

# **PROMOTING ENHANCED ENFORCEMENT OF DIRECTORS' FIDUCIARY OBLIGATIONS: THE PROMISE OF PUBLIC LAW SANCTIONS**

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*The substantive law which regulates the exercise of directors' powers is not self implementing. Action must be taken to enforce its observance. The legal system must therefore provide a reliable mechanism for enforcing the law which seeks to protect the interests of companies and, vicariously, the investing community. Unless that is done, the applicable rules are bound to deteriorate into voluntary obligations which the controllers of companies may or may not observe according to their whims. This article argues that dual (public and private) is required in order to achieve optimum enforcement of the law governing directors' fiduciary duties. Further, it advocates enhanced use of public (criminal) law sanctions as a means of promoting greater deterrence of wrongful director conduct. By reason of their stigmatic effects, these sanctions have great potential to deter undesirable conduct. Some of the impediments to the effective use of public law sanctions in this area are examined. Finally, the article explores ways in which the law could be reformed to overcome these obstacles.*

**Main subject area**      **Company Law**

**Key terms**                      **Directors' fiduciary obligations; private enforcement; public enforcement; public (criminal) law sanctions.**

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## 1 INTRODUCTION

Australia has witnessed some spectacular corporate collapses in the recent past. More memorable amongst these are the failures of Westpoint, Ansett, HIH, One. Tel and Harris Scarfe. It is generally acknowledged that these disasters were, in large measure, precipitated by serious derelictions of duty on the part of the directors of the companies involved. Indeed, describing the conduct of the directors in the recent Westpoint saga, Justice French of the Federal Court of Australia said:

the evidence placed before the Court . . . was extensive and detailed and was not the subject of any substantial challenge. It is indicative of serious misconduct in the affairs of the companies . . . Indeed there are aspects of the evidence suggestive of a ruthless disregard by the Westpoint groups' controllers of the interests of investors and other creditors . . . Other aspects of the evidence . . . are indicative of a degree of carelessness and indifference on their part to their duties as directors.<sup>1</sup>

In similar vein, commenting on the conduct of the directors of HIH, Justice Owen, the Commissioner appointed to investigate its collapse, noted in his report that, in the conduct of its affairs, there was a 'culture of apparent indifference or deliberate disregard on the part of those responsible for the well-being of the company.'<sup>2</sup>

There can be no doubt that because of their cataclysmic effects on various segments of the community<sup>3</sup> particularly investors, employees and creditors,<sup>4</sup> these catastrophes

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1 See *Australian Securities and Investments Commission, In the Matter of Richstar Enterprises Pty Ltd (ACN 099 071 968) v Carey* (No 3) [2006] FCA 433; (2006) 24 ACLC 581 at 583-4.

2 See Commonwealth of Australia, *HIH Final Report, Vol 1, A Corporate Collapse and its Lessons*, 2003 at 10. Report available at [http://www.hihroyalcom.gov.au/finalreport/Front%20Matter.%20critical%20assessment%20and%20summary.HTML#\\_Toc37086537](http://www.hihroyalcom.gov.au/finalreport/Front%20Matter.%20critical%20assessment%20and%20summary.HTML#_Toc37086537) (date accessed 9 May 2006).

3 For example, Justice Owen noted that the conduct of the directors of HIH produced a calamity of monumental proportions. See Commonwealth of Australia, above, n 2 at 10.

4 The negative consequences of these failures are attested to by news headlines like 'The demise of Ansett left thousands of airline workers out of pocket. But has it also resulted in

seriously undermined public confidence in the integrity of Australia's financial markets.<sup>5</sup> This has serious implications for the proper functioning of the economy as a whole and has, not surprisingly, once again brought to the fore the vexed question of the enforcement of the rules designed to regulate the conduct of company directors.

It may be recalled that in an attempt to protect the interests of the company and, conceivably, forestall the kind of problems just referred to, the law imposes certain obligations upon directors. Foremost amongst these is the duty of honesty and loyalty to the company, to which directors are subject under the equitable doctrines of fiduciary law.<sup>6</sup> This requires every exercise of the directors' discretionary powers to be in good faith, for the benefit of the company as a whole,<sup>7</sup> and not their own interest<sup>8</sup> or that of any other party.<sup>9</sup> Further, it enjoins the directors to exercise their powers for proper purposes,<sup>10</sup> not to fetter their discretion<sup>11</sup> and to avoid any conflict of interest.<sup>12</sup>

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some 40 suicides and other stress-related deaths?' *The Age*, 14 November 2004.

See <http://www.theage.com.au/articles/2004/11/13/1100227636089.html?from=storylhs> (date accessed 9 May 2006).

5 Indeed, speaking of the effects of the collapse HIH, Justice Owen said that they have 'reverberated throughout the community, with consequences of the most serious kind.' See Commonwealth of Australia, above, n 2 at 10.

6 Austin, R P & Ramsay, I M, *Ford's Principles of Corporations Law*, 13th ed 2007, Lexisnexis Butterworths, Sydney, at paras 8.070-8.090 (pp 353-6); Austin *et al*, *Company Directors: Principles of Law and Corporate Governance*, Lexisnexis Butterworths, Sydney, 2004 at paras 7.4-7.6 (pp 271-6)

7 *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199 at 217; *Re Smith & Fawcett Limited* [1942] 2 Ch 304, 306; *Pergamon Press Limited v Maxwell* [1970] 2 All E R 809 at 813.

8 *Ngurli Limited v McCann* (1954) 90 CLR 425 at 440.

9 *Howard Smith Limited v Ampol Petroleum Limited* [1974] A C 821; *Re W & M Roith Limited* [1967] 1 WLR 432; *Furs Limited v Tomkies* (1936) 54 CLR 583.

10 *Re Smith And Fawcett Limited* [1942] 1 Ch 306; *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656, 671; *Greenhalgh v Ardenne Cinemas Limited* [1950] 2 All ER 1120 at 1126; *Pergamon Press Limited v Maxwell* [1970] 2 All ER 809 at 813; *Mills v Mills* (1938) 60 CLR

These general equitable obligations have now been adopted by the Parliament and codified into statutory obligations. In particular, the *Corporations Act 2001* (Cth), s 181(1) provides that:

a director . . . of a corporation must exercise their powers and discharge their duties

(a) in good faith in the best interests of the corporation; and

(b) for a proper purpose.

To enhance the effectiveness of this provision, the *Corporations Act* expressly prohibits directors from improperly using their position<sup>13</sup> or any information<sup>14</sup> obtained by virtue of their position to their personal advantage.

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150 at 185; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923 ) 33 CLR 199 at 217; *Hindle v John Cotton Limited* (1919) 56 Sc L R 625 at 630.

11 *Thorby v Goldberg* (1965) 112 CLR 597.

12 See for example *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1; *Consul Developments Pty Ltd v D P C Estates Pty Ltd* (1975) 49 ALJR 74; *Furs Limited v Tomkies Limited* (1936) 54 CLR 583; *Phipps v Boardman* [1967] 2 AC 46; *Bray v Ford* [1896] AC 44; *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461; [1843-60] All ER Rep 249.

There is a substantial volume of literature on the directors' duty of loyalty. As a starting point, the following works may prove quite helpful: Austin *et al*, above, n 6 at 264-358; Austin & Ramsay, above, n 6 at 353-87; Davies, P L, *Gower and Davies' Principles of Modern Company Law*, 7th ed 2003, Thomson Sweet & Maxwell, London at 380-395; Farrar, J H & Hannigan, B M, *Farrar's Company Law*, Butterworths, London, 4th ed 1998 at 377-391; Butcher, B S, *Directors' Duties: A New Millennium, A New Approach?*, Kluwer Law International, London, 2000 at 95-127; Nolan, R C, 'The Proper Purpose Doctrine and Company Directors' in Rider, B (ed), *The Realm of Company Law*, 1998, Kluwer Law International, London, at 1-35; Worthington, S, 'Directors' Duties, Creditors' Rights and Shareholder Intervention' (1991) 18 *Melbourne University Law Review* 121 at 122-5; Sealy, L S, "'Bona Fides" and "Proper Purposes" in Corporate Decisions' (1989) 15 *Mon L R* 265.

13 See *Corporations Act 2001* (Cth), s 182(1).

14 See *Corporations Act 2001* (Cth), s 183(1).

For an erudite discussion of the legal effect of the codification of the directors' fiduciary obligation to act in the best interests of the company see Austin & Ramsay, above, n 6 at para 8.065 (pp at 320-1); Austin *et al*, above, n 6, para 7.3 (pp 267-8); Butcher, B S, *Directors' Duties: A New Millennium, A New Approach?* 2000, Kluwer Law International, London, at 141.

The clear intent of these injunctions is to eliminate or at least minimise the potential for directors to act in abuse of the immense managerial powers commonly conferred on them.<sup>15</sup> They render invalid any action of the directors that is not motivated by considerations of good faith concern for the interests of the company.<sup>16</sup>

The fiduciary duty of loyalty is supplemented by the common law<sup>17</sup> and statutory<sup>18</sup> duties of care and diligence. These have as their principal aim to protect the company by ensuring that directors do not shirk their responsibilities.<sup>19</sup>

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15 Under modern commercial practice, very wide powers are usually vested in the directors for the effective and efficient management of the business and other affairs of the company. See, for example, *Corporations Act 2001* (Cth), s 198A (a replaceable rule) which provides thus:

198A(1) The business of a company is to be managed by or under the direction of the directors.

198A(2) The directors may exercise all the powers of the company except any powers that this Act or the company's constitution (if any) requires the company to exercise in general meeting.

Where a company adopts a rule similar to this, the directors' power to manage the company is complete and exclusive. Only they may participate in the management of the company. On this see for example *Automatic Self Cleansing Filter Syndicate Company v Cunninghame* [1906] 2 Ch 34; *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113; *National Roads and Motorists Association v Parker* (1986) 4 ACLC 609.

16 *Mills v Mills* (1938) 60 CLR 150 at 185-6; *Ampol Petroleum Limited v R W Miller (Holdings) Limited* [1972] 2 NSWLR 850 at 856; *Re W & M Roith Limited* [1967] 1 WLR 432; *Furs Limited v Tomkies* (1936) 54 CLR 583.

17 *Re City Equitable Fire Insurance Company Limited* [1925] Ch 407; *Re Brazilian Rubber Plantations* [1911] 1 Ch 425 at 435; *Re Denham* (1884) 25 Ch D 752; *The Overend & Gurney Co v Gibb* (1871-72) LR 5 HL 480.

For an illuminating analysis of the duty of care see, by way of example only, Austin *et al*, above, n 6, at 229-59; Austin & Ramsay, above, n 6 at 387-414; Lipton, P, & Herzberg, A, *Understanding Company Law*, 13th ed 2006, Thomson Law Book Company Limited, Sydney at 345-361.

18 As to the scope and dictates of the duty of care see generally *Daniels t/a Deloitte Haskins & Sells v AWA Ltd* (1995) 37 NSWLR 438; Sievers, A S, 'Directors' Duty of Care: What is the New standard?' (1997) *C&SLJ* 392; Cassidy, J, 'An Evaluation of Corporations Law s 232(4) and the Directors' Duty of Care, Skill and Diligence' (1995) 23 *Australian Business Law Review* 184.

19 Austin & Ramsay, above, n 6 at 339-40; Austin *et al*, above, n 6, at 212-3.

However, it is common knowledge that the substantive law which regulates the exercise of directors' powers is not self implementing. Action must be taken to enforce its observance. The legal system must therefore provide a reliable mechanism for enforcing the rules seeking to prevent directors from acting in abuse of their powers and thereby, vicariously, protect the interests of the investing community.<sup>20</sup> Unless that is done, those rules are bound to deteriorate into voluntary obligations which the persons who control the affairs of companies may or may not observe according to their whims.<sup>21</sup> For, as Justice Holmes once perceptively observed, 'legal obligations that exist but cannot be enforced are ghosts that are seen in the law but that are elusive to the grasp.'<sup>22</sup>

Recognising that the effectiveness of the law depends on the mechanisms available for its enforcement,<sup>23</sup> the Parliament has established an independent public regulatory agency, the Australian Securities and Investments Commission (ASIC),<sup>24</sup> to administer all aspects of corporate law. To discharge that responsibility, ASIC has been vested with very wide powers. It may seek criminal sanctions<sup>25</sup> and civil

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20 See further Cranston, R, *Law, Government and Public Policy*, Oxford University Press, Melbourne, 1987 at 21 et seq.

21 See Ziegler, D H, 'Rights Require Remedies: A New Approach to the Enforcement of Rights in Federal Courts' (1987) 38 *Hastings Law Journal* 665 at 678.

22 *The Western Maid* 257 US 419 at 433 (1922).

23 On this see further Redmond, P, 'The Reform of Directors' Duties' (1992) 15 *UNSWLJ* 86 at 95.

24 Established under the *Australian Securities and Investments Commission Act 1989* (Cth), Part 2. The body established under this Act is continued in existence by the *Australian Securities and Investments Commission Act 2001* (Cth), s261.

25 *Australian Securities and Investments Commission Act 2001* (Cth), s 49. However, it should be recalled that criminal sanctions are not available for the enforcement of the statutory duty of care. See *Corporations Act 2001* (Cth), s 180(1) and 1317E. For a discussion of the rationale for this position see Austin & Ramsay, above, n 6 at 389; Austin *et al*, above, n 6 at 231-2.

remedies<sup>26</sup> from the courts. In addition to this, private parties (generally members of a company) affected by a breach of directors' fiduciary duties may take action to enforce the law, by pursuing private law remedies to vindicate their rights.<sup>27</sup>

For reasons which need no elaboration here, the enforcement of directors' duties has for sometime now been and continues to be a subject of intense public interest and debate in Australia.<sup>28</sup> This debate has intensified with the occurrence of the very high profile corporate collapses alluded to above. This article is a contribution to that debate. Its main thrust is that dual (public and private) enforcement is required to ensure that the law governing directors' fiduciary duties is to be more fully enforced. It is further suggested that in view of the very dire consequences that serious breaches of fiduciary duty potentially have on the proper functioning of the economy, the public enforcer, ASIC, should invoke public (criminal) law sanctions more readily in cases of deliberate, reckless or fraudulent conduct as a means of deterring such undesirable conduct. Because of their stigmatic effects, criminal law sanctions have great potential to deter serious wrongful director conduct. It should be noted that although this discussion is specifically oriented to the fiduciary duty of loyalty and honesty, most of the points explored in this essay apply with equal force to the other duties of directors.

The ensuing discussion proceeds in four parts and is organised as follows. Part 2 sets out the case for dual enforcement, highlighting the relative merits and weaknesses of

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26 *Australian Securities and Investments Commission Act 2001* (Cth), s 50.

27 An excellent account of the remedies available to shareholders in these circumstances can be found in Boros, E J, *Minority Shareholders' Remedies*, Clarendon Press, New York, 1995.

28 See, for example, Assaf, F, 'What Will Trigger ASIC's Enforcement Strategies?' (2002) 40 *Law Society Journal* 60; Ramsay, I M, 'Enforcement of Corporate Rights' (1995) 23 *ABLR* 174; Cameron, A, 'Getting the Regulatory Mix Right' (1994) 4 *Aust Jnl of Corp Law* 122; Tomasic, R, 'Sanctioning Corporate Crime and Misconduct: Beyond Draconian and Decriminalization Solutions' (1992) 2 *Aust J of Corp Law* 82; Tomasic, R, 'Corporate Crime: Making the Law More Credible' (1990) 8 *C&SLJ* 369.

private and public enforcement of the law governing the exercise of directors' fiduciary powers. Part 3 demonstrates that although one of the major advantages of the public enforcement system is the availability of public law sanctions, the criminal process is, presently, very cautiously invoked in the endeavours to promote observance of directors' fiduciary duties. An attempt is made here to ascertain the reasons for this phenomenon. Having done this, Part 4 canvasses ways in which the law could be improved to enable society to more fully harness the benefits of criminal law penalties in the fight against undesirable director conduct. Part 5 concludes the discussion.

## **2 THE CASE FOR DUAL PUBLIC AND PRIVATE ENFORCEMENT OF DIRECTORS' FIDUCIARY DUTIES**

Disregard by directors of their fiduciary obligations can have very serious detrimental consequences for the community. The detrimental effects of such conduct increase in magnitude the larger the size of the company involved is. Quite significantly, such conduct has the potential to sap investor confidence in the capital markets. This can adversely affect the proper functioning of the economic order of society.<sup>29</sup> So, ideally, all violations of the law governing the conduct of directors should be pursued to the point where the marginal benefit of enforcement is equal to its cost. However, because both public and potential private enforcers have different motivations and incentives, and are subject to different constraints, exclusive dependence upon either public or private enforcement might yield less than optimum enforcement. Therefore, if the law is to be adequately enforced, it is essential that both public authorities and

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<sup>29</sup> See further Bosch, H, 'Introduction' in CCH, *Collapse Incorporated: Tales, Safeguards & Responsibilities of Corporate Australia*, Sydney, 2001 at 1-3.



private parties play an active role in pursuing recalcitrant directors. The ensuing discussion explores these issues in more detail.

## **2.1 The need for private enforcement**

According to a study by Professor Ramsay, actions for the enforcement of directors' duties are, presently, mostly undertaken by the public enforcer.<sup>30</sup> However, even though there is in place a robust system of public enforcement, there are still some residual problems.<sup>31</sup> This renders simultaneous enforcement by private parties imperative.<sup>32</sup>

In the first place, the costs of public enforcement are a charge on the public purse. Unless the parliament appropriates adequate funds to the task of corporate regulation, the public enforcer will not be able to act in respect of all violations of the law which should be pursued.<sup>33</sup> This problem is amply illustrated by the experience of the National Companies and Securities Commission, the erstwhile national regulator of corporate law. It has been widely acknowledged that it proved spectacularly

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30 Ramsay, above, n 28 at 175-6.

31 The discussion in this section has benefited substantially from my Note 'Enforcing the Directors' Statutory Duty of Honesty' (1997) 7 *Aust Jnl of Corp Law* 268 at 272-4.

32 On the role of private enforcement see generally Posner, R, *Economic Analysis of Law*, 6th ed 2003, Aspen Publishers, New York at 634-6; Ramsay, I, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *UNSWLJ* 149 at 152; Brunt, M, 'The Role of Private Actions in Australian Restrictive Practices Enforcement' (1990) 17 *MULR* 582 at 601-2; Alston, P, 'Representative Class Action in Environmental Litigation' (1973) 9 *MULR* 307 at 308.

33 Posner, above, n 32 at 634-5; Cameron, above, n 28 at 123; Brunt, above, n 32 at 601-2; Alston, above, n 32 at 308; Ramsay, above, n 30 at 152; Duns, J, 'A Silent Revolution: The Changing Nature of Sanctions in Companies and Securities Legislation' (1991) 9 *C&SLJ* 365 at 371.

ineffective largely as a result of its scandalously low funding.<sup>34</sup> Indeed, Mr Henry Bosch, a former Chairman of the NCSC once complained that that organisation was required to undertake the task of enforcing corporate laws in the entire country on a budget equivalent to that spent by the Commonwealth government on bus subsidies in the Australian Capital Territory.<sup>35</sup> This led one commentator to lament that 'the administration of [the law] . . . is so hopelessly under-funded that the people who are committing . . . breaches [of corporate law] can walk away scot-free.'<sup>36</sup>

The current regulator, ASIC, is now better funded than the NCSC was. But as Mr Cameron, a former Chairman of ASIC realistically observed, ASIC is not now and is not likely in the future to be funded to deal with all breaches of directors' duties.<sup>37</sup> Indeed, there have been several instances in the recent past where, as a result of a lack of resources, ASIC has not been able to pursue suspect conduct on the part of the controllers of certain companies.<sup>38</sup> Because of this under-funding, the public enforcer, is unlikely to concern itself with breaches of the law that affect solely private interests. Rather, it is most likely to take on those serious violations of the law likely to have a substantial impact on the corporate governance process as a

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34 See for example Commonwealth of Australia, Parliament, House Standing Committee on Legal and Constitutional Affairs (the Lavarch Committee), *Corporate Practices and the Rights of Shareholders*, AGPS, Canberra, 1991, paras 2.5.3-2.5.5; Grabosky, P & Braithwaite, J, *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies*, Oxford University Press, Melbourne, 1986 at 13 et seq; Tomasic, above, n 28 369.

35 See Bosch, H, *The Workings of a Watchdog*, William Heinemann Australia, Melbourne, 1990 at 41; *The Australian*, 22 June 1990, at 16.

36 See press article titled, 'Watch-dog Funding Slammed' *Money Management*, 26 April 1990, at 7.

37 Cameron, above, n 28 at 123.

38 For an account of some of these see Wilson, S, 'Starving the Watchdog is No Way to Prevent Corporate Crime', *The Australian*, 21 Feb 2006. Also available at <http://www.theaustralian.news.com.au/story/0,20867,18213618-643,00.html> (date accessed 12 May 2006).

whole. The strategy will be to select those cases which can be made examples of for purposes of promoting deterrence.<sup>39</sup> Consequently, without private enforcement, some breaches of the law may not be pursued.

Cost considerations aside, public regulatory authorities might, either arbitrarily or as a result of political pressure, refrain from proceeding against particular breaches of the law.<sup>40</sup> In addition, the public enforcer may on occasions fail to act to stem violations of the law out of a lack of a proper regulatory ideology or mere bureaucratic inertia. As Galbraith once observed, regulatory agencies tend with the passage of time to 'mellow and . . . become with some exception, either an arm of the industry they regulate or senile.'<sup>41</sup>

It thus appears that exclusive reliance upon public enforcement might result in an enforcement gap.<sup>42</sup> In the circumstances, it is advisable that the rules governing the conduct of directors are open to both public and private enforcers. The availability of private enforcement may serve a fail-safe function and ensure greater stability in the

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39 Brunt, above, n 32 at 595-6 and 601-2; Cameron, above, n 28 at 123; Australian Securities Commission, *Annual Report 1996-1997*, at 17; Australian Securities and Investments Commission, *Annual Report 1997-1998*, at 24.

40 On the problems of political interference see generally Grabosky & Braithwaite, above, n 34, Chapter 2.

41 Quoted by Mr Leigh Masel, inaugural Chairman of the defunct National Companies and Securities Commission in the preface to *Understanding The New Takeover Code*, The Commercial Law Association of Australia Limited & Monash University Faculty of Law, 1980 at 4. See also Posner, above, n 32 at 635; Brunt, above, n 32 at 606; Ramsay, above, n 30 at 152.

On the theory that public regulatory agencies tend to serve the interests of the regulated rather than the public interest (the capture theory), see Cranston, R F, 'Regulation and Deregulation: General Issues' (1982) 5 *UNSWLJ* 1 at 17 et seq.

42 Posner, above, n 32 at 635.

application of the law.<sup>43</sup> In addition, by making it possible for private enforcers to take up cases which the public enforcer would otherwise not consider worth pursuing, and vice-versa, complementary enforcement increases the chances that violations of the law will be found out and pursued.<sup>44</sup>

Further, the availability of both public and private enforcement exposes potential violators to a wider array of sanctions. That prospect might go a long way in discouraging directors from engaging in undesirable conduct.<sup>45</sup> Duality of enforcement has the further advantage that it might lighten the burden of the public enforcer. Public resources need not be applied where the requisite level of deterrence can be achieved through the initiative, energies and expertise of private enforcers.<sup>46</sup> An added advantage is that 'when the legal system assigns a substantial enforcement role to private litigation, . . . the tendency of . . . public agencies to expand their jurisdiction is less likely to produce excessive bureaucratic regulation of private enterprise.'<sup>47</sup>

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43 American Law Institute, *Principles of Corporate Governance and Structure: Restatement and Recommendations* (Tentative Draft No 1), 1982 at 220-21. This discussion was not carried over in the final report.

44 Indeed, the Australian Securities Commission (the predecessor of ASIC) used this argument to support initiatives aimed at promoting greater private enforcement of corporate law. See ASC, Submission to the Inquiry by the House Standing Committee on Legal and Constitutional Affairs into Corporate Practices and the Rights of Shareholders, December 1990 at 128.

45 See generally Ramsay, above, n 30 at 152.

46 Brunt, above, n 32 at 609; Kluver, J, 'ASC Investigations and Enforcement: Issues and Initiatives' (1992) 15 UNSWLJ 31 at 54; Harding, D E, 'The Role of Lawyers in the Regulation of Economic Activity' in Hambly, A D & Goldring, J L, *Australian Lawyers and Social Change*, The Law Book Company Limited, Sydney, 1976 at 214.

47 ALI, above, n 43, at 220-21.

In the particular context of corporate litigation, it is noteworthy that the procedural (standing) hurdles created by the rule in *Foss v Harbottle*<sup>48</sup> which previously rendered enforcement action by private enforcers extremely difficult<sup>49</sup> have now been largely overcome. Under reforms introduced to the *Corporations Act*,<sup>50</sup> where a violation of the rights of a company has occurred or is about to occur, a member, former member, or person entitled to be registered as a member of the company or of a related company may now make an application to the court for leave to commence a derivative suit on behalf of the company in order to vindicate its rights. So also may an officer or former officer of the company.<sup>51</sup> The Court is authorized to grant such leave where it is satisfied that a breach of duty has occurred or is about to occur, that it is probable that the company will not take any action in respect of the matter in issue, that the applicant is acting in good faith, that it is in the best interests of the company for leave to be granted to plaintiff, that there is serious a question to be tried and that at least 14 days demand has been made of the company for action to be taken

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48 (1843) 2 Hare 461; 67 E R 189.

49 On the authority of the rule established in this case, persons other than the company itself were, prima facie, precluded from challenging before the courts the validity of actions taken or proposed to be taken by anyone in violation of its rights. A similar principle was also enunciated in *Mozley v Alston* (1847) 1 Ph 790.

This is not the place for an exegesis into the problems raised by the doctrines enunciated in this case. Interested readers may, as a starting point, refer to the following works where this issue is very competently discussed: Wedderburn, K W, 'Shareholders' Rights and the Rule in *Foss v Harbottle*' [1957] *Cambridge Law Journal* 194; DeMott, D A, 'Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions' (1987) 11 *Sydney Law Review* 259; Kluver, J, 'Derivative Actions and the Rule in *Foss v Harbottle*: Do We Need a Statutory Remedy?' (1993) 11 *C&SLJ* 7; Bottomley, S, 'Shareholder Derivative Actions and Public Interest Suits: Two Versions of the Same Story?' (1991) 15 *UNSWLJ* 127.

50 See the *Corporations Act 2001* (Cth), Part 2F.1A.

51 *Corporations Act 2001* (Cth), s 236. This is commonly referred to as the statutory derivative action.

to rectify the extant problem.<sup>52</sup> The implementation of this measure should assist interested private parties to challenge actions taken by directors in breach of their duties. In turn, this is likely to promote greater observance of the law. The propensity of controllers of companies to engage in contestable conduct will likely decline as the probability rises that their actions will be questioned before the courts.

However, whilst it appears that private parties (predominantly shareholders) can play a significant role in deterring wrongful director conduct, available evidence suggests that litigation commenced by members of a company to enforce directors' fiduciary duties does not occur that frequently in Australia.<sup>53</sup> This difficulty is engendered primarily by the problem of litigation costs, a matter which is explored in the next section of this article. It is thus apparent that public regulatory authorities must also assume a big role in enforcing the law governing the conduct of directors. Only then will the objectives of maintaining, facilitating, and improving the performance of the financial system and the entities within that system and the development of the economy, objectives which the law partly seeks to achieve,<sup>54</sup> be realized. The discussion in the next section has as its task to highlight the important role that the public enforcement system can play in promoting the observance of directors' fiduciary duties.

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52 *Corporations Act 2001* (Cth), s 237. For a fuller discussion of the statutory derivative action see Austin & Ramsay, above, n 6 at 674-685; Kluver above, n 49 at 12-25; Ramsay, I, 'Corporate Governance, Shareholder Litigation and the Prospects For A Statutory Derivative Action' (1992) 15 *UNSWLJ* 149 at 151-167.

53 Ramsay, above, n 28 at 175.

54 *Australian Securities and Investments Commission Act 2001* (Cth), s 1(2)(a).

## 2.2 Why public enforcement is desirable.

Professor Ramsay's study on the enforcement of corporate rights referred to before demonstrates that litigation to enforce directors' duties is more typically undertaken by a public regulatory agency.<sup>55</sup> A good explanation of this phenomenon is to be found in the problem of litigation expenses. Private parties must look to their own resources to enforce their rights. Under the costs indemnity rule applicable in all Australian jurisdictions, the plaintiff is, in addition to meeting his or her own expenses, also exposed to the risk of paying the defendant's costs in the event of a court action failing.<sup>56</sup> Whilst provision is made in a case where a member acts to enforce the rights of the company<sup>57</sup> for the Court to order the costs of such action to be met by the company,<sup>58</sup> it appears that the Courts take a very cautious approach in exercising this power. They are generally loath to impose the costs of such proceeding on the company.<sup>59</sup> In consequence, there is often no assurance that a private litigant, though acting for the benefit of the company, will be able to recoup its costs from the company itself.

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55 Ramsay, above, n 28 at 175.

56 As to the problems posed by the rules governing litigation costs, see by way of example, *Wallersteiner v Moir* (No 2); *Moir v Wallersteiner* (No 2) [1975] Q B 373; Australian Law Reform Commission, *Grouped Proceedings in the Federal Court*, Report No 46, AGPS Canberra, 1988, para 254-256; Cairns, B C, *Australian Civil Procedure*, 5th ed 2002, The Law Book Company Limited, Sydney, Chapter 17, especially at 519-23.

57 On members' statutory derivative actions, see the discussion at notes 48-52 above.

58 *Corporations Act 2001* (Cth), s242.

59 See generally *Swasson v Pratt* (2002) 20 ACLC 1594 (Supreme Court of New South Wales); *Metyor v Queensland Electronic Switching Pty Ltd* (2002) 20 ACLC 1517 (Supreme Court of Queensland, Court of Appeal); *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732 (Supreme Court of New South Wales); *Charlton v Baber* (2003) 21 ACLC 1671 (Supreme Court of New South Wales). On this see further Ramsay, I M & Saunders, B B, *Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action*, Research Report, Centre for Corporate Law and Securities Regulation, The University of Melbourne, 2006, available at <http://cclsr.law.unimelb.edu.au/research-papers/ASIC%20Enforcement.pdf> at 36-8 (date accessed 20 June 2006).

Because of the financial burden imposed on them, which can be fairly substantial, private parties are bound to be generally loath to challenge suspect director conduct unless the suit stands a very high chance of success. Without public enforcement, therefore, claims of breaches of duty whose chances of success are not rated highly are likely to be neglected, even if they involve important points of law. The interpretation, elucidation and development of the law is, in the process, bound to suffer.

Further, even in the case of claims which stand a good chance of success, private parties will not act if the cost of enforcement is likely to be high relative to the value of the claim. A private action will thus ordinarily be commenced only if a particular affected party has a substantial interest in the matter and the prospective returns from pursuing the claim are likely to exceed the investment in litigation by a sizable margin. In the absence of a private party with a sufficient interest, no action is likely to be taken however egregious and detrimental to the proper running of the economy the conduct in issue may be.<sup>60</sup> This is because, where undesirable conduct affects all shareholders equally, an individual shareholder (or any other private party) would be

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60 One Supreme Court Justice has highlighted this problem thus:

my own experience, especially in this List, suggests that there are many serious breaches of duty in relation to the affairs of public listed companies. Usually, if these are brought to light it is in litigation commenced by a major shareholder. The major shareholder is concerned with his own interests, not those of shareholders generally.

Per Brooking J in *Knightswood Nominees Pty Ltd v Sherwin Pastoral Company Ltd* (1988-1989) 15 ACLR 151 at 159 (Supreme Court of Victoria).



insufficiently rewarded for the expense and time consumed in litigation, the risks arising from the costs rules and the free riding of other shareholders.<sup>61</sup>

The *Federal Court of Australia Act 1976* (Cth), has established an improved class action procedure which promotes the consolidation of numerous small claims into one big enough to render litigation worthwhile.<sup>62</sup> Also, assisted litigation is now available in some limited cases<sup>63</sup> especially those involving companies in liquidation or under administration.<sup>64</sup> It is now becoming increasingly acceptable for private litigation funders<sup>65</sup> to provide financial assistance to potential litigants who might otherwise not be able to sue because of the cost involved, in return for a share of the

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61 For an erudite discussion of the determinants of private enforcement in general see Salop, S C & White, L J, 'Private Antitrust Litigation: An Introduction and Framework' in White, L J, (ed), *Private Antitrust Litigation: New Evidence, New Learning*, MIT Press, Cambridge, Massachusetts, 1988, at 17 et seq; Brunt, above, n 32 at 583-7. On shareholder apathy see generally Roe, M, *Strong Managers, Weak Owners - The Political Roots of American Corporate Finance*, Princeton University Press, Princeton, New Jersey, 1994 at 6; Blackman, B S, 'Shareholder Passivity Reexamined' (1990) 89 *Michigan Law Review* especially at 526-8; Easterbrook, F H & Fischel, D R, 'Takeover Bids, Defensive Tactics, and Shareholders' Welfare' (1981) 36 *The Business Lawyer* 1733 at 1736; Easterbrook, F H & Fischel, D R, 'The Proper Role of Target Management in Responding to a Tender Offer' (1981) 94 *Harvard Law Review* 1161 at 1173; Ramsay, above, n 30 at 152-3; Partlett, D F & Burton, G, 'The Share Repurchase Albatross and Corporation Law Theory' (1988) 62 *ALJ* 139 at 141; Redmond, above, n 23 at 92; Mandelbaum, A, 'Economic Aspects of Takeovers Regulation With Particular Reference to New Zealand' in Farrar, J H (ed), *Takeovers, Institutional Investors and the Modernization of Corporate Laws*, Oxford University Press, Auckland, 1993 at 206.

62 See *Federal Court of Australia Act 1976* (Cth), Part IVA.

63 The tort/crime of maintenance and champerty has now been abolished in New South Wales, Victoria, South Australia and the Australian Capital Territory but remains in Queensland, Western Australia, Tasmania and the Northern Territory.

64 See further Aitken, L, "'Litigation Lending' After Fostif: An Advance in Consumer Protection, or a Licence to 'Bottomfeeders'?" (2006) 28 *Sydney Law Review* 171 at 172-4.

65 There are a number of commercial funders of litigation in Australia, two of which [IMF (Australia) Ltd and Hillcrest Litigation Services Ltd] are now listed on the Australian Stock Exchange.

proceeds of the litigation.<sup>66</sup> In addition, solicitors now frequently act on a contingency “no win no fee” basis, as a means of shifting the burden of litigation costs from private litigants, including shareholders, in class actions. However, even with the implementation of these measures and initiatives, the incentive problems alluded to before may not be fully overcome. Unless there is a shareholder with a substantial interest, no one may come forward to act as class representative. Furthermore, unless a claim is fairly substantial, it is unlikely that private funders will finance it. Neither are lawyers likely to take it on on a contingency fee basis. As a result, small claims which, nonetheless, may involve important points of legal principle may still be excluded from the courts. There is thus need for a system which ensures that all serious violations of the law are pursued. Otherwise, the economic and social objectives which the law seeks to promote will be frustrated.<sup>67</sup>

Public enforcement can alleviate the incentive gap noted above.<sup>68</sup> The cost of public enforcement is met by the community as a whole. Not being subject to the same motivations or financial constraints as most shareholders, the public enforcer can take the larger view. It can thus act in those cases where the impugned conduct is likely to have substantial adverse ramifications for the functioning of the economy. The public enforcer can also raise issues of fundamental importance to the development of the law, which otherwise would be ignored by private enforcers, either because the

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66 See for example *Fostif v Campbells Cash and Carry Pty Ltd* (2005) 218 ALR 166; *IMF (Australia) Ltd v Sons of Gwalia Ltd (Administrator Appointed)* (2005) 53 ACSR 657 (Federal Court of Australia); *Cadence Asset Management Pty Ltd v Concept Sports Ltd* [2005] FCAFC 265; *Clairs Keeley (A Firm) v Treacy* [2005] WASCA 86; *Dorajay Pty Ltd v Aristocrat Leisure Ltd* [2004] FCA 634; *Giles v Thompson* [1994] 1 AC 143.

67 As to these, see *Australian Securities and Investments Commission Act 2001 (Cth)*, s 1(2).

68 On the role of public enforcement see further Posner, above, n 32, at 631-40; Ogus, A I & Veljanovski, C G, (eds), *Readings in the Economics of Law and Regulation*, Clarendon Press, Oxford, 1984, Chapter 8; Goldring, J, *Consumers Or Victims*, George Allen & Unwin, Sydney London and Boston, 1983, Chapter 13; Crumplar, T C, 'An Alternative to Public and Victim Enforcement of the Federal Securities and Antitrust Laws: Citizen Enforcement' (1975) 13 *Harvard Journal of Legislation* 76 at 77-8; Brunt, above, n 32 at 606-8.

affected party has not the means to launch the necessary litigation, or because the benefit to that party of doing so would not be justified by the costs involved.<sup>69</sup>

Problems of litigation expenses aside, private enforcers might, in some cases, not be able to gain access to all information necessary for the satisfactory resolution of the dispute at hand.<sup>70</sup> On the other hand, the public enforcer is not subject to such limitations. It enjoys special powers of investigation.<sup>71</sup> It can subpoena any document<sup>72</sup> and examine any witness.<sup>73</sup> In addition, it has a general power to do whatever is necessary for or in connection with, or reasonably incidental, to the performance of its functions.<sup>74</sup> Through the exercise of these powers, it might gain access to relevant documents and records not otherwise available to private enforcers. It may also be able to obtain information through the assistance of foreign regulatory authorities. The availability of such information may enable the court to render a better informed decision and thereby promote higher quality law enforcement.

Another major advantage of public enforcement is that public (criminal law) sanctions can be invoked to enforce observance of the law. Several studies indicate that the criminal law is imbued deeply with notions of morality and immorality,

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69 See generally Brunt, above, n 32 at 607-9.

70 On the difficulties faced by shareholders in gaining access to corporate information see Norman, P J, 'Access to Corporate Information' (1986) 4 *C&SLJ* 149; Hill, J, 'Inspection By Shareholders of Corporate Books and Documents' (1987) 61 *ALJ* 657; Sinnott, P & Duns, J, 'Shareholders' Rights of Access to Corporate Books' (1990) 8 *C&SLJ* 73; Dharmananda, B, 'A Shareholder's Access to Company Documents under Corporation Law s 309: Some Lessons From the Interpretation of Companies Code s265B' (1991) 7 *Aust Bar Rev* 261.

71 *Australian Securities and Investments Commission Act 2001* (Cth), s 13.

72 See *Australian Securities and Investments Commission Act 2001* (Cth), Part 3 Division 3.

73 *Australian Securities and Investments Commission Act 2001* (Cth), s 19(2). For a lucid summary of ASIC's investigations and information gathering powers, see Kluver, J, 'ASC Investigations and Enforcement: Issues and Initiatives' (1992) 15 *UNSWLJ* 31 at 31-47.

74 *Australian Securities and Investments Commission Act 2001* (Cth), s 14(4).

public censure and punishment.<sup>75</sup> As a result, the threat of exposure to the criminal justice system can be a powerful deterrent against undesirable social conduct.<sup>76</sup> Indeed, it has been argued that the criminal law can convey public censure far more effectively than the civil-law process.<sup>77</sup> This is because a criminal prosecution generates adverse publicity. Publicity begins with the indictment. Some element of the punishment thus precedes conviction. The adverse publicity may tarnish the name, reputation and status of the named respondent throughout the business community as well as in the minds of some portion of the general public.<sup>78</sup> In some cases, an acquittal may not even fully undo the damage resulting from adverse publicity.<sup>79</sup>

Available studies suggest that, generally, corporations value their prestige highly.<sup>80</sup> And so do the middle and upper class strata of society to which corporate management belong.<sup>81</sup> In particular, as the stigma of criminality means something

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75 In this connection see Ball, H V & Friedman, L M, 'The Use of Criminal Sanctions in Enforcing Economic Legislation: A Sociological View' (1965) 17 *Stanford Law Review* 197; Australian Law Reform Commission, *Product Liability: Remedies and Enforcement*, Research Paper No 5, AGPS, Canberra, 1989, para 123; Coffee Jr, J C, ' "No Soul To Damn: No Body To Kick": An Unscandalized Inquiry Into the Problem of Corporate Punishment' (1981)79 *Michigan Law Review* 386 at 425.

76 Brunt, above, n 32 at 608; Crumplar, above, n 68 at 77-8; Chappell, D & Norberry, J 'Deterring Polluters: The Search for Effective Strategies' (1990) 13 *UNSWLJ* 97 at 102-5; Fisse, B & Braithwaite, J, *The Impact of Publicity on Corporate Offenders*, State University of New York Press, Albany, 1983 at 247-8; Blumstein, A & Nagin, D, 'The Deterrent Effect of Legal Sanctions on Draft Evasion' (1976-77) 29 *Stanford Law Review* 241 at 259-69; Note, 'Developments in the Law: Regulating Corporate Behavior Through Criminal Sanctions' (1979) 92 *Harvard Law Review* 1227 especially at 1231-41.

77 See the works cited in note 75 above.

78 Ball & Friedman, above, n 75 at 216 et seq; Coffee Jr, above, n 75 at 425; Fisse & Braithwaite, above, n 76 at 3.

79 Fisse, B, 'Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions' (1982-83) 56 *Southern California Law Review* 1141 at 1147-54.

80 Fisse & Braithwaite, above, n 76 at 247.

81 Coffee Jr, above, n 75 at 428.

very substantial in business life,<sup>82</sup> directors are generally anxious to avoid the stigma associated with a prosecution or a finding of guilt.<sup>83</sup> Such stigma could seriously affect their chances of future employment.<sup>84</sup> It thus appears that an appeal to the criminal justice system may play a critical role in suppressing breaches of directors' fiduciary duties.<sup>85</sup> This view is, indeed, strengthened by Professor Loss' observation that:

whatever may be the deterrent effect of threatened imprisonment as far as the common crimes are concerned, it has been found in the United States that an occasional term of imprisonment, however short, for something like an SEC offence causes the particular industry to make a keen re-examination of its practices.<sup>86</sup>

It is reasonable to expect the same consequences to flow from an increased use of criminal sanctions in the enforcement of directors' fiduciary duties in Australia. Company directors and, indeed, other business executives in Australia do tend to feel shame and humiliation too when exposed to criminal prosecution.

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82 Fisse & Braithwaite, above, n 76 at 3.

83 Fisse, above, n 74 at 1153; Coffee Jr, above, n 75 at 425; Ball & Friedman, above, n 75 at 217-8; Blumstein & Nagin, above, n 76 at 268; Duns, above, n 33 at 371.

84 Blumstein & Nagin, above, n 76 at 268. Coffee Jr, above, n 75 at 433-4.

85 See for example Ball & Friedman, above, n 75 at 216; Duns, above, n 33 at 375; Friedman, W, *Law in a Changing Society*, Penguin Books, 2nd ed 1972 at 191-200; Fattah, E Z, *A Study of the Deterrent Effect of Capital Punishment with Reference to the Canadian Situation*, Department of the Solicitor General, Research Centre Report 2, Information Canada, Ottawa, 1972 at 9-10.

86 Loss, L, *Proposals for Australian Companies and Securities Legislations: Comments From the American Experience*, Commonwealth Parliamentary Paper 190, AGPS, Canberra 1974 at 16.

### **3 PROSECUTING BREACHES OF DIRECTORS' FIDUCIARY DUTIES: THE CURRENT STATE OF PLAY.**

Although criminal sanctions can play a significant role in deterring breaches of directors' fiduciary duties, available evidence reveals that they are invoked by Australian corporate regulators quite sparingly.<sup>87</sup> It is therefore important to identify and, so far as possible, address the reasons giving rise to this circumstance so that the deterrent potential of the criminal justice system may be effectively harnessed.

#### **3.1 Conviction without moral culpability.**

For sometime, the law failed to distinguish between situations where directors may have acted in breach of fiduciary duty in the belief that what they were doing was for the benefit of the company and cases in which they may have acted fraudulently or deliberately for irrelevant purposes, for example, to promote their own interest or that of another party. Both forms of conduct were potentially punishable by criminal sanctions. *Australia Growth Resources Corporation Proprietary Limited v van Reesema*<sup>88</sup> illustrates this point magnificently.

The appellant company in this case was engaged in the plant nursery business. It entered into contracts with growers under which it provided them with

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<sup>87</sup> On this see, for Bird *et al*, *ASIC Enforcement Patterns*, Research Report, Centre for Corporate Law and Securities Regulation, The University of Melbourne, 2003, available at <http://cclsr.law.unimelb.edu.au/research-papers/ASIC%20Enforcement.pdf> at 79-87 (date accessed 22 May 2006). Earlier studies showed a similar pattern too. See, for example, Commonwealth of Australia, Parliament, Joint Committee on Corporations and Securities, Briefing with the Director of Public Prosecutions, Hansard, AGPS, Canberra, 7 September 1992 especially at 10-22 [hereinafter Joint Committee]; Duns, above, n 33 at 370; Grabosky, & Braithwaite, above, n 34 at 188 et seq; See also the press reports in *The Age* issues of 10 and 11 September 1992.

<sup>88</sup> (1988) 6 ACLC 529 (Supreme Court of South Australia).

consultancy services, materials and equipment for the purpose of growing plants. It then purchased plants from the growers for resale at a profit.<sup>89</sup>

After investigating the company's mode of operation, the Corporate Affairs Commission of South Australia determined that the arrangement violated the provisions of the *Companies (South Australia) Code*, then governing the offer of prescribed interests.

Instead of taking steps to enable the company comply with its statutory obligations, the directors caused it to enter into an agreement pursuant to which all its business and assets were transferred to the first respondent, one of the directors, in consideration of the sum of \$1 and an unsecured indemnity by that director in respect of the company's liabilities and future obligations. The effect of this transaction was to divest the company of all its business and assets and to leave it in a hopeless position of insolvency. Indeed, King CJ described the transaction as a most improvident one.<sup>90</sup>

Following the cessation of its business and the appointment of a receiver, the company instituted an action against the directors in which it challenged the validity of the agreement entered into with the first respondent and also sought to recover the value of the business and assets received by him. It was contended, inter-alia, that the agreement was entered into fraudulently and/or dishonestly in breach of s 229(1) of the *Companies Code* then in force<sup>91</sup> or, alternatively, in

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89 This statement of facts is taken from Mayanja, J, 'Proper Purposes and the Duty of Honesty - Australia Growth Resources Corporation Proprietary Limited v van Reeseema' (1988) 6 C&SLJ 306 at 307-8.

90 (1988) 6 ACLC 529 at 537.

91 That provision stipulated that '*an officer of a corporation shall at all times act honestly in the exercise of his or her powers and the discharge of the duties of his or her office.*' (emphasis supplied).

breach of the directors' fiduciary duties. In answer to this claim, it was contended on behalf of the directors that they honestly believed the agreement to be in the best interests of the company.

Describing the effect of section 229(2) of the *Companies Code*, the forerunner of section 181 of the *Corporations Act 2001* (Cth), which the directors were alleged to have breached, King CJ said that the section recognise[d] that:

an officer may fail to "act honestly" within the meaning of the section without fraud. The section therefore embodies a concept analogous to constructive fraud, a species of dishonesty which does not involve moral turpitude. I have no doubt that a director who exercises his powers for a purpose which the law deems to be improper, infringes this provision notwithstanding that according to his own lights he may be acting honestly.<sup>92</sup>

It is likely that the possibility of visiting the ignominy of conviction upon persons who may have acted without moral blame may have discouraged the regulators from invoking criminal sanctions to enforce the law. There is a view in the community that the primary role of criminal sanctions is the stigmatization of the morally culpable.<sup>93</sup> 'Without culpability, there is . . . an explicable and justifiable reluctance to affix the stigma of blame.'<sup>94</sup>

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92 See *Australia Growth Resources Corporation Proprietary Limited v van Reesema* (1988) 6 ACLC 529 at 539. On the [unfortunate] consequences of this position see Parliament, Senate Standing Committee on Legal and Constitutional Affairs (the Cooney Committee), *Company Directors' Duties*, AGPS, Canberra, 1989 at 188.

93 See generally Kadish, S H, 'Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations' (1963) 30 *University of Chicago Law Review* 423 at 437; Duggan, A, 'Criminal Law Control of Misleading Advertising' in Trebilcock, M J *et al*, *A Study on Consumer Misleading and Unfair Trade Practices*, Vol 1, Information Canada, Ottawa, 1976 at 47-55; Companies and Securities Law Reform Committee, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No 10, May 1990, para 100.

94 Kadish, above, n 93 at 437.



This problem has now been rectified. Under reforms effected to the law, the statutory provisions dealing with the exercise of directors' powers<sup>95</sup> have now been converted to civil penalty provisions.<sup>96</sup> As a result of this reform, a contravention of the civil penalty provisions does not constitute an offence<sup>97</sup> unless the person concerned is reckless or intentionally dishonest and fails to exercise their powers and discharge their duties in good faith in the best interests of the corporation or for a proper purpose and with the intention of directly or indirectly gaining an advantage for themselves or someone else.<sup>98</sup>

So, criminal sanctions now apply only in cases of culpable disregard of the law or where directors knowingly or recklessly defy the law. This is a significant development. It recognises that the indiscriminate application of the criminal law to conduct which is morally neutral is undesirable. It had the potential to weaken the overall effectiveness of the criminal law as an instrument of social control. As Kadish has observed, 'the proliferation of convictions without grounds for condemnation tends in the long run to impair the identity of the criminal sanction and its ultimate effectiveness as a preventive sanction in the area of economic crimes and in the area of its traditional application.'<sup>99</sup> With this problem overcome,

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95 *Viz Corporations Act 2001 (Cth)*, sections 180, 181, 182 and 183.

96 See *Corporations Act 2001 (Cth)*, s 1317E(1).

97 *Corporations Act 2001 (Cth)*, s 1317E(1).

98 *Corporations Act 2001 (Cth)*, s 184. For a review of these reforms, see Redmond, above, n 23 at 115-8; Greenwood, A B, 'Corporate Officers - Bounden Duty and Service . . . and Reasonable and Lively Sacrifice?' [1992] *Butterworths Corporations Law Bulletin*, para 102.

99 Kadish, above, n 93 at 444. See also Hart, G, 'Some Aspects of Government Regulation of the Capital Markets: An Assessment of the Securities Industry Acts' in Tomasic R (ed), *Legislation And Society In Australia*, The Law Foundation of New South Wales and George Allen and Unwin, Sydney, 1979 at 239-40; Duggan, above, n 93 at 47-50; Friedman, W, above, n 85 at 191-4; "Developments", above, n 76 at 1235.

enforcement authorities should now be able to invoke the criminal justice system more readily and vigorously.

### **3.2 Cost and delay**

There is a perception that the criminal justice system is inordinately slow and expensive. Because a matter must be proved beyond reasonable doubt, a disproportionate investment of resources may be required in establishing the guilt of errant directors.<sup>100</sup> For example, extensive investigations may need to be undertaken to unravel the often complex transactions engaged in by directors in disregard of their obligations and to the detriment of the company. This raises the cost of law enforcement quite substantially.<sup>101</sup> To compound the problem, more procedural safeguards must be observed in a criminal trial, which further slows down the enforcement process considerably. These concerns were graphically described by Mr Tony Hartnell, inaugural Chairman of the ASC (now ASIC) thus:

you have some action taken at a point in time; you probably have two or three years before it even becomes apparent to the public; then a two or three year investigation and a two year prosecution phase. If you are going to be relying on criminal law as the primary instrument of corporate law, then you are always going to be five or ten years behind the times.<sup>102</sup>

Partly as a result of these considerations, there has been some reluctance on the part of Australia's corporate regulators to invoke the criminal justice system. The

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100 See for example Tomasic, above, n 28 at 86-7 (quoting ex NCSC Chairman H Bosch).

101 Commonwealth of Australia, Parliament, House Standing Committee on Legal and Constitutional Affairs (the Lavarch Committee), *Corporate Practices and the Rights of Shareholders*, AGPS, Canberra, 1991, para 6.4.15 (pp 211-2); Duns, above, n 33 at 373-5; Santow, G F K, 'Regulating Corporate Misfeasance and Maintaining Honest Markets' (1977) 51 *ALJ* 541 at 543.

102 See Duns, above, n 33 at 373.

erstwhile regulator, the NCSC, starved of funds as it was, relied principally on commercial settlements<sup>103</sup> as a means of enforcing the law.<sup>104</sup> In taking this course, the NCSC was, apparently, following a predictable line. It has been observed by some commentators that:

enforcement agencies, squeezed for resources as they are, typically take the line of least resistance, obtaining consent agreements from defendants wherever possible.<sup>105</sup>

For its part, the present regulator also initially displayed a disinclination to appeal to the criminal law. Under its inaugural Chairman, it adopted the policy that it would pursue violators of the law primarily through the civil process.<sup>106</sup> This was based on the view that the civil route is faster and less costly.<sup>107</sup>

In 1992, the Commonwealth Attorney-General issued a direction to the ASC and the Commonwealth Director of Public Prosecutions setting out some guidelines for collaboration to ensure that, so far as possible, cases of serious corporate wrongdoing

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103 On this see Joint Committee, above, n 87, at 14; Duns, above, n 33 at 373; Tomasic, above, n 28, at 85; Green, J M, 'An Australian Takeover Panel - What Do We Want? A Panel Poll and Critique' (1989) 7 *C&SLJ* 6 at 13.

104 On the drawbacks of commercial settlements as an enforcement strategy see Mayanja, J, 'Preventing the Frustration of Hostile Takeover Activity: The Role of Administrative Sanctions' (1995) 13 *Aust Bar Rev* 87 at 90-93.

105 Fisse & Braithwaite, above, n 76 at 2.

106 See Hartnell, A G, 'The National Companies Scheme: The ASC's Approach to Enforcement' [1990] *Butterworths Corp L Bull* para 72 especially at pp 83-7; Commonwealth of Australia, Parliament, House Standing Committee on Legal and Constitutional Affairs (the Lavarch Committee), *Corporate Practices and the Rights of Shareholders*, AGPS, Canberra, 1991, para 6.4.15 (pp 211-212); Redmond, above, n 23 at 115. For a comment as to the (undesirable) effect of such a policy see Tomasic, above, n 28, at 93.

107 Hartnell, above, n 106, at 83-7. See further Duns, above, n 33 at 373-5; "Developments", above, n 76 at 1311; Goldwasser, V R, 'The Regulation of Stock Market Manipulation' (1998) 9 *Aust J of Corp Law* 109 at 116-7.

were prosecuted.<sup>108</sup> This resulted in a slight change in the ASC's enforcement policy. According to available data, investigations of the of the penal provisions of the *Corporations Act*, and more particularly those involving breaches of directors' duties, now constitute the bulk of ASIC' enforcement activities.<sup>109</sup> This approach is most desirable. It goes some way towards maintaining public confidence in ASIC as a vigilant and effective corporate watchdog. Certainly, strong and decisive action is required in this area in order to protect the integrity of the market and deter wrongdoing.

Nonetheless, it appears that because of the problems mentioned before,<sup>110</sup> ASIC is still cautious about resorting to the criminal justice system to enforce the law governing the duties of directors. Indeed, addressing this issue more recently, Mr Cameron, another former Chairman of ASIC, reiterated that the problems of cost and delay associated with the use of the criminal justice system in corporate regulatory offences remain intractable. He said:

even when it has become apparent that there may have been a crime committed, the form the crime took, those involved and the gathering of evidence is an arduous task.<sup>111</sup>

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108 Titled "Serious Corporate Wrongdoing: Direction Relating to Investigation and Enforcement". For the full text of that direction see ASC Memo 19/92. One commentator has questioned the validity of the direction. See O'Bryan, N, 'Will the ASC Toe the Attorney-General's (Guide) Line? (1993) 11 *C&SLJ* 47.

109 See, for example, Bird *et al*, above n 87 at 78-86. In relation to this, see also the comment at p 102 of the report.

110 See text accompanying notes 100-102 above.

111 Cameron, above, n 28 at 122.

By reason of its stigmatic effects, punishment through the criminal law has great potential to reinforce society's condemnation of inappropriate director conduct.<sup>112</sup> To exploit this potential more fully, it is advisable to reform the law to minimise the delays and extra expense associated with the processes of the criminal law. It is important that criminal consequences are visited upon errant directors in cases of breach of fiduciary duty involving moral turpitude. Otherwise, the law might be discredited. Truly, as the Cooney Committee counseled, 'if the breach is criminal in nature, criminal penalties should follow.'<sup>113</sup> When criminal penalties are provided for but the authorities are disinclined to pursue them, the law tends to fall into disrepute.<sup>114</sup> Measures that may be adopted to promote greater use of criminal sanctions are set out in a later part of this paper.<sup>115</sup>

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112 Duns, above, n 33 at 372; "Developments", above, n 76 at 1305. See further text accompanying notes 75-86 above.

113 Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties*, AGPS, Canberra, 1989 at 188. See also pp 16-7 of the same report.

114 *Id.*

In this connection, the public furor that followed ASIC's failure to prosecute Mr Steve Vizard, a prominent business person, over alleged breaches of fiduciary duties arising from some share trades is most instructive. For examples of public reaction to ASIC's decision see Mayne, S, 'Steve Vizard - Insider Trader', <http://www.crikey.com.au/articles/2005/07/12-1612-7738.html> (date accessed 28 June 2006); Thornton, H, 'The Vizard affair', [http://www.henrythornton.com/article.asp?article\\_id=3357](http://www.henrythornton.com/article.asp?article_id=3357) (date accessed 28 June 2006). One particularly disaffected member of the public wrote:

Every few years we need to be reminded that the law applies in one way for the rich and in another way for the lower orders. Full marks to Steve Martin Vizard for bringing this Australian principle of justice to our attention again.

See Hart, G, Letters to the editor, *Sydney Morning Herald*, 30 July 2005.

For a more detailed discussion of the Vizard affair see Ramsay, I, 'Steve Vizard, Insider Trading and Directors' Duties' (2005) 15 *CCH Australian Corporate News* 177.

115 See Part 4 below.

### 3.3 Sanctions

It has been postulated that the nature of sanctions available impacts on enforcement practice.<sup>116</sup> So, there is need for a range of sanctions of increasing potency on which enforcement authorities can draw if the criminal justice system is to play its proper role in deterring abuses of directors' powers.<sup>117</sup>

Regrettably, the scheme of criminal sanctions available in cases of breach of fiduciary duty is quite limited. Presently, the *Corporations Act* relies primarily on two penal sanctions for enforcing the obligations imposed on directors in managing the affairs of companies, namely a fine<sup>118</sup> of up to \$200 000 or imprisonment for a period of up to 5 years, or both.<sup>119</sup>

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116 Bird *et al*, above, n 87 at 16.

117 *Id.*

118 Indeed, it may be of interest to note here that the fine is the most commonly specified sanction in Commonwealth legislation. See Australian Law Reform Commission, *Sentencing of Federal Offenders*, Issues Paper 29, 2005 at 112 - paper available at <http://www.austlii.edu.au/au/other/alrc/publications/issues/29/IP29.rtf> (date accessed 23 June 2006).

119 *Corporations Act 2001 (Cth)*, s 1311 and Schedule 3. Again, it should not be forgotten that these sanctions are not available in cases of breach of the duty of care. See note 25 above.

In addition to these penalties, a person convicted of a criminal offence that concerns the making of decisions that affect the business of a company or concerns an act that has the capacity to affect significantly the company's financial standing is automatically disqualified from managing or being involved in the management of a corporation – see *Corporations Act 2001 (Cth)*, s 206B(1). It should be noted, however, that the purpose of disqualification orders is not to impose a penalty but to protect the public. See *ASIC v Adler (No5)* (2002) 20 ACLC 1146 (Supreme Court of New South Wales); *Australian Securities and Investments Commission v Kippe* 137 ALR 423; *Re Magna Alloys & Research Pty Ltd* (1975) 1 ACLR 203 at 205 (Supreme Court of New South Wales); *Re van Reesema* (1975) 11 SASR 322 at 332. See further Bird *et al*, above, n 87 at 50; Cassidy, J, 'Disqualification of Directors Under the Corporations Law' (1995)13 *C&SLJ* 221 at 225-6.

While disqualification orders are supposed to be predominantly protective of the community, it is arguable that because of their incapacitation effect, they serve as an indirect tool of punishment. On this see further *Rich v ASIC* (2004) 50 ACSR 242 (High Court of Australia); Austin & Ramsay, above, n 6 at 93-4; Austin *et al*, above, n 6 at 732; Bird *et al*, above, n 87 at 49-50.

Apart from being limited in range, there is a further problem in that as currently applied, the effectiveness of the sanctions now available is quite doubtful. Although custodial sentences for breach of the duty of to act in good faith are provided for by the law, available evidence suggests that the courts are loath to impose heavy prison terms upon wrongdoing corporate management. According to a recent study, the average custodial sentence imposed by the courts in cases involving a contravention of the directors' statutory of good faith is 23.96 months.<sup>120</sup> This leaves the fine as the most prominent sanction for enforcing the law regulating the exercise of directors' fiduciary duties.

To achieve deterrence, the fine imposed by the court must be large enough. It should bear some relation to the harm occasioned to investors and society generally by undesirable director conduct.<sup>121</sup> However, available evidence again indicates that the maximum fine is rarely imposed against directors who act in violation of their fiduciary and statutory duties of good faith. According to the latest study on the penal sanctions imposed by the courts in such cases, the average amount of fine imposed is \$27 077.<sup>122</sup> While sentencing judges are enjoined to impose penalties of 'a severity appropriate in all the circumstances of the offence'<sup>123</sup>, it appears that that the courts are unwilling to impose heavy

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120 Bird *et al*, above, n 87 at 101. Earlier studies also showed a similar trend. See for example Tomasic, above, n 28 at 89; Grabosky & Braithwaite, above, n 34 at 188 et seq; Note, 'Increasing Community Control Over Corporate Crime - A Problem in the Law of Sanctions' (1961-62) 71 *Yale Law Journal* 280 at 291; Dam, K W, 'Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interests' (1975) 4 *Journal of Legal Studies* 47 at 66.

121 See generally Duggan, above, n 93 at 71-4; Dam, above, n 120 at 67.

122 Bird *et al*, above, n 87 at 100. See further Fisse, B, 'Sanctions Against Corporations: Dissolving the Monopoly of Fines' in Tomasic, R (*ed*), *Business Regulation in Australia*, CCH Australia Limited, Sydney 1984 at 131; Grabosky & Braithwaite, above, n 34 at 13 et seq; Crumplar, above, n 68 at 77-8; Tomasic above, n 28 at 85-6 and 100.

123 See *Crimes Act 1914* (Cth), s 16A(1).

monetary exactions upon offenders where the purpose of the fine is not to compensate the victim of the crime.<sup>124</sup> However, considering the potential loss and damage that serious breaches of fiduciary duty are certain to inflict on shareholders, employees, creditors and society as a whole, a fine of \$27 077 is too low to be a deterrent.<sup>125</sup>

Unless the legal system provides appropriate practical and effective sanctions, it will be difficult to enforce the law which seeks to prevent wrongful director conduct. In consequence, the values which the law seeks to promote, including maintaining investor confidence in the capital markets, might not be attained. This threatens the fabric of society.<sup>126</sup> Further steps must therefore be taken to improve the scheme of sanctions if the criminal law is to play its role in protecting the economic order of the community.

## **4 SOME PROPOSALS FOR REFORM.**

### **4.1 Sanctions.**

One of the major impediments to the use of the criminal justice system in fighting improper director conduct is the limited range and effectiveness of the sanctions available to the regulators.<sup>127</sup> The sanctions now most applied by the courts are the

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124 Dam, above, n 120 at 66; Coffee Jr, above, n 75 at 388-90; Tomasic, above, n 28 at 85-6.

125 The economy is harmed, for example, when, perceiving that their interests are not likely to be adequately protected, potential investors shun the capital markets. On this, see further Bosch, above, n 29.

126 On the consequences of non-enforcement of the law see Ziegler, above, n 21, especially at 678 et seq.

127 See Part 3.3 above.



fine and imprisonment. However, the amount of maximum fine prescribed by the law does not appear to be high enough to deter improper director conduct. To compound that problem, the courts appear to be reluctant to impose the maximum amount of fine.<sup>128</sup> It is therefore necessary to reform the law relating to sanctions if the objective of deterring breaches of directors' fiduciary duties is to be attained.

In his path-breaking work on crime and punishment, the noted Chicago School economics scholar Gary Becker demonstrated that deterrence is a function not only of the probability of detection and prosecution, but also of the attitude of the potential offender towards risk, as well as the severity of the sanction likely to be imposed in the event of conviction.<sup>129</sup>

His analysis argued that if the regulated are risk preferrers, deterrence is likely to be more effectively achieved if there is a high probability of detection of the offender, and a low penalty upon conviction.<sup>130</sup> This is because a risk preferrer would receive greater expected utility from the small probability of a large loss than from the large probability of a small loss.<sup>131</sup> Conversely, Becker argued, if potential offenders are risk averse, optimum deterrence would be achieved if there was a lower probability of apprehension combined with the prospect of the violators being visited with a heavy penalty following conviction.<sup>132</sup>

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128 See discussion accompanying note 122 above.

129 See generally Becker, G S, 'Crime and Punishment: An Economic Approach' (1968) 76 *Journal of Political Economy* 169 especially at 176-9. See also Posner, above, n 32 at 220; Breit, W & Elzinga, K G, 'Antitrust Penalties and Attitudes Towards Risk: An Economic Analysis' (1972-73) 86 *Harvard Law Review* 693 at 699 et seq; Ehrlich, I, 'The Deterrent Effect of Criminal Law Enforcement' (1972) 1 *Journal of Legal Studies* 259 at 265 et seq.

130 Becker, above, n 129, at 176-9.

131 *Id.*

132 *Id.*

A number of studies indicate that modern corporate management are generally risk averse.<sup>133</sup> They generally go to great length to protect their reputation. Indeed, one commentator has gone as far as to assert that 'any risky moves that are made by today's management are aberrations, atypical phenomena having little connection with the risk attitudes of management at large.'<sup>134</sup>

Building on Becker's hypothesis and other studies dealing with the risk preferences of modern management, several scholars have argued that the most appropriate sanction for deterring undesirable managerial conduct is the threat of a sufficiently high level of monetary fine, coupled with a low rate of policing by the enforcer.<sup>135</sup> The optimum penalty for violation of the law should be the sum of the costs of the harm arising from the unlawful activity and of the costs of enforcement.<sup>136</sup> In view of this, it is advisable to reform the law to raise the level of the maximum fine. A strategy of high fines coupled with a low rate of policing has the added advantage that it is likely to consume fewer societal resources.<sup>137</sup>

The penalties provided by the law will not achieve the desired deterrent effect unless they are applied by the courts. So, in addition to raising the level of the maximum fine, it is essential to ensure that the fines actually imposed are adequate to deter directors from engaging in improper conduct. To achieve this objective, the law

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133 As to the risk preference of modern corporate management, see Calvani, T & Siegfried, J, *Economic Analysis and Antitrust Law*, Little, Brown and Company, Boston and Toronto, 2nd ed 1988 at 401; Breit & Elzinga, above, n 129, at 704-6.

134 Breit & Elzinga, above, n 129 at 705 (quoting Jay, A).

135 See, for example, Becker, above, n 129 at 176-9; Posner, above, n 32 at 219-27; Dam, above, n 120 at 66 et seq; Duggan, above, n 93 at 72-4; Landes, W M & Posner, R A, 'The Private Enforcement of Law' (1975) 4 *Journal of Legal Studies* 1 at 31 et seq; Breit, W & Elzinga, K G, 'The Purposes of Private Treble Damage Suits: Deterrence and Compensation' in Calvani & Siegfried, above, n 133 at 399 et seq.

136 *Id.*

137 *Id.*

should be reformed to narrow the courts' discretion by prescribing a minimum fine to be levied in such cases.

It is recognized that because of the wide and diverse range of factors which bear on the sentencing process,<sup>138</sup> it is desirable to leave wide sentencing discretion to judges. However, as Barwick CJ once observed, 'it cannot be denied that there are circumstances which may warrant the imposition on the court of a duty to impose a specific punishment.'<sup>139</sup> In view of the judges' reluctance to impose substantial fines in cases of breach of fiduciary duty as outlined above, the proposal set out here is justified. It is the most effective means of achieving the twin objectives of punishment and deterrence underlying the law.<sup>140</sup>

In addition, legislative reform is needed to overcome judicial reluctance to utilise the sanction of imprisonment. While imprisonment may mean food and shelter for some, it can be a very traumatic experience for a member of the business community.<sup>141</sup> Its

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138 As Sir Arthur James has observed:

the sentencing process has to be applied not only to a very large number of individuals but also to the variations in response to the sentence, often unpredictable, which may be exhibited by any one individual. The process has to be applied to offenders ranging in character from the determined, committed criminal, who is intelligent and in full possession of his faculties, to those of low-intelligence, the immature, the inadequate, and those addicted to drink or drugs. The practice has to be applied to the old lag and to the first offender, to the elderly and to children.

See James, Sir A, 'A Judicial Note' reproduced in Ashworth, A, *Sentencing and Penal Policy*, Weidenfeld and Nicolson, London, 1983 at 68.

139 *Palling v Corfield* (1970) 123 CLR 52 at 58.

140 As to the objectives pursued by the law governing the sentencing of Federal offenders in Australia, see *Crimes Act 1914* (Cth), s 16A(1); ALRC, above, n 118 at 106-7.

141 It is certainly doubtful if Joad's experience of gaol life, as narrated in this extract, would be of much appeal to a company director:

'How they treat you in McAlester?', Casey asked?

cost, in terms of foregone income,<sup>142</sup> restrictions on consumption and freedom during the period of incarceration and the possible impairment of the imprisoned director's ability to engage in legitimate activities after release, is likely to be great.<sup>143</sup> Thus, if imprisonment it is effectively used, it could prove a most powerful disincentive against unlawful director conduct.

To ensure that the benefits of the sanction of imprisonment are not lost, it is desirable, once again, to narrow the courts' discretion by clearly specifying the circumstances when that penalty is warranted. It is therefore recommended that the law be reformed to require the courts to impose a sentence of imprisonment in all cases of egregious disregard of the law, for example, where it is shown that directors have acted fraudulently or knowingly defied the law to serve their own interest or that of another party. Such intransigent conduct must be strongly discouraged. It has the potential to sap investor confidence in the capital markets. A jail sentence should, further, be imposed against repeat offenders.

As they are likely to restrict the discretion of sentencing judges, these recommendations might be opposed by the proponents of current law and practice

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'Oh, awright. You eat regular, an' get clean clothes, and there's places to take a bath. It's pretty nice some ways . . . 'They was a guy paroled,' . . . 'Bout a month he's back for breakin' parole. A guy ast him why he bust his parole. "Well, hell," he says. "They got no conveniences at my old man's place. Got no 'lectric lights, got no shower baths. There ain't no books, an the food's lousy." Says he come back where they got a few conveniences an' he eats regular. He says it makes him feel lonesome out there in the open havin' to think what to do next. So he stole a car an' come back . . . 'The guy's right too,' . . . 'Las' night, thinkin' where I'm gonna sleep, I got scared.

See Steinbeck, J, *The Grapes of Wrath*, Heinemann, London, 1972 Reprint at 21.

142 One U S study on the effect of conviction on the legal income of fraud offenders suggests that those sentenced to prison experience about 10% larger reductions in income than those who are not. See Waldfogel, J, 'Are Fines and Prison terms Used Efficiently? Evidence on Federal Fraud Offenders' (1995) 38 *Journal of Law and Economics* 107 at 113.

143 Becker, above, n 129 at 179-80; Posner, above, n 32 at 223; Redmond, above, n 23 at 115.

under which the sentencing judge has maximum discretion to select the sentence which he or she believes to be the most appropriate in each case. The difficulty, however, is that by prescribing maximum sentences only and leaving discretion to the sentencing judge to determine the level of penalty to be imposed, the current regime does not deal with the question of the factors which should be recognised as aggravating certain breaches of directors' duties.

Egregious breaches of directors' fiduciary duties menace society. As argued before, this type of conduct threatens the economic order of society. It has the potential to undermine public confidence in the capital markets. For this reason, it is submitted that some restrictions on the discretion of sentencing judges to require them to impose some minimum penalties in cases of this nature is justified. A policy of mandatory sentences in cases of deliberate, reckless or fraudulent conduct would expressly recognize such conduct as a form of aggravated director misconduct. It would also make the Parliament's policy of promoting and maintaining investor confidence<sup>144</sup> by, among other things, discouraging director misconduct and promoting best corporate governance practices clear.<sup>145</sup> Such a policy is also likely to achieve enhanced deterrent effect.<sup>146</sup>

The impact of criminal sanctions is likely to be enhanced if they are given publicity. As Seneca observed, 'the more publicity punishments have, the more they may avail as an admonition and warning.'<sup>147</sup> Therefore, in order to reinforce the deterrent potential of criminal sanctions, the law should be reformed to

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144 *Australian Securities and Investments Commission Act 2001* (Cth), s 1(2)(b).

145 As to this see the *Corporations Act 2001* (Cth), Ch 2D, Officers and Employees - Outline. For an illuminating discussion of sentencing policy see Ashworth, above, n 138 especially at 60-81.

146 On the effect of mandatory penalties generally see Ashworth, above, n 138 especially at 73-76.

147 Quoted in Fattah, above, n 85 at 16. See also Fisse & Braithwaite, above, n 76 at 285 et seq.

authorise the use of adverse publicity as a formal sanction, in the fight against impermissible director conduct. Publicity of exposure to the criminal justice system can be a significant factor in deterring middle-class potential defendants, of whom corporate management form a part.<sup>148</sup> In this connection, it may be noted that publicity has been and continues to be used as a deterrent both in Australia and overseas.<sup>149</sup>

It is suggested that following the conviction of a director for breach of the statutory duty of good faith, the court be at liberty to order the fact of that conviction to be publicised. To achieve effective publicity, details concerning the conviction, naming the directors concerned should be published in the Government Gazette. In addition, a suitable advertisement should be placed in at least one major newspaper circulating in the area where the affected company has its principal place of business. Further, details of the misconduct should be notified to shareholders in the company's annual report.

Adverse publicity is currently used as an informal sanction by ASIC. The Commission issues a media release whenever it initiates enforcement action and on the conclusion of such action. The stigmatizing impact of such releases is, however, limited. The Commission's releases have limited circulation. Moreover, the information in the Commission's releases may not always be picked up by the media. It is thus desirable to formalise adverse publicity as a sanction in the manner suggested above.

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148 See further text accompanying notes 75-86 above; Fisse & Braithwaite, above, n 76 at 247-8; Fisse, B, 'The Use of Publicity as a Criminal Sanction' (1971) 8 *MULR* 107.

149 See for example the *Consumer Claims Act, 1998* (NSW), s 16 and comparable legislation in other Australian jurisdictions; *Land and Income Tax Act, 1954* (NZ) s 238. Under the *Black Marketeering Act 1942* (Cth) (repealed), adverse publicity was, until shortly after the second world war, used as a formal sanction to combat the practice of black-marketeering.

These measures might be criticised on the ground that the prospect of exposure to heavy criminal penalties is likely to discourage worthy persons from accepting directorships.<sup>150</sup> Indeed, as far back as 1916, the House of Lords warned against 'establishing rules as to directors' duties which would impose upon them burdens so heavy and responsibilities so great that men of good position would hesitate to accept office.'<sup>151</sup> However, considering the significant costs that serious violations of directors' fiduciary duties can impose on investors and the economy generally,<sup>152</sup> these measures are highly desirable.

#### **4.2 Administration**

Apart from the problem of sanctions, several other important matters need to be addressed before the public enforcement system can effectively play its role in preventing breaches of directors' fiduciary duties.

It is vital to the effective regulation of corporate activity that the regulator is patently independent and free from political interference in the exercise of its powers and the determination of its priorities. Where this is not the case, there is a danger that the law could be enforced more harshly against opponents than supporters of the party in power.<sup>153</sup> In some cases, the law may not be enforced at all.<sup>154</sup>

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150 See for example Senate Standing Committee on Legal and Constitutional Affairs, above, n 92 at 187; Greenwood, above, n 98 at 64 et seq.

151 *Cook v Deeks* [1916] AC 554 at 563.

152 See for example Justice Owen's comments in notes 3 and 5 above; Bosch, above n 29.

153 Landes & Posner, above, n 135 at 41 et seq.

Indeed, there are some suspicions that this might be happening in Australia as the following comments, which were made in relation to the recent Rene Rivkin / Steve Vizard insider trading incidents, suggest:

It is, therefore, a matter of considerable concern that the public enforcer is, currently, subject to the constraints of ministerial control and direction. The Minister is empowered to give to the Commission directions as to the policies it should pursue, or the priorities it should follow, in performing its functions or exercising its powers.<sup>155</sup> Such directions could seriously influence the course of the Commission's enforcement agenda, including its investigations and, ultimately, the prosecution of offenders.

Incidents of ministerial interference in the corporate regulator's enforcement programme have occurred. By way of illustration, reference may be made to the Minister's direction of November 1992 to the ASC regarding the investigation of corporate wrongs.<sup>156</sup> Earlier on, the Minister unilaterally extended the moratorium for complying with the provisions relating to the Australian company number when the ASC had, after due consideration, decided not to grant any extension.<sup>157</sup>

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Rene Rivkin must be turning in his grave. Australia's s best known and most prolific insider trader was arrested and eventually convicted in the criminal courts for buying 50,000 shares in Qantas and pocketing a tiny profit.

...

Steve Vizard is an extremely lucky man. ASIC, a body responsible to Treasurer Peter Costello, has treated him with kid gloves in the face of strong evidence.

...

The Howard Government appointed Vizard to the Telstra board in September 1996 . . . Rivkin had strong labor connections, while Vizard is a Liberal party man – and the treatment appears to be quite different.

See further Mayne, above, n 114 at 1.

154 See for example the press articles entitled "NCSC Push for Criminal Action on Carter 'Ignored' in the *Sydney Morning Herald*, Friday 14 September 1990 at 25 and 'Greiner 'Snub' to Request from NCSC' *The Australian*, 24 October 1990 at 5 where some examples of this problem are set out.

155 *Australian Securities and Investments Commission Act 2001* (Cth), s 12(1).

156 See note 108 above and accompanying text.

157 See the ASC Digest (1991) for this direction.



Further evidence of the potential to use ministerial power to influence the regulators' decisions can be gleaned from the several directions issued by the Attorney-General to the Trade Practices Commission.<sup>158</sup> Whilst it is not in doubt that some degree of ministerial oversight is necessary in order to ensure the regulator's accountability,<sup>159</sup> there is need to reconsider the desirability of conferring such extensive powers of direction on the Minister. ASIC was established essentially to regulate market behaviour. In order to provide confidence to the regulated that its operations are carried out in an independent and objective manner, it is essential that it is subjected to minimum interference.

Another matter that needs to be considered very seriously is the funding of the public regulator. It is acknowledged that the current regulator is better funded than its predecessor. Indeed, ASIC recently received a funding boost.<sup>160</sup> ASIC has indicated that it will use some of these extra resources to fund enforcement activities associated with the investigation and litigation of exceptional matters that are of significant public interest.<sup>161</sup> This is most encouraging. However, adequate funding of the public enforcer is required on a continuing, not episodic basis. Although this is undeniably an observed fact, it appears that the authorities are reluctant to ensure sufficient funding to enable the regulator to discharge its

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158 For a discussion of some of these directions, see Pengilley, W, 'Competition Policy and Law Enforcement: Ramblings on Rhetoric and Reality' (1984) 2 *Australian Journal of Law and Society* 1 at 6-7. On the problem of political interference generally, see further Cranston, above, n 41 at 19.

159 See further, Commonwealth of Australia, *Review of the Corporate Governance of Statutory Authorities and Office Holders*, Canberra, 2003, at 33-4 and 52-3. Report available at <http://www.apf.gov.au/Library/pubs/RN/2004-05/05rn50.htm> (date accessed 12 February 2007).

160 Further particulars of this can be gleaned at <http://www.budget.gov.au/2006-07/pbs/html/asic-02.htm> (date accessed 29 May 2006).

161 See ASIC, Media Release 06-148, *Additional Budget Funding for ASIC*, Wednesday 10 May 2006. Available at [http://www.asic.gov.au/asic/asic\\_pub.nsf/byheadline/06-148+Additional+budget+funding+for+ASIC?openDocument](http://www.asic.gov.au/asic/asic_pub.nsf/byheadline/06-148+Additional+budget+funding+for+ASIC?openDocument). (date accessed 29 May 2006).

mandate effectively.<sup>162</sup> This has serious implications for the enforcement of directors' duties. As one commentator has observed, 'starving ASIC of funds ensures that the regulator cannot go the extra mile in its enforcement activities.'<sup>163</sup>

That problem aside, it has been pointed out that briefs received by the Commonwealth Director of Public Prosecutions from some regulatory agencies are not properly presented.<sup>164</sup> It appears that some of the officers charged with the task of investigating breaches of the law and preparing briefs for prosecution are not adequately trained or sufficiently experienced to discharge that responsibility. As a result, in some instances, the Director of Public Prosecutions has to request additional work to be done before any further action can be taken on the matter.<sup>165</sup> This inevitably causes unnecessary delay in the initiation of court action. In some cases, wrongdoers might escape prosecution altogether. In order to improve the quality of law enforcement, ASIC must, as a long term remedy, devote substantial resources out of its now improved budget<sup>166</sup> to a vigorous program of staff training.

Allied to the foregoing, it is necessary for ASIC and the Office of the DPP to harmonise their enforcement policies by developing criteria as to when a matter will be proceeded with in the civil courts or by way of criminal prosecution. This will go towards reducing delays in the initiation of appropriate action against offenders. It is also necessary to ensure fairness to, and equality of treatment of all the regulated.

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162 On this see further the discussion accompanying note 37 above.

163 Wilson, S, 'Starving the Watchdog is No Way to Prevent Corporate Crime', *The Australian*, 21 Feb 2006.

164 See the Commonwealth of Australia, Senate, Legal and Constitutional Legislation Committee, *Official Committee Hansard*, , AGPS, Canberra, 27 February 2006, at 2. Also available at <http://www.aph.gov.au/hansard/senate/commtee/S9186.pdf> (date accessed 29 May 2006).

165 *Id.*

166 On this see note 160 above.

Otherwise a situation might arise where some citizens are subjected to the criminal law while others accused of the same or similar conduct are not.<sup>167</sup> That might bring the justice system into disrepute.<sup>168</sup>

## **5 CONCLUSION.**

Breaches of the rules designed to control director behaviour have the potential to seriously undermine public and investor confidence in Australia's capital markets, with disastrous consequences for the proper functioning of the economy. In order to promote the welfare of society, it is desirable that the law which seeks to protect the interests of companies is enforced to the fullest extent possible. This is likely to be achieved through a regime of active dual (public and private) enforcement of the law governing directors' fiduciary duties.

Further, in order to combat improper director conduct effectively, the law must mobilise all weapons in its armoury. By reason of their stigmatic effects, criminal law sanctions have great potential to deter undesirable wrongful director conduct. However, as a result of the problems explored in this paper, the full deterrent potential of these sanctions cannot, presently, be wholly exploited. It is therefore desirable to reform the law, in the manner suggested in this paper, to remove the obstacles to the use of criminal sanctions in the battle against abuses of directors' powers. This will go a long way in protecting the investing public and the economic order of society generally.

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167 See Note, "Developments", above, n 76 at 1310 et seq; Cranston, above n 41 at 12-3.

168 In this connection, see some of the public the comments in note 114 above regarding ASIC's handling of the Steve Vizard affair in contrast to the treatment earlier on of a similar case involving Mr Rene Rivkin.