

8 June 2007

Review of Sanctions for Breaches of Corporate Law  
Corporations and Financial Services Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

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Dear Sir/Madam

### **Treasury Review of Sanctions in Corporate Law**

Our submission is enclosed for your consideration. Thank you for the opportunity to comment on the Treasury paper.

The Australian Institute of Company Directors (AICD) is the peak organisation representing the interests of company directors in Australia. Our current membership consists of over 21,000 individuals drawn from large and small organisations, across all industries, and from private, public and the not-for-profit sectors.

If you have any questions in connection with this letter please do not hesitate to contact me or Gabrielle Upton on (02) 8248 6635.

Yours sincerely

**[SIGNED]**

Ralph Evans  
**Chief Executive Officer**

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## REVIEW OF SANCTIONS IN CORPORATE LAW

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### 1. Responsive regulation and responsible risk taking

Decision making by boards of directors is often based on a wide range of matters, including relevant regulatory issues. There is no doubt that directors do take into account issues such as taxation, workplace, environmental and a wide range of other laws (including relevant sanctions) when making decisions, especially decisions about where to locate a business.

Generally, we believe that decision making by directors is based on the assumption that laws will be complied with. However, given the choice between two jurisdictions for locating a new business, commercial considerations will often result in the jurisdiction with the less onerous regime being chosen. We often see this where a choice is to be made between two states and where other considerations are generally equal.

In the same way, where the choice between Australia and another comparable jurisdiction where corporate regulation is perceived to be less onerous, international investors will choose that other jurisdiction. Certainly we believe Australia is considered internationally to be a country with high levels of corporate regulation. Having said that, we doubt that penalties and sanctions which may be imposed on directors and officers would alone influence such a decision but rather be considered along with other areas of corporate regulation and the legislative environment more generally.

In terms of local impact, while there is no shortage of directors willing to step up to lead major Australian companies, more senior and experienced directors and potential directors (most particularly recently retired senior executives) are shying away from taking on high profile positions, especially in the listed environment, because of concerns of potential personal risks of liability or, even if they are able to defeat claims, of severely damaged reputations. The question many recently retired senior executives ask themselves is why they would accept a risky position, such as director of a high profile company, which could place their hard earned reputations and their retirement benefits at risk.

The evidence that this is happening can be seen from the willingness of many potential well regarded director candidates to take up positions on boards of companies owned or controlled by private equity investors, away from the public environment.

The trend of various legislatures throughout Australia to make directors and senior executives personally liable for corporate fault is impacting on corporate decision making and entrepreneurship by creating an environment which encourages more cautious and conservative decision making. In saying this, we do not single out the sanctions regime in the *Corporations Act*, although, as we note below, there is considerable room for improvement especially in areas where directors should be afforded defences where they have acted responsibly where no such defences currently exist.

The final observation we want to make is that many directors are forming the view that there is no longer a fair balance between risk and reward, with the risks directors take exceeding by a margin the rewards they can earn from holding office. The consequence is likely to be a smaller and potentially less experienced pool of company directors for our corporate community to draw upon. Certainly those directors who have moved from the public to private (meaning private equity) environment indicate that the balance between risk and reward (especially given the ability for them to participate in the company's success through significant share and option holdings) is a much more favourable one.

## **2. Criminal, civil and administrative sanctions**

### *2.1 Criminal sanctions*

AICD supports the criminal regime currently applying in section 185 of the *Corporations Act* which makes corporate personnel liable to criminal offences for breaches of sections 181, 182 and 183 where they have acted dishonestly or recklessly. AICD does not support situations where directors are exposed to strict liability, no matter how serious the consequences.

We especially support the approach taken in section 184 of not exposing directors who breach section 180 to criminal sanctions, as to do so would potentially expose directors and officers to criminal sanctions for negligence. That would be highly inappropriate as an offence of criminal negligence for directors would discourage many from continuing to act.

### *2.2 Administrative sanctions*

The paper identified a number of *Corporations Act* sections which carry anachronistic sanctions and are clearly in need of reform, whether to bring them under the civil penalty regime, or, as suggested under a new administrative sanction regime. We attach a copy of our recent submission to Treasury detailing our serious concerns regarding the infringement notices regime application to continuous disclosure breaches.

AICD does support the civil penalty regime applying under the Corporations Act and notes that the High Court, as recently as May 2007, in the case of *Albarran v Members of the Companies Auditors and Liquidators Disciplinary Board*, acknowledged their place as an appropriate form of judicial punishment under the Constitution.

### **3. Better defining the contravention**

#### *3.1 General protection for directors*

AICD strongly supports the introduction of a general defence for directors.

The defence suggested (which is intended to apply consistently to Corporations Act offences by directors), is proposed to be available where directors 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.

Having considered this proposal, AICD does not support this formulation of the defence, especially the second and third elements, as we do not understand why the conduct must be within the scope of, or reasonably incidental to, the corporation's business before the defence can be relied on.

AICD prefers a model which requires directors to establish that they have:

- acted in good faith;
- informed themselves about the subject matter to the extent that they reasonably believe appropriate; and
- which they reasonably believe is in the best interests of the corporation.

As can be seen, this formulation is based on the existing business judgment rule defence in section 180(2). However, AICD prefers to express the requirement to act 'bona fide' as a requirement to act 'in good faith'. We have also omitted the requirement to act for a proper purpose. We are concerned that inclusion of the expression could lead to uncertainty as to when the defence might be available. We think that little or nothing is lost from the omission of the expression in any event because the requirements for the directors to act in good faith and have a rational belief that what they are doing is in the best interests of the company ensure that directors will indeed be acting for a purpose consistent with the best interests of the company and its shareholders before being able to avail themselves of the defence.

AICD considers that because the proposed formulation of the defence requires directors to have acted in good faith and rationally believe that what they are doing is in the best interests of the company, it is superfluous to impose a further requirement that a director have no material personal interest in the matter.

We note that the four elements of the defence proposed in the Sanctions paper also do not include a requirement that the director have no material personal interest in the matter.

AICD believes that the defence should be available for each of the following sections:

Section No	Provision
S 181	Officers to act in good faith in the best interests of the company and for a proper purpose
S 182	Officer or employee making improper use of position
S 183	Officer or employee making improper use of position
S 197	Potential liability for debts of trustee company where right of indemnity is lost
SS 295(4) and 303(4)	Director's declaration regarding the accounts
S295A	CEO and CFO declaration regarding accounts
SS 299, 299A, 300 and 300A	Contents of Annual Directors' Report
S 588G	Director's duty to prevent insolvent trading
S 670A	Liability for misstatements in or omissions from takeover documents
S 674(2A)	Person involved in a contravention by a listed company of its continuous disclosure obligations
S 728	Liability for misstatements in or omissions from prospectuses or other disclosure documents
SS1041A to 1041G	Market manipulation, false trading, and related conduct
S 1043A	Insider trading
S 1041H	Person engaging in conduct in relation to a financial product or service which is misleading or deceptive
S 1307	Falsification of books
S 1308	(1) Advertising false or misleading statements about share capital ; and (4) failing to take reasonable steps to ensure that a statement required by the Act or is lodged under the Act is not misleading in a material respect
S 1309	Giving false or misleading information to director, member or auditor or failing to take reasonable steps to ensure it is not false or misleading
SS 12CA to 12CC ASIC Act	Engaging in unconscionable conduct in relation to certain financial services transactions
SS 12DA to DC ASIC Act	Making false or misleading representations in relation to financial products

One section where difficulty might arise is section 181 where the requirements of the section are such that a director must act in good faith in the best interests of the company and for a proper purpose. The defence, as proposed, could be applied to this section, but (especially if, as proposed in the Sanctions paper, the language of section 181 is brought into line with the business judgment rule defence), there seems to be considerable overlap between the language of the offence and the defence.

In relation to sections 182 and 183, while we support the adoption of the defence, its application to conduct which has been characterised as 'improper' requires some consideration.

AICD strongly supports the general defence being made available under section 588G. We do not believe that it would encourage insolvent trading. One of the problems with the current provision is that sometimes directors are just too cautious where a company is experiencing liquidity problems and choose to call in an administrator to protect themselves (before the company is insolvent) when the interests of shareholders would have been better served by the company continuing to trade.

The combination of the trigger for the risk for liability for insolvent trading (being the existence of reasonable grounds for suspecting insolvency) and the uncertainty as to the circumstances in which the directors may be relieved from any such liability (under section 1317S or section 1318) presents a very real problem for the directors of companies in financial distress who acting reasonably and honestly attempt a restructure.<sup>1</sup>

AICD considers that for the sake of uniformity, the new general defence should replace the business judgment defence and should be in addition to the existing defences to section 588G.

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<sup>1</sup> In *Edwards v A-G (NSW)* (2004) 50 ACSR 122 Young CJ in Eq (though dealing with the issue of an application to be excused "in advance" which is a different issue) pragmatically described the problem in these terms:

*"Whilst it is important to ensure that people do not misuse the corporate veil and the principle of limited liability and trade whilst insolvent, it is also necessary to see to it that where companies are in a precarious position they are managed by people with the appropriate business expertise. One consequence of the trading whilst insolvent provisions is that such expertise is not available to companies because of the justified fear that personal liability might attach or even that there will be an attempt by a creditor to say that personal liability attaches which can only be tested in an expensive set of proceedings.*

*The solution latterly suggested by Mr Jackman of receivership is with respect, just another manifestation of the way in which the Corporations Act compels companies in a precarious financial position to spend mega dollars on accountants to endeavour to salvage their position instead merely of appointing more experienced directors to the board."*

### *3.2 Inconsistent approach*

We consider that section 181 should be made consistent with the business judgment defence in section 180(2), so that the requirement for directors to act in the best interests of the company is replaced with a requirement that they act in a manner which they rationally believe to be in the best interests of the company.

### *3.3 Review of section 189*

AICD believes that the original formulation of section 189(b)(ii) is preferable so that directors are only required to make enquiry before relying on advice from others if the circumstances indicate the need for enquiry, rather than being obliged to make an independent assessment of the information. We agree that given the uncertainty around the meaning of what an 'independent assessment' requires, it would be preferable to return to the original drafting.

### *3.4 Obligation to keep financial records*

There would appear to be benefits in making section 286 consistent with section 344.

### *3.5 Drafting of offence provisions*

There would be benefits in having the maximum penalties for breach of the law set out in the relevant section rather than in a schedule at the back of the Corporations Act.