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Ms Ruth Smith
Manager, Corporations and Financial Services Division
Corporate and Financial Services Regulation Review
The Treasury
Langton Crescent
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Dear Ms Smith,

Review of Sanctions in Corporate Law

The Australian Bankers' Association (ABA) welcomes the opportunity to provide comments on the *Review of Sanctions in Corporate Law* consultation paper.

The Regulation Taskforce's *Rethinking Regulation* report recommends that the Australian Government should review the penalties for breaches of director's duties to ensure that they strike an appropriate balance between promoting good behaviour and ensuring business is willing to take sensible commercial risks¹.

1. General observations

Australia's corporate law provides ASIC with a suite of sanctions – including criminal, civil, administrative, infringement notices and enforceable undertakings – which may be imposed where there has been a contravention and to address corporate misconduct.

The ABA acknowledges that sanctions are intended to discourage and deter undesirable behaviour that might reduce the efficiency and development of the economy as well as provide the regulator with the flexibility to tailor a regulatory response to the circumstances of the contravention or breach of the law.

The ABA also acknowledges that sanctions are intended to apply to companies and individuals. Personal liability provisions for corporate misconduct are intended to create specific and general incentives for individuals to take responsibility for corporate compliance as well as ensure that individuals are held accountable for their actions. However, uncertainty can discourage innovation and responsible risk-taking in corporate decision making.

¹ Recommendation 5.3

It is the ABA's view that currently the law is unclear in the application of penalties, offences and defences and it should be amended accordingly. Uncertainty about the extent of liability of directors and officers can result in risk-averse behaviour by directors and officers. While some risk-taking behaviour is undesirable, such as legal risk, risk-averse behaviour can impede corporate decision making, limit efficient management of companies, inhibit innovative business activity and restrict commercial judgement. Excessive penalties, without adequate defences, can also discourage qualified and suitable candidates from accepting director and senior manager positions.

It is vital that directors and officers:

- Clearly understand their general duties and legal obligations;
- Recognise the offences and penalties for a contravention or breach of the law; and
- Have confidence that the law affords adequate defences and protections for directors acting in good faith with respect to their general duties and obligations.

Directors and officers should have certainty regarding their duties and responsibilities and adequate defences as they apply in the Corporations Act, other statutes and common law. Equally, shareholders, stakeholders and the community should have confidence that the law provides a sensible and fair framework that protects directors and officers, but penalises 'rogue' directors and officers.

Therefore, the ABA commends the Government for giving consideration to reexamining the principles guiding the use of different types of sanctions and refining the underlying offence provisions to more clearly identify the circumstances in which a sanction may be imposed.

2. Specific comments

2.1 Responsive regulation, responsible risk taking and better defining the contravention

It is the ABA's view that directors should have regard for the short-term and long-term interests of the company to ensure sustainable economic growth and increased profitability for the company. Corporate decision making should involve determining relevant interests, based on the nature of the business activities, the different business models and industry sectors, and the different operational issues impacting their stakeholders. Companies and directors should be responsible for their decisions as they impact on shareholders and stakeholders.

The ABA recommends that the 'business judgement rule' should be extended to apply across all the core provisions relating to directors' duties contained in the Corporations Act and Trade Practices Act; and the 'reliance on others' defence should be clarified and extended to apply to officers in the Corporations Act.

Under both the Corporations Act and common law, directors have a duty to act in the best interests of the company. In addition to duties based on a directors' fiduciary relationship with the company, companies must also meet a wide range of Commonwealth, State and Territory statutes regarding occupational health and safety, anti-discrimination, industrial relations, equal opportunity, consumer protection and environmental impact as well as adhere to international covenants.

2.1.1 Directors' duties

The Corporations Act contains a number of general duties that requires directors and officers to exercise care and diligence or prohibits directors and officers from improperly using their position or information attained from their position to gain an advantage².

The broad nature of these general duties means that Australian courts have successfully applied directors' duties to different circumstances. In 1992, Justice Rogers outlined a range of responsibilities that builds on the general law business judgement doctrine as a wider concept embodying that a duty of a director may be to "display entrepreneurial flair" and "accept commercial risks" to produce sufficient return on capital invested³. Furthermore, in 2003, Justice Austin held that a director is to articulate and apply a standard of care that reflects "contemporary community expectations"⁴.

The various court interpretations of directors' duties implies that directors have a duty not merely to inform themselves about the company's activities and financial position and to make inquiries, but to exercise care, skill and diligence in the best interests of the company, that being the company as a whole, reflecting wider expectations, that being of the community. Thus, directors have both a right and a duty to decide where the company's interests lie and how those interests may be best served. When exercising business judgement, the Corporations Act requires directors to exercise care and diligence and to act in good faith in the 'best interests of the company' and for a proper purpose.

It is the ABA's view that a director acting in the best interests of a company is not restricted from focusing beyond maximising short-term profits and shareholder wealth when making corporate decisions. (Some commentators argue that 'shareholder primacy' restricts innovative decision making.) Taking a broader view that is consistent with the interests of the company that creates long-term value is indeed acting in the best interests of the company. Failure to manage shareholder and wider stakeholder interests, as expected by the community, may create harm for the company.

Therefore, the ABA considers that the duties of directors to exercise reasonable commercial judgement can enable and encourage directors to discharge a standard of care that takes into consideration the interests of shareholders and other stakeholders. However, we also consider that to encourage innovative decision making, it is reasonable for directors and officers to have available objective tests and adequate defences.

² Section 180(1) sets out that a director or officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence. This is a civil penalty provision.

Section 181 of the Corporations Act sets out that a director or officer of a corporation must exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose. This is a civil penalty provision.

Section 182 of the Corporations Act sets out that a director, secretary or other officer or employee of a corporation must not improperly use their position to gain an advantage for themselves or someone else or cause detriment to the corporation. This is a civil penalty provision.

Section 183 of the Corporations Act sets out that a person who obtains information because they are, or have been, a director or officer or employee of a corporation must not improperly use the information to gain an advantage for themselves or someone else or cause detriment to the corporation. This is a civil penalty provision.

Section 184 sets out that a director or officer of a corporation commits an offence if they are reckless or intentionally dishonest and they fail to exercise their powers and discharge their duties in good faith in the best interests of the corporation or for a proper purpose. This is a criminal offence provision.

³ *AWA v Daniels*

⁴ *ASIC v Rich*

2.1.2 Business judgement rule

The 'business judgement rule' was introduced to protect directors in the exercise of their duties and to give directors confidence to engage in entrepreneurial or informed decision-making that takes into consideration the wider interests of the company and the company's long-term performance.

Section 180(2) sets out that a director or officer of a corporation who makes a business judgement is taken to meet their duty of care and diligence if they make the judgement in good faith for a proper purpose; and do not have a material personal interest in the subject matter of the judgement; and inform themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate; and rationaly believe that the judgement is in the best interests of the corporation.

The business judgement rule applies only to the duties contained in subsection 180(1). The 'rational belief' test does not apply to section 181.

It is the ABA's view that the 'business judgement rule' should be extended to apply across all the core provisions relating to directors' duties contained in the Corporations Act and Trade Practices Act. However, we note that altering the law may have unintended consequences, i.e. implications for liquidators or receivers and the insolvency system. It is also likely that the business judgement rule would need to be tailored to the circumstances of the duty, i.e. whether the duty requires a director to act in good faith or prohibits a director using their position improperly.

2.1.3 Reliance on others defence

Section 189 sets out that if a director relies on information, professional or expert advice and that their reliance was made in good faith and after making an independent assessment of the information or advice, the director has performed their duty and equivalent general law duty. The director's reliance on the information or advice is taken to be reasonable unless the contrary is proved.

Apart from the limited business judgement rule and the ability for a director to rely on others to fulfill their duty, directors are not afforded protections or defences in relation to civil penalties and criminal offences applied to directors' duties. In the absence of other protections or confusion about other defences, directors may be overly cautious about proving this defence and thereby make extensive inquiries or require excessive independent assessments. This is costly and inefficient.

The reliance on others defence only applies to directors and not officers.

It is the ABA's view that the 'reliance on others' defence should apply to directors and officers in the Corporations Act. Furthermore, the law should clarify that reliance would be reasonable after making proper inquiries if the circumstances indicated the need for inquiries.

2.1.4 General defence

The Corporations Act imposes a range of general and specific obligations on companies, directors and officers. Currently the law contains multiple defences for separate provisions.

A general defence in the Corporations Act could relieve directors and officers of liability for decisions made where they act:

- in a bona fide manner;

- within the scope of the corporation's business;
- reasonably and incidentally to the corporation's business; and
- for the corporation's benefit.

The ABA acknowledges there would be merit in introducing a general defence into the law. However, a general defence is unlikely to enable directors and officers to clearly understand their general duties and legal obligations, nor have confidence that the law affords them adequate protection. Therefore, we prefer the following approach:

- (1) Extension of the business judgement rule to the 'core' duties. This would improve certainty in the law and resolve concern about the lack of symmetry between sections 180 and 181.
- (2) Alignment of the various offences with the appropriate defence (containing necessary elements, including reasonable steps or due diligence, etc) and relevant penalties. This would improve certainty in the law and resolve concerns regarding ambiguity of legal obligations and applicable sanctions and penalties.

Alternatively, where a general defence is introduced, the elements of the defence would need to be clarified, as interpretation of the elements of the defence would necessarily be subjective and difficult to align to the discrete nature of some of the obligations. It is also unclear how a general defence would operate with the existing business judgement rule that applies to the duties in section 180(1).

It is the ABA's view that it would be undesirable if the business judgement rule was not extended or a general defence was not introduced, leaving the existing defences as the only defence available to directors and officers.

2.2 Sanctions in corporate law

It is the ABA's view that:

- Criminal offences and civil penalties should only apply to the most egregious behaviour and severe contraventions in the law;
- Administrative sanctions should not be used as 'quick wins' or due to perceived deficiencies within the law relating to criminal or civil sanctions;
- Derivative liability should only be imposed where the director or officer knew or, or was reckless or negligent as to the contravention;
- Strict liability offences must be accompanied by adequate defences; and
- Personal liability should only be imposed in circumstances where the director or officer directly participated in, or contributed to, the contravention.

2.2.1 Criminal and civil sanctions

It is the ABA's view that the severity and nature of the conduct, the magnitude of the damage caused by the conduct, and the harm to society, should be factors considered when determining which sanctions to apply. Currently the regulator has substantial discretion to decide if criminal, civil or hybrid proceedings should be taken against a company and/or individual.

Firstly, the ABA supports the view of the Corporations and Markets Advisory Committee (CAMAC) that, as a general principle, individuals should not be made criminally liable for misconduct by a company except where it can be shown that they have personally helped in or been privy to that misconduct, that is, where they are accessories⁵. Furthermore, it is our view that legislation that treats directors and officers as criminally liable for misconduct by their company must make out a relevant defence. The law should not contain criminal sanctions on a strict liability offence without adequate defences.

Secondly, the ABA believes that criminal and civil sanctions should only be used for the most serious contraventions involving sufficient misconduct or moral wrongdoing. For example, generally breaches of low level record keeping, reporting or disclosure should not be subject to criminal sanctions, such as financial service providers failing to provide a FSG or SOA to a retail client. However, fraudulent behaviour or deliberate dishonest conduct, such as destroying documents, falsification of books or amending files that relate to the affairs of the company, should be subject to civil and criminal sanctions and a breach of the directors' duties.

Thirdly, the ABA considers that differences between the Corporations Act and the Criminal Code should be addressed. We are particularly concerned with the treatment of dissenting directors or officers under provisions that do not adequately provide clear defences.

Example: If an action is brought against an officer for an offence under section 674(2A) for being involved in a contravention, the defence is that the officer took all steps (if any) that were reasonable in the circumstances to ensure that the listed disclosing entity complied with its obligations, and, after doing so, believes on reasonable grounds that the listed disclosing entity was complying with its obligations.

Example: If an action is brought under the Criminal Code 11.2, a defence applies if before the offence was committed, the officer terminated his/her involvement, and, took all reasonable steps to prevent the offence.

Therefore, if an officer were in a situation where they tried unsuccessfully to get the company to make a disclosure, there is likely to be a different outcome under the Corporations Act (convicted) and the Criminal Code (not convicted).

It is the ABA's view that some criminal sanctions should be removed where the contravention is less severe – that is, where the breach does not involve sufficient misconduct or moral wrongdoing. Civil sanctions should be amended to ensure that penalties are proportionate. Furthermore, the differences between the Corporations Act and Criminal Code should be addressed.

2.2.2 Administrative sanctions

ASIC has a number of administrative remedies available, including the ability to ban, disqualify and remove an individual from being a director or officer of a company or from providing financial services.

It is the ABA's view that due to the perceived difficulties with administering the law – whether that is the burden of proof or the resources required to pursue such cases and conduct such proceedings – the regulator has demonstrated a tendency to pursue administrative solutions. While in some cases this course of action would be reasonable and sensible given the nature of the contravention, it is our view that use of these sanctions should be only for minor breaches, where the breach does not involve sufficient

⁵ CAMAC (2006). *Personal Liability for Corporate Fault*. September 2006. p33.

misconduct or moral wrongdoing, and where the breach can not be addressed through other means.

Administrative sanctions act as a useful deterrent for minor breaches of the law. However, banning a director has significant implications for the director and the company. Administrative sanctions should not be extended to trivial or inconsequential breaches where compliance can be achieved through other means, such as persuasion and education.

2.2.3 Infringement notices

ASIC has the power to issue an infringement notice for a breach of the continuous disclosure provisions contained in section 674(2). Infringement notices are intended to provide an additional remedy for addressing less serious breaches of the continuous disclosure obligations. Infringement notices enable ASIC to enforce compliance without the commencement of a prosecution or proceeding.

It is the ABA's view that efficacy of the infringement notice provision is questionable and it can have unintended consequences for market efficiency, corporate conduct and disclosure to the market. For example, on the one hand, companies, directors and officers may be making decisions about disclosure based on the possibility of a sanction, rather than based on commercial judgement and in the interests of good disclosure practices ("risk-adverse" behaviour). On the other hand, the incentive to accept an infringement notice (and subsequent penalty) and not be subject to further civil penalties or criminal proceedings from ASIC may engender careless or reckless conduct with perceived minimal ramifications (payment without admission) ("irresponsible risk-taking" behaviour). Whether the behaviour is risk-adverse or risk-taking, the outcome is adverse for market disclosure.

The ABA supports the Business Council of Australia's views on the operation of the infringement notice provisions in the Corporations Act. We believe that the infringement notice regime should be abolished.

2.2.4 Enforceable undertakings

ASIC has the power to give and accept an undertaking that is enforceable in a court. Enforceable undertakings are an alternative to civil or administrative actions.

It is the ABA's view that enforceable undertakings can be a useful deterrent for a minor breach, where the breach does not involve sufficient misconduct or moral wrongdoing. However, the regulator has demonstrated a tendency to use media releases with enforceable undertakings. While an enforceable undertaking may provide a cost-effective enforcement tool for the regulator, the cost of adverse media attention (sometimes for a sustained period of time) can have a substantial and disproportionate impact on the director and company.

2.3 Liability in corporate law

2.3.1 Derivative liability

The ABA believes that the law should not automatically impose fault on directors and other officers simply because of a contravention by the company, and liability must be based on whether the director or officer knew of, or was reckless or negligent as to the contravention.

The ABA supports appropriate defences attributed to offences for derivative liability, including due diligence, reasonable steps, no knowledge, no control/influence, reasonable reliance on information provided by others and reasonable mistake.

2.3.2 Strict liability

The ABA believes that directors and officers should be afforded the same presumption of innocence as is given to other members of the community within the criminal system. The onus should rest on the prosecutor to establish all the elements of the offence, that include proof that the director or officer was complicit, negligent or reckless and most importantly, that this conduct caused the offence to occur.

The ABA does not support strict liability where directors or officers are deemed liable without some personal culpability. We are particularly concerned with the treatment of dissenting directors or officers under strict liability provisions.

2.3.3 Personal liability

The ABA believes that individuals who knowingly participate in a breach of the law should be held accountable for their actions. However, generally there should be a direct connection between the actions or omissions of the individual and the contravention. In this instance, penalties should be proportionate to the degree of direct involvement in, or responsibility for, the offence, rather than simply based on the severity of the offence. Personal liability should only be imposed if the prosecutor proves four elements beyond reasonable doubt about the individual, that the person:

- is a director or officer of a company;
- was in a position to influence the contravening conduct of the company;
- knew, or was reckless or negligent as to whether the contravening conduct would occur; and
- failed to take all reasonable steps to prevent the contravening conduct.

We are concerned about the growing trend to apportion personal liability irrespective of personal fault in corporations and other law.

3. Concluding remarks

It is important that directors and officers that contravene the law knowingly, recklessly or negligently are held accountable for their actions. However, it is also important that directors and officers do not become overly concerned with compliance to the detriment of the efficient management and functioning of the company.

Regulation is necessary to make sure the interests of business, consumers and the community are protected. However, regulation should aim to reduce the red tape burden on business, while striking a balance between economic growth and community interest.

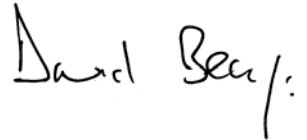
It is the ABA's view that over regulation has led to a conservative and compliance-focused approach by many directors and officers. The law should be amended to achieve a better balance between promoting good corporate behaviour and ensuring directors and officers are willing to take sensible commercial risks.

Extending the application of the business judgement rule and the reliance on others defence, coupled with restructuring the provisions regarding other obligations, offences, penalties and defences should encourage directors and officers to have confidence to make decisions and remove uncertainty regarding whether the law is unduly influencing corporate decision making.

The ABA notes the recent reports by the Corporations and Markets Advisory Committee (CAMAC) reports: *Corporate duties below Board level* (April 2006); *Personal Liability for Corporate Fault* (September 2006); and *The Social Responsibility of Corporations* (December 2006). The ABA made submissions to these consultations and would be happy to provide Treasury with a copy of our submissions.

The ABA would be happy to discuss any of the issues raised in this letter with you further. Please contact me or Diane Tate, Director, Corporate & Consumer Policy on (02) 8298 0410: dtate@bankers.asn.au.

Yours sincerely

A handwritten signature in black ink that reads "David Bell:".

David Bell