superior*.⁶⁵ Such liability gives companies incentives to put in place systems to prevent future breaches, but most importantly, commonly gives the plaintiff a financially stronger, or well insured, entity to sue. However, the doctrine is a practical one, and is not applied to defeat claims of negligence against employees themselves.

It is particularly important to recognise this where the defendant company has few assets and no insurance, possibly expressly to make it judgment-proof, or where a large penalty or compensation award would send a struggling company into liquidation to the detriment of shareholders, employees and creditors. In these circumstances, it is proper that the plaintiff may seek a remedy from the actual tortfeasor. The law on the liability of directors for the torts of their companies is dismally unsettled in Australia, with no less than four tests of liability, often depending on the particular tort. Despite this confusion, it is important to note that the cases do uphold directors' liability for their own wrongdoing or for wrongs for which the law considers them responsible.⁶⁶

B Criminal liability

In early times the theoretical difficulty for criminal liability was in imposing it on the corporation itself, rather than on its officers. Khanna notes four initial obstacles to corporate criminal liability: attributing acts to a juristic fiction; the lack of moral blameworthiness needed to found crimes of intent; the doctrine of ultra vires; and the lack of a physical defendant to sit in the dock.⁶⁷ These objections were steadily overcome, first through crimes of public nuisance, then to crimes not involving intent,

⁶³ Hardie Boys J in *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517 said: 'The problem that has vexed the common law courts in this area is that of respecting the doctrine of separate legal personality on the one hand, and of allowing an adequate remedy on the other': at 525.

⁶⁴ Watson and Willekes noted that 'despite an increasingly widespread perception to the contrary, tortious liability of directors to tort victims has nothing to do with protecting shareholders from liability, which is what the corporate veil from *Salomon* onwards was intended to do': Susan Watson and Andrew Willekes, 'Economic Loss and Directors' Negligence' (2001) *Journal of Business Law* 217, 218.

⁶⁵ Latin, 'let the master answer'.

⁶⁶ See further John H Farrar, 'The Personal Liability of Directors for Corporate Torts' (1997) 9 *Bond Law Review* 102; Helen Anderson, 'The Theory of the Corporation and Its Relevance to Directors' Tortious Liability to Creditors' (2004) 16 *Australian Journal of Corporate Law* 73 and references cited therein.

⁶⁷ VS Khanna, 'Corporate Criminal Liability: What Purpose Does it Serve?' (1996) 109 *Harvard Law Review* 1477, 1479-80.

and finally to crimes of intent. Importantly, it was understood that controlling corporate misconduct could only be achieved if the company, which benefitted from the illegal conduct, were made the object of prosecution. Corporate civil liability may have been just as effective in deterring corporate wrongdoing, but in an era before civil penalty provisions, public enforcement through criminal sanction was required to address public harms.⁶⁸

In general terms, criminal liability has been justified on the basis of specific and general deterrence, as well as retribution.⁶⁹ Given the company is an artificial legal entity, anthropomorphically made 'person' only through the device of incorporation under the law, it might be expected that corporate criminal liability would be readily side-stepped and substituted with the personal criminal liability of the perpetrator. This would appear to return liability to the rightful bearer. This natural legal person, with their own reputation to protect and in fear of punishment, could be deterred from their misbehaviour and thus the company would not engage in the particular undesirable conduct. This would avoid the difficulties of attributing the acts or omissions of those individuals to the company through vicarious liability. It would also avoid the need to grapple with the doctrine of identification, whereby the intentions of the company's 'directing mind and will' are the intentions of the company itself,⁷⁰ even under Lord Hoffman's more generous interpretation of that doctrine in *Meridian Global Funds Management Asia Ltd v Securities Commission*.⁷¹

We do not question that companies, in appropriate circumstances and by appropriate methods of attribution,⁷² should be liable for the criminal wrongs of their servants or agents if for no other reason than that, as a practical matter, finding and prosecuting the human offender presents difficulties. These include identifying the particular person or persons who engaged in the conduct that breached the law. Where the crime in question is one of omission, or where many acts or failures to act have contributed to the overall crime, it may be impossible to ascertain the culprits and prosecute them beyond reasonable doubt.

⁶⁸ Ibid 1484–6.

⁶⁹ Lawrence Friedman, 'In Defense of Corporate Criminal Liability' (1999) 23 *Harvard Journal of Law and Public Policy* 833, 841.

⁷⁰ *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705; *Tesco Supermarkets Ltd v Natrass* [1972] AC 153, 170–1; David Wishart, 'Anthropomorphism Rampant: Rounding up Executive Directors' Liability' [1993] *New Zealand Law Journal* 175.

⁷¹ [1995] 2 AC 500, 507, 511. Lord Hoffman held that there was no general theory of attributing states of culpability to companies, but rather that corporate liability in any given case, based on the knowledge or intentions of its employees, depended on the terms of the particular offence. It is important to note that the identification doctrine was not introduced for the purpose of exculpating directors or managers from liability for their behaviour, but rather for the purpose of attributing to the company liability for actions and intentions which might otherwise fall solely on the particular actor. See further G R Sullivan, 'The Attribution of Culpability to Limited Companies' (1996) 55 *Cambridge Law Journal* 515, 521–3; Neil Campbell and John Armour, 'Demystifying the Civil Liability of Corporate Agents' (2003) 62 *Cambridge Law Journal* 290, 292–7; Eilis Ferran, 'Corporate Attribution and the Directing Mind and Will' [2011] 127 *Law Quarterly Review* 239, 243–50. See also Stephen J in *Smorgon v Australia and New Zealand Banking Group Ltd* (1976) 134 CLR 475, 483.

⁷² See further Celia Wells, 'Corporate Crime: Opening the Eyes of the Sentry' (2010) 30 *Legal Studies* 370, 384–8.

Yet a regime of purely corporate criminal liability, especially for relatively minor strict liability offences, may lead to a culture of breach of the law followed by criminal sanction as 'the cost of doing business'. It may be cheaper for a manufacturer to dump toxic waste and pay a small fine, assuming the conduct is detected, than to dispose of the waste properly.⁷³ Fisse and Braithwaite argue that '[t]he impact of enforcement can easily stop with a corporate pay-out of a fine or monetary penalty ... because that is the cheapest or most self-protective course for a corporate defendant to adopt.'⁷⁴ Therefore in appropriate circumstances, there are sound justifications to impose criminal liability where there is wrongdoing on the part of a company director, servant or agent.

C Types of directorial liability for corporate fault or default

The preceding discussion has shown that the imposition of civil and criminal liability on company directors for their actions on behalf of their company is well grounded theoretically. Different pieces of legislation impose liability on directors in a number of ways, encompassing civil remedies, civil penalties and criminal sanctions. Rather than classifying certain defaults as giving rise to criminal or civil action, the law identifies an area of corporate behaviour to be addressed, and then provides for different types of liability depending on the culpability of the director or other persons involved. Three types of liability are considered here: personal liability for corporate default where the company itself is not liable; accessorial liability for corporate contravention where the company is not liable; and derivative liability for the company's fault, whether that fault was attributable to the directors' personal acts or omissions or not. It will be seen that the first two, by focusing on the directors' own actions or omissions, are readily defensible. Derivative liability, on the other hand, is subject to criticism for going too far.

1 Personal liability

The first type provides for liability to be imposed on the directors personally, but where the company itself is not in contravention of the *Corporations Act* despite defaulting on one of its legal obligations.⁷⁵ For example, s 588G of the Act makes directors liable for failing to prevent their companies from incurring debts when there are reasonable grounds for suspecting that the company is insolvent. Here, the company has defaulted on its contractual obligation to pay a debt, and the aim of the

⁷³ 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.' 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.

⁷⁴ Brent Fisse and John Braithwaite, 'The Allocation of Responsibility for Corporate Crime: Individualism, Collectivism and Accountability' (1988) 11 *Sydney Law Review* 468, 469. See also Daniel R Fischel and Alan O Sykes, 'Corporate Crime' (1996) 25 *Journal of Legal Studies* 319, 324.

⁷⁵ A less successful provision is the imposition of liability on directors under s 596AB(1) for intentionally preventing the recovery of the entitlements of employees of a company, or significantly reducing the amount of the entitlements of employees of a company that can be recovered. Action for recovery of losses caused by this behaviour can be brought by the company's liquidator under s 596AC(2). No actions have ever been brought under this section due to the difficulty of establishing the intention requirement.

law is the protection of creditors once a company is in its death throes. The string of defences under s 588H makes it clear that directors remain liable despite not being personally involved in the incurring of the debt, unless they have an appropriate excuse. These include absence from management due to illness or some other good reason, taking all reasonable steps to prevent the incurring of the debt, or reasonable reliance on a competent and reliable person to supply information as to solvency *and* a belief that the company was solvent based on that information.

The purpose of liability for insolvent trading being framed in this way is to require an active involvement of all directors in the company's financial monitoring and decision-making that cannot be avoided on the basis that the director was not part of the company's operational structure. As such, it is not problematic because it simply reinforces the standard of behaviour required of directors under s 180.⁷⁶ Note that the insolvent trading provisions allow for a civil penalty action by ASIC,⁷⁷ a direct action for compensation by the company's liquidator,⁷⁸ or a criminal prosecution by ASIC where the conduct is dishonest.⁷⁹ By having this range of outcomes, it allows for action to be taken which reflects the director's own culpability.

2 Accessorial liability for the company's contravention

The second type of liability is sections that are contravened by the company itself and then accessorial liability is placed on the director as a person involved in the company's contravention. An example is the related party transactions of a public company under s 208 of the *Corporations Act*. The company is not guilty of an offence as a result of contravening s 208,⁸⁰ but a person involved in the company's contravention, as defined by s 79 of the Act, contravenes s 209(2). The degree of involvement under s 79 includes aiding, abetting, counselling or procuring the contravention, or being in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention. It makes sense here not to penalise the company and its shareholders through the imposition of a penalty, since the related party provisions are designed to protect the company from its directors giving financial benefits without prior shareholder approval to themselves, family members or related entities. Other examples of this kind of provision include the capital maintenance rules under ch 2J of the Act.⁸¹

Liability under provisions such as these is not problematic because they cannot be committed with inadvertence, due to the s 79 definition of involvement. In any event, a director on a public company board considering a transaction is obliged to turn their mind to conflicts of interest,⁸² and the related party transaction mechanism which *allows* non-arm's length transactions with related parties should be examined as part of those board deliberations. The same applies to company boards considering

⁷⁶ *Daniels v Anderson* (1995) 37 NSWLR 438; *ASIC v Healey* (2011) 196 FCR 291.

⁷⁷ *Corporations Act* s 1317E(1)(e).

⁷⁸ *Ibid* s 588M(2).

⁷⁹ *Ibid* s 588G(3).

⁸⁰ *Ibid* s 209(1).

⁸¹ *Ibid* ss 256D(3), 259F(2), 260D(2).

⁸² *Ibid* ss 181, 182, 191.

maintenance of capital issues. Again, these provisions allow for civil penalty action by ASIC,⁸³ as well as a criminal sanction where the involvement was dishonest.⁸⁴

3 *Derivative liability for the company's contravention*

Thirdly, there are various forms of directors' and officers' derivative liability, for example under statutes regulating occupational health and safety and environmental protection, to name the most prominent two. These are criminal provisions, and they were examined extensively by the CAMAC in 2005 and 2006.⁸⁵ In contrast to the two forms of liability just discussed which are based primarily on the actions or omissions of the directors, derivative liability, by definition, derives from the company's own liability. Hence there is a need to establish first that the corporation is liable and cannot avail itself of defences. The company's breach may come from the actions or omissions of the board, or from those of company servants or agents. The liability of the director is a secondary consideration.⁸⁶ Directors' derivative liability arises as a

consequence of the positions they hold or the functions they perform in their corporations. 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.⁸⁷

The CAMAC 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 accessory liability.⁸⁸ The aim of derivative liability is to motivate those occupying positions of responsibility to monitor those under their control and to put appropriate systems in place to ensure compliance with the law by everyone in the company. Liability cannot be escaped by turning a blind eye and saying 'I didn't know'. To this extent, positional liability has its roots in the personal default of the particular manager, who is only liable where they cannot avail themselves of various due diligence-type defences.

Nonetheless, there has been a great deal of criticism of derivative liability.⁸⁹ It is seen to be harsh because it involves liability for acts or omissions of persons other than the director or officer found liable, and because the onus is on the director or officer to

⁸³ Ibid s 1317E(1)(b).

⁸⁴ Ibid s 209(3). The capital maintenance provisions also have criminal equivalents: ss 256D(4), 259F(3), 260D(3).

⁸⁵ Corporations and Markets Advisory Committee, *Personal Liability for Corporate Fault*, Discussion Paper (2005) ('Personal Liability Discussion Paper'); Corporations and Markets Advisory Committee, 'Personal Liability Report', above n 1.

⁸⁶ Prior conviction of the corporation is usually not necessary in order for derivative liability to arise. Corporations and Markets Advisory Committee, 'Personal Liability Discussion Paper', above n 85, 21 [4].

⁸⁷ Ibid 1 [1].

⁸⁸ Ibid 27–8 [6.2.1].

⁸⁹ These are neatly summarised in Corporations and Markets Advisory Committee, 'Personal Liability Report', above n 1, 29–33 [3.3].

establish their defence. It is also unpopular because of the inconsistency between states and different pieces of legislation, leading to additional compliance costs. In its report,⁹⁰ CAMAC favoured directorial liability for corporate fault only where there was a degree of personal involvement.⁹¹ Following CAMAC's report, the Ministerial Council for Corporations undertook a program of harmonisation through the development of a set of principles agreed between states, against which states would audit and amend their own laws.⁹²

D Directors' objections to liability for corporate fault

In response to any form of liability, directors complain that they are constrained from doing the very job they were appointed to do – take appropriate entrepreneurial risks to maximise shareholder wealth, and indirectly, to benefit the economy by producing goods or services, creating employment and paying taxes.⁹³ The overall economic costs to society of risk-averse corporate directors may exceed the occasional loss to a particular individual from an errant director.⁹⁴ If an unacceptable degree of liability is imposed on directors, experienced, well-qualified business people may be reluctant to take up directorships, thus depriving companies of a valuable resource. Oesterle remarked that '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.'⁹⁵

⁹⁰ Ibid.

⁹¹ The Committee was of the view that, as a general principle, individuals should not be penalised for misconduct by a company except where it can be shown that they have personally assisted or been privy to that misconduct, that is, where they were accessories: *ibid* 9-10 [1.5.2]. Model legislation imposes liability on 'persons conducting a business'. The liability of each duty-holder under the legislation is limited by the extent to which they influence and control the work of the persons to whom the duty is owed.

⁹² The Hon Chris Bowen, 'Minco Agrees on Principles for Reform of Directors' Liability Provisions' (Media Release, No 036, 6 November 2009). One piece of model legislation, the *Work Health and Safety Act 2011* (Cth) began its operation on 1 January 2012, and state adoptions have been passed or are in the process of being considered by the state parliaments. In addition, the federal government is in the process of harmonising pieces of federal legislation so that the same rules of derivative liability occur in each. The first of these is the Personal Liability for Corporate Fault Bill 2012 (Cth), released in January 2012, which tackles some aspects of liability under the *Corporations Act*, the *Foreign Acquisitions and Takeovers Act 1975* (Cth), the *Insurance Contracts Act 1984* (Cth), and the *Pooled Development Funds Act 1992* (Cth).

⁹³ See 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) (Cooney Committee) [2.39].

⁹⁴ Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991) 62. Coase argued that it is wrong to simply impose restraints upon director behaviour without weighing up the total cost of that intervention. R H Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1, 2.

⁹⁵ Dale A 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 M Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (Centre for Corporate Law and Securities Regulation and CCH Australia Ltd, 2000) 19, 30.

Moreover, imposing liability on directors may be detrimental to a large company's ability to attract non-executive directors, when the prospect of liability is weighed against the difficulties of properly monitoring board and company activities.⁹⁶

This line of argument does not go unchallenged. Byrne has suggested that directors' fear of liability is exaggerated.⁹⁷ This is possibly as part of a strategy to lobby politicians to tone down existing liabilities and discourage the imposition of new ones. 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 ... Rather than inhibiting efficiency, it might well lead to improvements that could be made in the company's procedures and profit-making processes ...⁹⁸

E The advantages of the stepping stone approach

Clearly a balance is needed. As noted in the preceding discussion, there is ample justification for imposing liability on directors civilly or criminally where they have committed wrongs or failed to behave as their position demands. This can be in addition to corporate liability, however established. Liability must be adequate to motivate directors to fulfil their duties in managing or monitoring the management of their companies, but not so harsh that it makes qualified people reluctant to take up board positions, or risk averse when they do so.⁹⁹ It is our contention that the stepping stone approach achieves this balance automatically by only imposing liability on directors where their involvement in the company's breach of the law amounts to a breach of their existing duties. It overcomes the objection that 'innocent' directors can unwittingly find themselves liable for behaviour in which they did not participate, which is a familiar refrain with derivative liability. As it is presently applied, the stepping stone approach goes no further than existing liability provisions, so it does not represent any expansion of the grounds for directors' liability. Rather, by filtering directors' liability for corporate fault through the lens of directors' duties, it creates a more robust and rational basis for liability.

In practical terms, the stepping stone approach also has a series of undoubted operational advantages over provisions imposing derivative or accessorial criminal liability on directors. As civil penalty provisions, the burden of proving breaches of directors' duties is on the balance of probabilities, and not on the criminal 'beyond reasonable doubt'. As noted above, while the business judgment rule does not apply to decisions related to compliance or non-compliance with the *Corporations Act*,¹⁰⁰ directors can still utilise defences under ss 189 and 190 for the actions of those they

⁹⁶ Vanessa Finch, 'Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance' (1994) 57 *Modern Law Review* 880, 885.

⁹⁷ Mark Byrne, 'Directors' Fear of Derivative Liability and Occupational Health and Safety Laws' (2011) 29 *Company and Securities Law Journal* 213.

⁹⁸ Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *Modern Law Review* 665, 686.

⁹⁹ See also Treasury, Australian Government, *Review of Sanctions in Corporate Law*, Consultation Paper (2007) vii.

¹⁰⁰ See above nn 41, 42 and accompanying text.

monitor. Section 189 relieves a director from responsibility for the exercise of a power by a delegate, where the director believed on reasonable grounds at all times that the delegate would exercise the power in conformity with the duties imposed on directors of the company and believed on reasonable grounds, in good faith, and after making proper inquiry if the circumstances indicated the need for inquiry, that the delegate was reliable and competent in relation to the power delegated. Section 190 provides a similar defence in relation to information provided by reliable and competent employees, fellow directors and professional advisers, where the reliance was made in good faith and after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations of the corporation.

This regime of liability is much less harsh than some of the forms of derivative liability examined by CAMAC, where liability was strict and the onus of establishing defences was placed on the directors. Liability for breach of directors' duties is not strict and involves consideration of the director's behaviour against a body of case law. The prosecution is still obliged to make out the constituent elements of the duty breached. For the approach to be successful, there still needs to be elements of the director's own failure to adhere to the required standard of conduct. One major advantage of the stepping stone approach under s 180 is that the court can easily take into account the size of the company and the role played by the particular director. As Byrne noted in relation to derivative liability for OHS breaches,¹⁰¹ this is not so easy under the harshest type of derivative liability provision where those 'real life' factors can only be considered in the defences. The fact that the statutory directors' duties are civil penalty breaches under pt 9.4B of the *Corporations Act* is a major advantage. This allows ASIC to take action to disqualify or penalise the person, or seek compensation from them.¹⁰² The practical importance of this is discussed in Part IV below.

In addition, where appropriate, criminal liability can be imposed on directors where their conduct in allowing the company to contravene legislation is reckless or intentionally dishonest. While contravention of the duty of care under s 180 is not a criminal offence, s 184 provides criminal equivalents to the duties under ss 181 to 183 in such circumstances. It is important to recognise that the application of s 184 through the stepping stone approach does *not* impose criminal liability on directors for corporate breaches that was not available previously, for instance through accessory liability under the provision which the company has breached. Section 184 has always provided for criminal liability for reckless or intentionally dishonest conflicts of interest, for example. The stepping stone approach simply asks the question: did the directors' action in allowing the company to breach the law amount to a reckless or intentionally dishonest conflict of interest? In other words, it provides a concrete action – the company's breach of the law – and places it, as the court might with any other set of facts, into the requirements of s 184. Criminal liability is therefore appropriately ascribed to the director, rather than as a consequence of some automatic derivative liability mechanism.

¹⁰¹ Byrne, above n 97, 227.

¹⁰² The relevant sections are ss 206C, 1317G and 1317H respectively. The company may also seek compensation under s 1317H.

IV POSSIBLE EXTENSIONS OF THE STEPPING STONE APPROACH

The previous two parts examined the recent case law that developed the stepping stone approach to director civil liability for corporate fault as well as the theoretical underpinnings of such liability generally and civil liability in particular. This part asserts that the stepping stone approach could be extended in two important respects. First, it is argued that there is scope for ASIC to prosecute directors and officers for breach of their statutory duties where the first stepping stone involves the company contravening a non-*Corporations Act* law. For instance, ASIC may be able to employ the stepping stone approach to overcome legislative lacunae and to provide a fair and appropriate remedy against a director where presently the *Corporations Act* or another piece of legislation has failed to do so. Secondly, this part also addresses the possibility that third parties other than ASIC, such as corporate creditors or employees, could themselves utilise the stepping stone approach and make directors personally liable in damages for the company's contravention of either *Corporations Act* or non-*Corporations Act* laws. Such an extension of the stepping stone approach has the potential to open the floodgates on directors and become the overwhelming burden of liability feared by directors.

A Non-*Corporations Act* contraventions

Even though the various stepping stone cases considered in Part II above focused on a company's *Corporations Act* contraventions, we assert there is no reason in principle why a company's breach of non-*Corporations Act* laws could not also lead to the imposition of directors' liability for breach of their statutory duties. For example, ASIC could employ the stepping stone approach where a company commits criminal breaches of occupational health and safety laws or environmental protection laws. Contravention of such laws may expose the company to criminal penalties and adversely impact on its reputation just as much as a company's *Corporations Act* contraventions. Despite the fact that OH&S laws provide for directors' accessorial criminal liability, extending the stepping stone approach to such corporate contraventions would mean that executive directors or other officers who caused, authorised or permitted their company to engage in conduct that amounted to a contravention could be made liable for breaching their statutory duty of care. Indeed, in larger companies, non-executive directors who fail to monitor the company's risk management systems resulting in corporate contraventions of OH&S laws may also be subject to the stepping stone approach.

While ASIC may not be keen on trespassing on another regulator's jurisdiction to prosecute directors, the stepping stone approach in this context has two main advantages for ASIC. First, the civil standard of proof applies to s 180 contraventions which makes ASIC's case easier to prove than the criminal standard of proof that applies to directors' accessorial criminal liability for corporate occupational health and safety or environmental offences.¹⁰³ Secondly, the s 180(1) action will not be defeated by the business judgment rule. As the court pointed out in *Fortescue Metals Group*, discussed in Part II above, the business judgment rule defence in s 180(2) does not

¹⁰³ See Corporations and Markets Advisory Committee, 'Personal Liability Report', above n 1, for a discussion of directors' personal criminal liability for offences committed by their companies.

apply because a director's involvement in conduct that results in the company contravening a law is not regarded as a decision 'relevant to the business operations of the corporation' and therefore not a business judgment as defined in s 180(3).¹⁰⁴

Extending the stepping stone approach to allow directors, acting carelessly or improperly, to be sanctioned on the application of ASIC where the company contravenes provisions in other pieces of legislation *would* be an extension of the scope of their present liability. Courts can order the disqualification of directors who have breached civil penalty provisions, pursuant to s 206C of the *Corporations Act*. By utilising the stepping stone approach, ASIC could by making their case on the balance of probabilities seek the disqualification of directors who, by allowing their companies to contravene *other* pieces of legislation, act carelessly or improperly and therefore in breach of ss 180–2 of the *Corporations Act*. For example, where a director has authorised, caused or permitted the company to breach the law by underpaying employees in breach of provisions of the *Fair Work Act*,¹⁰⁵ and then has deliberately sought liquidation of that company as a means of avoiding the consequences of the action, the stepping stone approach could be used to allow for orders of compensation or disqualification against that director where there is no matching provision in that other piece of legislation. Seeking disqualification of directors is not an avenue open to other regulators, and in the absence of the stepping stone approach, it is not otherwise open to ASIC to seek disqualification in relation to breaches of other pieces of legislation.

Another example is taxation debts. Companies have obligations to remit withholding taxes such as PAYG.¹⁰⁶ Where these amounts are unpaid, directors face personal liability pursuant to a Director Penalty Notice (DPN),¹⁰⁷ unless the company is either placed in liquidation or in voluntary administration (VA) within the specified time period. Therefore, timely entry into one of these forms of external administration allows directors to repeatedly avoid payment of company tax obligations, and arguably encourages 'phoenix company activity'. This occurs where one company closes and a new company is formed to carry on the same business for the purpose of avoiding payment of the defunct company's creditors.

The stepping stone approach would have two important uses here. First, by holding the company's failure to comply with its taxation obligations to be a breach of directors' duty of care or duty to act for a proper purpose, ASIC could apply for civil penalty remedies such as disqualification or the payment of compensation. Disqualification would be beneficial here to remove directors who were abusing the corporate form. The 2009 Treasury Paper, *Action Against Fraudulent Phoenix Activity*,

¹⁰⁴ (2011) 190 FCR 364, 427 [197]–[199].

¹⁰⁵ Employers must not contravene National Employment Standards, modern awards or enterprise agreements: *Fair Work Act 2009* (Cth) ss 44, 45 and 50 respectively. Section 546 allows for the making of pecuniary penalty orders against employers for failure to pay these wages, and gives the court discretion to order payment to the Commonwealth, a particular organisation or a particular person (s 546(3)). Section 550 imposes accessory liability on persons involved in the company's breach, but there are no orders provisions allowing for an order that the director be disqualified or expressly allowing the court to make orders of compensation against the accessory.

¹⁰⁶ *Taxation Administration Act 1953* (Cth) sch 1, sub-div B, 16–70.

¹⁰⁷ *Ibid* sch 1, 269–20.

canvassed re-introducing the 'failure to remit' offence, as a means of allowing ASIC to seek disqualification of directors.¹⁰⁸ However, as a criminal matter, it would require proof beyond reasonable doubt. One advantage of the stepping stone approach would be that proof would only be required on discharge of the civil burden.¹⁰⁹ The compensation remedy would *not* be subject to the DPN qualification that allows the penalty to be avoided by seeking liquidation or VA. Arguably, the second use here could be by the ATO itself. As a person interested in the breach of the directors' duty under ss 180 or 181, the ATO would have standing to seek damages or other injunctive relief under s 1324. The application of s 1324 is discussed further below.

B Third party actions

A company's contravention of the law may, of course, adversely affect its shareholders. Under existing provisions, shareholders may in some circumstances already have the means to make their directors personally liable for the company's fault.¹¹⁰ Shareholders also have the ability to bring legal actions in the name of the company under the statutory derivative action procedure in pt 2F.1A of the *Corporations Act*.¹¹¹ However, in the absence of these specific circumstances, the stepping stone approach may provide shareholders with a valuable means by which they may seek redress from directors where breaches of duty have caused the shareholders loss.

Corporate misbehaviour may also have an impact on creditors and others. For example, a company's criminal breaches of OH&S laws may expose it to criminal fines or other sanctions. The corporate fault may also stem from harmful products sold by the company in contravention of the statutory consumer guarantees of acceptable quality in ss 54(1) or 271(1) of the *Australian Consumer Law*.¹¹² While employees and injured consumers of harmful products may have negligence claims for damages against the company, this right is of little value if the company is insolvent or its product liability insurance cover is inadequate. To overcome the difficulties in seeking a tort remedy from a director,¹¹³ an extension of the stepping stone approach may be utilised to give victims of such corporate misbehaviour the ability to obtain personal remedies against the company's directors or officers.

¹⁰⁸ Note that a court may also disqualify directors on the application of ASIC for insolvency and non-payment of debts where the director has been involved in two or more failed corporations within the past seven years and 'the manner in which the corporation was managed was wholly or partly responsible for the corporation failing': *Corporations Act* s 206D(1)(b)(i).

¹⁰⁹ Australian Government, Treasury, *Action Against Fraudulent Phoenix Activity Proposals Paper*, November, 2009 [4.2.5].

¹¹⁰ For example, where the corporate fault consists of the company's contravention of s 1041H by engaging in misleading and deceptive conduct in relation to a financial product or a financial service, s 1041I gives persons who suffer loss or damage as a result of that conduct the right to recover that loss or damage from the contravener as well as *any person involved* in the contravention.

¹¹¹ Even if shareholders satisfy the s 237 criteria and are given leave to sue directors in the name of the company, pt 2F.1A of the *Corporations Act* does not enable them to derive a personal benefit because if such derivative litigation succeeds the company, not the shareholders, gains the benefit of any orders made against directors.

¹¹² *Competition and Consumer Act 2010* (Cth) sch 2 ('*Australian Consumer Law*').

¹¹³ See above n 66 and accompanying text.

The obvious way in which the reach of the stepping stone approach could be expanded to provide remedies for these third parties is through the statutory injunction. Section 1324 of the *Corporations Act* provides that where persons have engaged in contraventions of that Act¹¹⁴

the Court may, on the application of ASIC, or of a person whose interests have been, are or would be affected by the conduct, grant an injunction, on such terms as the Court thinks appropriate, restraining the first-mentioned person from engaging in the conduct and, if in the opinion of the Court it is desirable to do so, requiring that person to do any act or thing.

The section allows the court to grant a prohibitory injunction that restrains a person from engaging in particular conduct¹¹⁵ as well as a mandatory injunction requiring a person to do a particular act.¹¹⁶ In addition, the section also allows the court to make a damages order¹¹⁷ against the person who contravened the *Corporations Act* in addition to or in substitution for the grant of the injunction.

The mechanism for invoking the statutory injunction under the stepping stone approach would be, first, the company's contravention of the *Corporations Act* or indeed of any other Act, on which, second, a breach of duty under the *Corporations Act* by the director is based, which contravention, third, leads to injunctive relief or damages orders under s 1324. Indeed s 1324(10) damages are the most likely remedy to be sought by persons affected by the 'second step' contravention of the *Corporations Act*.

Of critical importance for the purposes of extending the stepping stone approach in this way is the meaning of 'persons whose interests have been affected' by a director's contravention of the *Corporations Act*. Apart from ASIC, only that class of persons has standing to apply for a remedy under s 1324. This expression was given a wide meaning in *Broken Hill Pty Co Ltd v Bell Resources Ltd*¹¹⁸ where it was held that the interests of an applicant for a s 1324 injunction must go beyond the mere interests of a member of the public.¹¹⁹

Until recently, there was judicial uncertainty as to whether directors' statutory duty breaches could be used as a ground for a s 1324 remedy, in particular where the applicant was a creditor of the company. Several cases¹²⁰ suggested that an unsecured creditor had standing to seek an injunction under s 1324(1) to prevent a breach of the *Corporations Act* including a breach by directors of their duties under pt 2D.1. While

¹¹⁴ The section is even broader than this, contemplating actual contraventions, attempts, aiding abetting counselling or procuring, inducing or attempting to induce, being knowingly concerned in or conspiring to contravene the Act.

¹¹⁵ *Corporations Act* s 1324(6).

¹¹⁶ *Ibid* s 1324(7).

¹¹⁷ *Ibid* s 1324(10).

¹¹⁸ (1984) 8 ACLR 609.

¹¹⁹ See also *Brookfield Multiplex Ltd v International Litigation Funding Partners Pte Ltd* (2009) 180 FCR 11.

¹²⁰ For early cases under the section's predecessor under the Companies Code, s 574, see *Broken Hill Pty Co Ltd v Bell Resources* (1984) 2 ACLC 157, 161–2 and *Cullen v Wills* (1991) 31 FCR 19, 27.

courts have not been unanimous in their opinions,¹²¹ the judgments, admittedly in the context of interlocutory applications, have been generally supportive of a broad interpretation of s 1324(1). Einfeld J, for example, in *Airpeak Pty Ltd v Jetstream Aircraft Ltd*,¹²² concluded that breaches of statutory duty are not dealt with exclusively under pt 9.4B of the Act. He stressed that the plain terms of s 1324 allows a wide usage and that the court in any event has discretion as to whether to grant the injunction or damages instead.¹²³ In addition, there is considerable support for a generous interpretation of creditor rights under s 1324(1).¹²⁴ The report of the Parliamentary Joint Committee on Corporations and Financial Services, entitled *Corporate Insolvency Laws: A Stocktake* (2004) makes the bold statement that

[s]ection 1324 of the *Corporations Act* (which confers a statutory right on shareholders and other persons who can establish that they have an interest in pursuing a claim to enforce the statutory duties of directors) also lends support to the proposition that directors not only owe a common law duty but also a statutory duty to creditors in certain circumstances.¹²⁵

The matter has been judicially considered recently by the Queensland Supreme Court in *Phoenix Constructions Queensland Pty Ltd v Coastline Constructions Pty Ltd*.¹²⁶ It is of particular interest because it is the first judicial decision on the merits of s 1324 to confirm that a creditor of a company had standing to claim damages under that section against a director who contravened s 182.

The court held that the director of a company had improperly used his position in contravention of s 182 to gain an advantage for another and cause detriment to the plaintiff. The plaintiff as a creditor was a person whose interests were affected by the director's breach of s 182 and hence came within s 1324(1). The court held that a plaintiff seeking damages under s 1324(10) also had to apply for an injunction even though injunctive relief was not actively pursued. Further, a court may make a s 1324(10) damages order provided the court had jurisdiction to grant the injunction, it being irrelevant that the injunction might have been on discretionary grounds.¹²⁷

¹²¹ *Allen v Atalay* (1993) 12 ACLC 7; *Airpeak Pty Ltd v Jetstream Aircraft Ltd* (1997) 73 FCR 161; cf *Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 39 NSWLR 128. For a criticism of *Mesenberg*, see Robert Baxt, 'Section 1324 Does Provide a Shareholder with a Cause of Action: *Mesenberg's* Case Criticised' (1997) 15 *Company and Securities Law Journal* 313.

¹²² (1997) 73 FCR 161.

¹²³ *Ibid* 167.

¹²⁴ Commentators have agreed with this interpretation. See, eg, John Dyson Heydon, 'Directors' Duties and the Company's Interests' in P D Finn (ed), *Equity and Commercial Relationships* (Law Book Co, 1987) 120; Irene Trethowan, 'Directors' Personal Liability to Creditors for Company Debts' [1992] *Australian Business Law Review* 41, 57; Robert Baxt, 'Will Section 574 of the Companies Code Please Stand Up! (And Will Section 1323 of the Corporations Act Follow Suit)' (1989) 7 *Company and Securities Law Journal* 388, 400. See also Keith Fletcher, 'CLERP and Minority Shareholder Rights' (2001) 13 *Australian Journal of Corporate Law* 290, 300.

¹²⁵ Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Corporate Insolvency Laws: A Stocktake* (2004) 66 [4.72].

¹²⁶ (2011) 84 ACSR 562.

¹²⁷ *Ibid* 570 [56(c)].

However, an appeal against the decision was upheld in *McCracken v Phoenix Constructions (Qld) Pty Ltd.*¹²⁸ The Queensland Court of Appeal held that '[t]here is no necessary correlation between the liberality of the test in s 1324(1) for standing to apply for an injunction and the entitlement to recover damages under s 1324(10).'¹²⁹ The Court was troubled by the apparently unfettered breadth of the section¹³⁰ and the fact that the compensation remedy under s 1317J of the *Corporations Act* was only available for breach of a civil penalty provision on the application of ASIC or the company.¹³¹ The possibility of double recovery where the applicant's claim under s 1324 overlapped with a claim by the company was also of concern.¹³² The Court distinguished or declined to follow earlier authorities supportive of a broad interpretation.¹³³

With due respect, the decision in *McCracken* is unlikely to be the last word on the subject, given the unambiguous nature of ss 1324(1) and (10) and the fact that Parliament has not taken the opportunity to limit the breadth of the provisions. Indeed, when Parliament chose to amend s 1324 in 1998¹³⁴ to include s 1324(1A), the effect was to *confirm* the ability of creditors to seek a s 1324(1) order (with respect to capital maintenance breaches) rather than to impose any limits on the applicability of s 1324 to civil penalty breaches. The capital maintenance provisions are themselves civil penalty breaches¹³⁵ and therefore governed by the pt 9.4B regime. The legislature has therefore made it clear that despite the availability of remedies available only to ASIC and the company under pt 9.4B with respect to capital maintenance breaches, the s 1324 remedies may also be sought by creditors. This would appear to substantiate the legislature's intention that s 1324 be complementary to pt 9.4B.

Just because pt 9.4B only permits ASIC or the company¹³⁶ to initiate civil penalty compensation claims ought not be a bar to a broad interpretation of the s 1324(10) damages remedy. The Act contains multiple overlapping remedy provisions. For example, a member who has been unfairly prejudiced by the conduct of a director, whether or not that conduct amounts to a breach of directors' duties, can invoke the oppression provision s 232 and seek damages under the court's broad powers of s 233(1)(j). There is no authority that the courts' powers under s 233 are constrained by the provisions relating to civil penalty breaches in pt 9.4B. It would be anomalous that unfairly prejudicial conduct by a director that was *not* a breach of directors' duties gave rise to a better right for members than conduct that was a breach.

The decision in *McCracken* to deny creditors the right to apply for injunctive or damages relief under s 1324 in relation to breaches of directors' ss 180–3 statutory duties in effect means that ASIC has exclusive jurisdiction to enforce these statutory duties under s 1324. The learned authors of *Ford's Principles of Corporations Law* argue

128 [2012] QCA 129 ('*McCracken*').

129 *Ibid* [30].

130 *Ibid* [29], [33].

131 *Ibid* [26]–[28].

132 *Ibid* [28].

133 *Ibid* [34]–[39].

134 *Company Law Review Act 1998* (Cth) sch 2 cl 240.

135 *Corporations Act* s 1317E(1)(c).

136 *Ibid* s 1317J(4).

this is undesirable for three main reasons.¹³⁷ First, budgetary constraints may mean that ASIC cannot pursue all breaches of the law. Second, ASIC's priorities for law enforcement may not necessarily be the correct ones. Third, assigning a substantial role to private litigation means there is less need for the legal system to rely on public agencies with their tendency to produce excessive bureaucratic regulation of private enterprise.¹³⁸

Regardless of whether the availability of the damages remedy under s 1324 is confirmed or denied, it is important to recognise that the stepping stone approach combined with s 1324 does not greatly expand directors' liability. First, s 1324 is already available for use to seek a remedy against a director for any breach by the company of the *Corporations Act*, without the need to go via the stepping stone of breach of directors' duty. Directors could simply be liable under s 1324 as persons knowingly concerned in the company's breach of the Act. Courts have not been overwhelmed with applications from shareholders, creditors or others on this basis. Second, s 1324 allows the court wide discretion as to whether a remedy will be granted, and if so, its terms. Courts will not therefore find themselves obliged through the stepping stone approach to give remedies where they are disinclined to do so.¹³⁹ In particular, courts are likely to be unwilling to use s 1324 as part of the stepping stone approach to enable shareholders or creditors to obtain a remedy that they are expressly excluded from under other pieces of legislation. Therefore there is no need for directors to fear the opening of the floodgates of litigation.

V CONCLUSION

There has been extensive discussion about director's' criminal liability for corporate fault following the 2006 CAMAC report, 'Personal Liability for Corporate Fault'.¹⁴⁰ The stepping stone approach, on the other hand, focuses on directors' civil liability. The stepping stone cases discussed in Part II indicate that directors involved in their company's breaches of the *Corporations Act* may contravene their statutory duties in ss 180-3 and therefore be subject to civil penalty orders at the suit of ASIC. This approach has many attractions. It balances the need for directors to take appropriate risks in running the company against their obligation to adequately perform their role as monitors and managers. It ensures that civil liability is only imposed because of a

¹³⁷ R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (Butterworths, 14th ed, 2010) 754.

¹³⁸ American Law Institute, *Principles of Corporate Governance and Structure: Restatement and Recommendations* (Tentative Draft V44, 1982) 220-1, quoted in *ibid*.

¹³⁹ Baxt argues that '[t]here has been an unexplained failure on the part of the legal profession to use this section of the *Corporations Law*': Robert Baxt, 'Do We Really Need a Statutory Exception to *Foss v Harbottle*?' (1994) 22 *Australian Business Law Review* 298, 298-9. He further states that '[s]ection 1324 is rarely used in reported litigation. I have always been puzzled by this, particularly following the decision of Hayne J in the Victorian case of *Allen v Atalay* (1993) 11 ACSR 753': Robert Baxt, 'A Body Blow to Section 1324 of the Corporations Law? Will the Derivative Action Get a New Lease of Life?' (1996) 14 *Company and Securities Law Journal* 312, 312. See also Robert Baxt, 'Section 1324 Does Provide a Shareholder with a Cause of Action – Mesenberg's Case Criticised' (1997) 15 *Company and Securities Law Journal* 313, 313.

¹⁴⁰ See, eg, Byrne above n 97.

personal failure to perform well-recognised legal obligations, rather than as a derivative consequence of the company's own civil or criminal conduct.

In this paper we suggest that the stepping stone approach is not confined to the company's *Corporations Act* breaches but can also make directors liable for contraventions of other legislation as well as company's breaches of contract. While ASIC may be unlikely to trespass on another regulator's jurisdiction, the stepping stone approach may provide a useful avenue for disqualifying directors when that other legislation lacks such a remedy. We also suggest that it may be possible to extend the stepping stone approach to allow creditors and others affected by corporate misbehaviour to seek damages under s 1324(10). Although this may appear to open the floodgates of directors' personal liability, the courts still retain discretionary powers to refuse such relief.

