Empty Heads, Pure Hearts:[1] The Unintended Consequences of the Criminalisation of Directors' Duties

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Significant misconduct by directors, particularly involving the finance company collapses, a general lack of enforcement powers and a failure to use the limited powers available, provided the background for the enforcement of directors' duties becoming one of the key issues addressed in the current review of securities law in New Zealand. As well as changes to directors' duties proposed for the securities legislation, a more substantial change is proposed in the area of company law. In a paradigm shift, the government plans to introduce criminal sanctions for breaches of certain duties contained in the Companies Act 1993 where misconduct is considered to be egregious due to its having been committed dishonestly or recklessly. In addition, regulatory enforcement powers will be increased.

This article analyses the feasibility and desirability of criminalising directors' duties. Highlighting the rationales that speak to a need for a change in direction of the enforcement of directors' duties in New Zealand, together with setting out and critically assessing the proposed changes, the analysis embarks on a consideration of the general policy arguments for and against criminalisation of directors' duties. Additional insights for the debate can be gained from the Australian enforcement experience and from relevant case law in both jurisdictions. A discussion of the potential of civil penalties as part of the enforcement regime aims to add further food for thought for the ongoing reform process.

1 INTRODUCTION

> "[T]here is potential for substantial harm to individual and public interests from directors breaching their duties, in particular where they are directors of companies that hold substantial assets in a fiduciary capacity for broad groups of outsiders, as in finance companies. Many investors lost much or all of their savings and endured a significant fall in their standard of living as a result of finance company failures."

1 Phrase coined by Ashley Burrowes and John Karayan "Feltex and Enron bankruptcies" [2010] NZLJ 406, discussing the *Enron* and *Feltex* (*Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264,715 (DC)) cases.

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Commerce Minister Simon Power's recent words[2] indicate the inevitability of corporate sanctions following the failure of the finance company sector and its impact on New Zealand investors.

The Cabinet's decisions on a comprehensive review of securities law were announced on 17 March 2011 by Simon Power. The review will result in a re-write or amendment of legislation including the Securities Act 1978, the Securities Markets Act 1988, the Companies Act 1993, the Unit Trusts Act 1960, the Superannuation Schemes Act 1989, and the non-tax parts of the KiwiSaver Act 2006.[3] The next step in the process will be the release of a draft of the new legislation later this year with the Government intending to introduce the bill to Parliament by the end of 2011.[4]

The current review takes into consideration the work of the Capital Market Development Taskforce, the effects of the global financial crisis, and the failure of many New Zealand finance companies.[5] Together with the establishment of the Financial Markets Authority (FMA), the new securities law regime will largely complete the major regulatory reform programme in the financial sector. Recent reforms focused on the financial adviser regime, auditor regulation, the licensing of trustees and statutory supervisors, the prudential regulation of the non-bank deposit regime, finance company moratorium requirements, and the requirement for financial service providers to be registered and belong to a dispute resolution scheme.[6]

The new regime also includes changes that will have an impact on company directors. The proposed new provisions will allow for the most serious breaches by directors to result in criminal liability; increase the maximum period for the prohibition of a person from managing a company from five years to ten years, and allow the High Court to impose banning orders for an indefinite period.[7]

Simon Power has proposed that the FMA and Registrar of Companies become empowered to prosecute egregious breaches of directors' duties in some key areas with a high threshold to be met before action would be either possible or taken.[8] Recently, Finance Minister, Bill English, has announced that the Non-Bank Deposit Takers Bill will further tighten the regulation of finance companies. The Bill, which will be introduced to Parliament in early August, will grant the Reserve Bank the power to remove directors of finance companies and other financial institutions within its scope under certain circumstances.[9]

The focus of this article is on the criminalisation of directors' duties. The experience of the current legislative system on directors' duties and the resulting case law provide the initial support for the argument set out in this article in favour of a need for increased accountability. This is followed by a discussion of the duties where criminal liability for intentional breach is proposed as part of the securities law reform. Whether such criminalisation provides the best solution, then needs to be

2 Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [205].

3 Ibid, at [246]–[247].

4 Ibid, at [33], [253:159]; Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Business Committee: Securities Law Review – Additional Policy Decisions and Costings* (MED1201904, May 2011) at 47.

5 Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [23].

6 Ibid, at [21].

7 Ibid, at [210], [236], [237].

8 Ibid, at [26].

9 See Bill English "Govt toughens rules for non-bank finance firms" (press release, 25 July 2011) <www.beehive.govt.nz>.

addressed. For this discussion the article draws on the Australian experience with criminal sanctions for directorial misconduct and further directs attention to the potential pitfalls that can arise in the context of the proposed new offences in New Zealand.

The decisions concerning the directors of Feltex in New Zealand and Centro in Australia not only provide important insights into the different expectations on the performance of directors in the two jurisdictions, they also demonstrate that a clearly delineated scope of the directors' obligations is needed if compliance and an effective enforcement system are intended. The possibility of introducing complementary civil penalties for less serious breaches of directors' duties into the Companies Act 1993 also deserves detailed attention in the current reform process. Collating all the arguments of relevance to the enforcement debate, the article concludes that Government needs to assess the proposed changes and their resulting consequences carefully — this will necessarily include a reconsideration of the question of civil penalties in order to achieve a balanced reform in the area of directors' duties.

2 THE NEED FOR INCREASED ACCOUNTABILITY[10]

Directors hold a crucial position in the company structure and the way in which they perform the obligations they owe to the company as fiduciaries can have a profound impact on the company and its stakeholders. The board of directors controls the company and its assets; the aim of the duties imposed on directors is to ensure, first, that those who manage a company, its directors, put the interests of the company before their own interests where the two are in conflict and, secondly, that the shield of limited liability is not used by those who operate companies to take unacceptable risks.[11] Breaches of directors' duties can lead to dire results for a company and can threaten its continued existence. For example, a failure to disclose a conflict of interest under s 140 of the Companies Act 1993 may cause the company to enter into a transaction with a party related to the director on terms disadvantageous to the company. As another example, if a director causes the company to enter into an obligation that it reasonably will not be able to perform in breach of s 136, the company may quickly become insolvent. The importance of the duties of directors and the check that they provide on dishonest or careless behaviour by those in control of the company cannot be overstated.

A breach of one of these core duties[12] currently gives rise only to civil liability of the contravening director. The Companies Act 1993 requires the company or the shareholders (or another director) on behalf the company to address and enforce misconduct by directors by means of a private enforcement system.[13] In cases of breaches relating to the insolvency of a company, enforcement actions are more commonly brought by the liquidator or receiver or the creditors of the company.[14]

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10 This section of the paper draws on a submission made by the authors to the Ministry of Economic Development's review of securities law, see Susan Watson and Rebecca Hirsch "Submission to the Ministry of Economic Development in Response to the Discussion Document Review of Securities Law June 2010" (August 2010) <www.med.govt.nz>; as well as on parts of Rebecca Hirsch and Susan Watson "Blowing the Whistle on Protection for Corporate Whistleblowers: A Lacuna in New Zealand Law" (2010) 16 NZBLQ 393.

11 See also the wording of the Long Title of the Companies Act 1993.

12 See Companies Act, ss 131 ff.

13 Compare s 165 of the Companies Act 1993, which allows for derivate actions.

14 See also remarks in Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [202]; Companies Act 1993, s 301.

Despite a primary focus on civil liability of directors, there are some criminal sanctions in place for breaches of other legislation that may occur in conjunction with breaches of directors' duties. For example, a breach of duty by a director may also involve a breach of the Crimes Act 1961.[15] Section 260 of the Crimes Act 1961 creates an offence and makes liable for imprisonment individuals who make false entries in any book or account used for accounting purposes. It is entirely possible that a director of a company involved in reckless trading in breach of the duty contained in s 135 of the Companies Act 1993 may also be involved in false accounting. Directors can be made criminally liable under s 242 of the Crimes Act 1961, which relates to untrue statements in a prospectus. In addition, s 220 of the Crimes Act 1961 relating to theft in a special relationship can likewise give rise to criminal liability of directors.[16]

Similarly, breaches of the directors' duties in the Companies Act 1993 may also involve breaches of Part 21 of the Companies Act 1993, which relates to offences and penalties. For example, a breach of s 135 may also involve a breach of s 380, which relates to carrying on business fraudulently and can make directors criminally liable.[17] Making false statements relating to the company, falsifying records and fraudulently taking company property are also criminal offences.[18]

Directors may further be criminally liable under the Financial Reporting Act 1993. For example, the Feltex directors were charged under s 36A of that Act because Feltex's interim financial statements did not comply with the applicable financial reporting standard. Similarly, current securities legislation provides criminal sanctions for certain offences by directors. The directors of Nathans Finance were convicted under s 58 of the Securities Act 1978, which covers misstatements in advertisements and prospectuses.[19]

The position is almost the same for listed companies. Companies listed on the New Zealand Stock Exchange (NZX) are bound by the listing rules. The listing rules, with one exception, are contractual — between the listed company and NZX — and do not have any statutory force.[20] Again, the position is different in Australia. The Australian Stock Exchange (ASX) listing rules have general statutory force due to s 793C of the Corporations Act 2001. This means that public enforcement of the ASX listing rules is possible, for example, through an application to Court made by the Australian Securities and Investments Commission (ASIC).

Directors face additional obligations under the NZX rules. For example, under r 9 transactions with related parties (parties in which the director has a material interest) are not possible unless a waiver is

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15 For instance, in the case of the collapse of South Canterbury Finance, the Serious Fraud Office brought charges against Allan Hubbard under ss 220, 242 and 260 of the Crimes Act 1961. See Serious Fraud Office "SFO lays fifty charges against Allan Hubbard" (press release, 20 June 2011) <www.sfo.govt.nz>.

16 On this point see also Peter Watts "Criminal penalties and professional negligence" [2011] CSLB 51.

17 Compare ibid.

18 Companies Act 1993, ss 377–379.

19 Charges under s 58 of the Securities Act 1978 also form part of the several allegations in the criminal proceedings against the Bridgecorp directors. See Fiona Rotherham "Bridgecorp ruling 'impacts all directors'" (6 July 2011) Business Day <www.stuff.co.nz>; New Zealand Press Association "Fresh charges against Bridgecorp directors" (24 June 2010) TVNZ Business News <www.tvnz.co.nz>.

20 The one exception is the continuous disclosure provisions found in r 10 of the listing rules. If a listed company becomes aware of material information about itself, it must release that information to the NZX. That rule is given statutory force by s 19B of the Securities Markets Act 1988.

obtained from NZX. This is a much stricter obligation on directors than the disclosure obligation found in s 140 of the Companies Act 1993. But, again, failure to comply with r 9 is not an offence.

Private enforcement alone of directors' duties is patently inadequate. In the Cabinet Paper, the Minister highlights the current difficulties around private enforcement in New Zealand.[21] These include the costs of any action, the disincentive for individual shareholders to bring derivative actions because any compensation will go to the company, and the difficulty of coordinating class actions.[22] Similar comments have been made in academic literature highlighting a too lenient overall approach to corporate law enforcement in New Zealand.[23] This approach is reflected by the lack of powers as well as resources of the regulatory authorities.[24] On the other hand, reliance on an exclusively private enforcement system in the Companies Act 1993 combined with a lack of incentives for shareholders to use the existing civil remedies, have resulted in minimal enforcement of sometimes egregious corporate misconduct.[25]

Recent events, most particularly the collapse of the finance companies, highlight significant consequences for investors and, sometimes, shareholders, as a result of breaches of directors' duties. Apart from considerable financial losses to shareholders, investors, and other creditors, and the dissolution of the companies involved, a lack of confidence of the general public in the capital markets and the finance sector generally can be observed.

Acknowledging and responding to this unsatisfactory situation, the current securities law reform addresses the issues surrounding the enforcement of breaches of directors' duties as one of the core reform points.[26] The next section details the proposed changes to directors' duties in the area of securities law focusing especially on the intended criminalisation of certain duties within the Companies Act 1993.

3 THE NEW OFFENCES FOR DIRECTORS

The Minister proposes that the liability regime be simplified with a comprehensive regime developed with an escalating hierarchy of liability. Only egregious violations of securities law — those where the contravention was deliberate or reckless, will be serious criminal offences. The Minister considers that substantial fines or lengthy terms of imprisonment will provide the appropriate deterrents and sanctions.[27] Currently serious securities law breaches can be prosecuted under provisions in the Crimes

21 Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [203]. The cabinet paper (at [23]–[24]) also draws on the recommendations made by the Capital Market Development Taskforce. The Taskforce, although not commenting on the issue of private enforcement directly, pointed out that New Zealand's capital markets require: a consolidation of the existing regulatory agencies thereby closing potential regulatory and enforcement gaps, a more prioritised focus on monitoring and enforcement as well as increased powers for the new regulator. See generally Capital Markets Development Taskforce *Report of the Capital Markets Development Taskforce: Capital Markets Matter* (December 2009) at 80–88.

22 Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [203].

23 John H Farrar "Enforcement: A Trans-Tasman Comparison" (2005) NZ L Rev 383 at 386.

24 Ibid at 384, 386.

25 Ibid.

26 Compare Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [13].

27 Ibid, at [192].

Act 1961 (such as the provision relating to untrue statements in a prospectus)[28] but the intention is that new securities-specific offences will be created in the new Securities Act.[29]

In a similar way to the Australian provisions, there will be a pyramid of offences. Criminal penalties will be reserved for serious misconduct. Violations that are not serious enough to warrant criminal liability will be dealt with by a civil pecuniary penalty regime similar to the current regimes found in the Securities Act 1978 and the Securities Markets Act 1988.[30] An example would be pecuniary penalties for minor or careless misstatements in a prospectus.[31] Misstatements that are material and would have affected a reasonable person will give rise to investors having a right to compensation without needing to show reliance and causation elements.[32] As with the current legislation a breach would be a civil liability event with the person in breach potentially subject to a pecuniary penalty and also compensation orders possible for investors affected.[33]

Significantly, however, the decision has been made not to establish civil penalty provisions for breaches of directors' duties in the Companies Act 1993. Civil penalty provisions were thought to be a bad idea because it was considered that the lower standard of proof might deter people from taking on directorships. Also it was considered that their imposition would necessarily require regulators and courts to examine business judgments.[34]

The Minister highlighted that there is currently no offence provision that deals with breaches of directors' duties that take place after allotment of securities:[35]

> "A concern expressed following the finance company failures was the lack of appropriate powers for regulators to take action against directors of those companies for apparent reckless or dishonest conduct. In addition, there are not any offence provisions that would deal directly with the intentional breach of directors' duties, such as a situation where a director intentionally takes action which is to the detriment of the company in circumstances where the company will be unable to meet those obligations."

Intentional contravention of the following duties will, therefore, be offences:

- Section 131 — the duty of good faith and to act in what the director believes to be in the best interests of the company
- Section 135 — not to cause, allow or agree to the company carrying on business where there is a substantial risk of serious loss to the creditors of the company (the reckless trading provision)
- Section 136 — not agree to the company incurring an obligation unless the director believes on reasonable grounds that the company will be able to perform the obligation when required to do so.

28 Crimes Act 1961, s 242.

29 Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [193].

30 Ibid, at [195]–[196].

31 Ibid, at [195].

32 Ibid, at [198].

33 Ibid, at [197]–[199].

34 Ibid, at [206].

35 Ibid, at [209].

Such conduct is difficult for regulators to detect before it takes place so the Minister also plans to introduce whistleblower protection for those who voluntarily disclose a director's wrongdoing. The FMA will be empowered to bring criminal proceedings for egregious breaches of directors' duties.[36]

This new power for the FMA will be in addition to its new powers in the Financial Markets Authority Act 2011 to initiate or take over civil actions on behalf of investors and issuers against directors and others, including actions that began before the Act came into force.[37] The types of civil actions that the FMA can exercise are very wide and include actions arising under the Companies Act 1993.[38] They therefore include breaches of duties by directors. The targets are financial markets participants so the civil actions brought by the FMA will be limited to companies and unit trusts that issue securities to the public.[39]

4 IS CRIMINALISATION A PROPER MEANS OF PROTECTING INVESTORS?

4.1 Criminalisation of Directors' Duties — The Policy Background

The general policy considerations supporting or opposing the criminalisation of breaches of directors' duties provide a rich contrast. Arguments in favour of criminal sanctions for corporate crime include increased public interest in the prosecution of severe wrongdoings as a way of showing the public's moral reprobation towards such behaviour.[40] In addition, due to the higher publicity criminal prosecutions attract, a higher degree of deterrence as well as credibility of the enforcement authorities, may be achievable.[41] The public prosecutions following the corporate collapses in the United States are examples. The need for better deterrence as well as promotion of the importance of compliance with directors' duties have become obvious under the current enforcement regime.

On the negative side, the primary concern about such criminalisation is that individuals might be discouraged from becoming directors.[42] For instance, after the judgment in the Feltex case the directors warned that competent and reliable people would be deterred from taking on directorships if they faced criminal sanctions.[43] It could also be argued that the possibility of criminal liability might further inhibit directors from taking legitimate commercial risks.[44] Contributing to these concerns is the permissible content of Directors and Officers Insurance policies, which usually contain exclusion clauses for criminal conduct.[45] But these arguments alone should not drive the debate. It has to be borne

36 Ibid, at [214].

37 Financial Markets Authority Act 2011, s 34.

38 Compare Financial Markets Authority Act 2011, ss 9, 34.

39 See definition of "financial markets participant" located in s 4 of the Financial Markets Authority Act 2011.

40 Compare Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428 at 429, 441; Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 374–375.

41 Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428 at 437–438.

42 See Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 372.

43 Alastair Bull "Case no encouragement to potential directors – Thomas" (Newswire, 3 August 2010) <www.guide2.co.nz>.

44 Compare Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [204].

45 Compare Companies Act 1993, s 162.

in mind that, where the misconduct in question approaches the criminal nature of offences covered by the Crimes Act 1961, it is hard to justify not imposing similar consequences on wrongdoing directors.[46]

Assuming the provisions are drafted narrowly, directors who do not intentionally breach their legal duties in the Companies Act 1993 will have little to fear. Also, the standard of proof is beyond reasonable doubt, thereby imposing on the enforcement authorities high thresholds for the provision of evidence. It is the stated intention of the Minister and the FMA that prosecutions will only be conducted in the most egregious cases.[47] Accordingly, the criminal liability of a director will be hard to establish.[48] The severity of the possible criminal sanctions is further required to reflect the level of seriousness of the wrongdoing committed by the guilty director. It will also promote confidence in the robustness of the capital market framework.

In summary, the inclusion of public enforcement in the form of criminal sanctions for breaches of directors' duties is to be generally commended: it should deter, punish and, ideally, prevent a repetition of the corporate scandals of the recent past. The following sections of this article address in more detail the different issues arising in the context of a criminalisation of directors' duties.

4.2 The Australian Experience

The Australian legislative position is broadly similar to the New Zealand proposals. The availability of criminal sanctions for breaches of directors' duties in Australia is limited to the cases where the director's behaviour exceeds a certain limit of blameworthiness making the misconduct of a more criminal nature.[49] Accordingly, the Australian system relies on a staged approach of civil proceedings, civil penalty provisions and criminal sanctions. The idea behind the pyramidal framework is to provide different enforcement mechanisms — in Australia they are to some extent overlapping for civil penalty provisions and criminal sanctions — depending on the severity of the misconduct.[50]

Absent the civil penalty provisions for breach of directors' duties, the final form of the New Zealand provisions may resemble the Australian provisions. Directors commit an offence if they are recklessly or intentionally dishonest and fail to exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose.[51] The Australian provision differs

46 See also Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428 at 434.

47 Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [214]. Compare generally Sean Hughes, Financial Markets Authority Chief Executive "Presentation by Sean Hughes to the 7th Annual Securities Law Update" (Amora Hotel, Wellington, 11 July 2011) <www.fma.govt.nz>.

48 Compare Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428 at 432; Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 371.

49 See Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 373–374.

50 Compare RP Austin and IM Ramsay *Ford's Principles of Corporations Law* (14th ed, Lexis Nexis Butterworths Australia, Chatswood, 2010) at 91–92; Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428 at 433–434.

51 Corporations Act 2001 (Cth), s 184(1).

because it criminalises the failure to use a power for a proper purpose. There is no intention expressed to criminalise the proper purpose provision in New Zealand.[52]

In Australia it is also an offence for directors to use their position dishonestly with the intention of gaining an advantage or causing detriment to the corporation or to use company information dishonestly to gain an advantage.[53] Although New Zealand has equivalent duties for the use of information (but not for misuse of position) there is no intention expressed to criminalise either of these duties.[54]

Section 184(1) has been used in a number of Australian cases that therefore provide examples of the flavour of breach that is likely to attract a sanction from the criminal law. A number of the cases involved directors of HIH, the failed insurer. In *Adler v R*,[55] Mr Adler appealed against his sentence. In prior proceedings[56] he had, amongst other charges, pleaded guilty to being "intentionally dishonest and failing to discharge his duties as a director of HIH in good faith and in the best interests of the company".[57] In particular, he attended an HIH board meeting where approval was sought for the AUS$2 million investment in Business Thinking Systems Pty Limited (BTS), of which he was the non-executive chairman of directors and also held a significant effective interest.[58] He did not provide "adverse or negative information about the investment or the poor financial position of BTS".[59] He failed to correct false statements made in a fax sent to the CEO of HIH requesting the AUS$2M for BTS — these matters would have been material to the HIH board's decision to ratify the transaction.[60]

Adler was sentenced to four years and six months in total with the s 184(1)(b) sentence of three years.[61] The Court said, in relation to the s 184(1)(b) charge, that these were "deliberate lies" not just "stupid errors of judgment".[62] The actions were criminal and in breach of Adlers's fiduciary duties to HIH. A large amount of money was fraudulently obtained from the company. Leave was granted for appeal but the appeal was dismissed. In relation to s 184(1)(b), the 25 per cent discount for the guilty plea was considered appropriate and the decision of the sentencing Judge to specify a starting point of four years within the discretionary range open to him.[63]

52 Section 133 of the Companies Act 1993, the proper purpose provision, obliges directors to exercise their powers for the purpose for which they were given those powers. For example, directors cannot increase the capital of the company to thwart a takeover since the purpose of the power is to raise capital. The duty is misunderstood and rarely enforced.

53 Corporations Act 2001 (Cth), ss 184(2), 184(3).

54 Section 145 of the Companies Act 1993 contains the duty to not misuse company information.

55 *Adler v R* [2006] NSWCCA 158, (2006) 57 ACSR 675.

56 *R v Adler* [2005] NSWSC 274, (2005) 12 ACLC 590.

57 This was in breach of s 184(1)(b) of the Corporations Act 2001 (Cth); *R v Adler* [2005] NSWSC 274, (2005) 12 ACLC 590 at [1].

58 *R v Adler* [2005] NSWSC 274, (2005) 12 ACLC 590 at [23]–[26], [34]. Adler held effective interests of 35 to 38.5 per cent in Business Thinking Systems Pty Limited.

59 Ibid, at [35].

60 Ibid.

61 The sentences were partly concurrent and partly cumulative. See ibid, at [69].

62 Ibid, at [40].

63 Ibid, at [68].

In *R v Fodera*,[64] Fodera, chief financial officer of HIH and director of the company and many of its subsidiaries — pleaded guilty to a charge under the equivalent of s 184 for knowingly or recklessly failing to act honestly as an officer of HIH.[65] Fodera failed to disclose to the HIH board of directors and the company's auditors the particulars of the company's reinsurance. The reinsurance was secured by HIH's subsidiary HIH Underwriting and Agency Services Limited (of which Fodera was a director) agreeing effectively to insulate the reinsurers from most of their exposure.[66] The company's profits depended on the reinsurance coverage. The outcome of Fodera's actions was that HIH group was in effect not insured against the risk of loss under the policies. This was due to the fact that one of its subsidiaries was contracted to cover much of the liability risk that was apparently held by the European reinsurers.[67]

The issue was whether Fodera was knowingly or only recklessly dishonest. The Court held that Fodera was knowingly dishonest: Fodera was intimately involved in securing the reinsurance coverage. That he worked as part of a team of negotiators and was "not the architect of the policies or the agreements" with the subsidiary did not derogate from the fact that he failed to give proper disclosure.[68] Also, it did not make any difference that when obtaining tax advice Fodera disclosed the nature of the agreements to the audit firm of the company.[69] Fodera was sentenced to three years and four months imprisonment.[70] The Court considered the severity of the offence and general deterrence. The evidence of good character (extensive role in local church community) was not a strong factor given the abuse of trust involved in the commission of the offence.[71]

Within Australia, the use of the criminal sanctions has been criticised.[72] For instance, the former Chairman of ASIC, Tony D'Aloisio, recently said that "there are concerns out there as to whether or not it is going to discourage good people from becoming directors, particularly for the medium-to-small sized enterprises".[73] The comment refers to the current state of the law of directors' duties and calls for a review of the current regime, in particular with respect to the obligations of non-executive directors.[74] D'Aloisio's words tie in with an earlier review by the Australian Treasury on the sanction in corporate law.[75] The 2007 review, which addressed the entire corporate enforcement regime, expressed the need to reconsider the use of criminal sanctions in order to stop them being applied as the

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64 *R v Fodera* [2007] NSWSC 1194, (2007) 65 ACSR 109.

65 *R v Fodera* [2007] NSWSC 1194, (2007) 65 ACSR 109 at [1], charges were brought under previous provisions ss 232(2) and 1317FA of the Corporations Law (as carried over into the Corporations Act 2001(Cth) by ss 1400, 1401 of the Corporations Act 2001 (Cth)).

66 *R v Fodera* [2007] NSWSC 1194, (2007) 65 ACSR 109 at [21].

67 See for an explanation of the relevant transactions *R v Fodera* [2007] NSWSC 1194, (2007) 65 ACSR 109 at [5]–[21].

68 *R v Fodera* [2007] NSWSC 1194, (2007) 65 ACSR 109 at [31]–[34].

69 *R v Fodera* [2007] NSWSC 1194, (2007) 65 ACSR 109 at [35]–[40].

70 *R v Fodera* [2007] NSWSC 1194, (2007) 65 ACSR 109 at [73].

71 *R v Fodera* [2007] NSWSC 1194, (2007) 65 ACSR 109 at [59], [65].

72 Compare Antoinette Sernia and Mei-Ling Barkoczy "Directors Beware: Corporate Sanctions and Defences, a Matter for Review?" (2009) 16 Murdoch University Electronic Journal of Law 134; The Treasury *Review of Sanctions in Corporate Law* (Content ID 1182, Corporations and Financial Services Division, Canberra, 5 March 2007) at [2.10]–[2.17].

73 Damon Kitney "Go easy on directors, says retiring corporate regulator" *The Australian* (Sydney, 30 March 2011) <www.theaustralian.com.au>.

74 Ibid.

75 The Treasury *Review of Sanctions in Corporate Law* (Content ID 1182, Corporations and Financial Services Division, Canberra, 5 March 2007).

'default' sanction for breaches of corporate law.[76] In accordance with the ideas of the responsive regulation theory, criminal sanctions should rather be reserved only for the most serious offences where the severity of the wrongdoing is substantial.[77] ASIC has also been criticised about its enforcement of misconduct that meets the prescribed level of seriousness. Although it is possible for ASIC to initiate criminal proceedings, criminal charges have not been brought in several cases.[78]

The Treasury review regarded criminal sanctions to be warranted for the intentional or reckless breach of directors' duty to act in good faith and for a proper purpose.[79] This is similar to the proposed New Zealand position. The benefit of a more targeted use of criminal sanctions is that they would better reflect that some corporate law obligations are more procedural or mechanical in nature. Where such obligations are not discharged properly, enforcement should not take place by means of criminal sanctions — less drastic means should be used for enforcement.[80] The Australian review process has been temporarily abandoned due to a change in government.[81] The topic of a personal criminal liability was, in a more general form, brought back on the agenda by the Ministerial Council for Corporations (MINCO) in collaboration with the Council of the Australian Governments.[82] These harmonisation efforts to date have not met the original reform expectations.[83]

In New Zealand, the proposal to criminalise the intentional breach of the good faith provision — s 131 — would seem to meet the concern that criminal sanctions be reserved for only the most serious cases. The criminalisation of the reckless trading provisions — s 135 and s 136 — may raise greater concerns. Those concerns are discussed in the next section of the paper. And the existing criminal provisions, especially those where there is not also civil penalty provisions in place — may need to be reviewed as part of the reform process. Referring to this, the Feltex case experience is discussed in a later section of this article.

4.3 Criminal Sanctions for Reckless Trading

While a general Trans-Tasman consensus seems to exist on the criminalisation of the duty of good faith, concerns about the criminalisation of the directors' duty to prevent insolvent trading have been

76 Ibid, at [2.18].

77 Ibid. See also Vicky Comino "The Challenge of Corporate Law Enforcement in Australia" [2009] UQLRS 1 at 14.

78 Compare on this issue ibid, at 4.

79 Compare Corporations Act 2001 (Cth), s 184(1); The Treasury *Review of Sanctions in Corporate Law* (Content ID 1182, Corporations and Financial Services Division, Canberra, 5 March 2007) at [2.19].

80 The Treasury *Review of Sanctions in Corporate Law* (Content ID 1182, Corporations and Financial Services Division, Canberra, 5 March 2007) at [2.20].

81 Compare Antoinette Sernia and Mei-Ling Barkoczy "Directors Beware: Corporate Sanctions and Defences, a Matter for Review?" (2009) 16 Murdoch University Electronic Journal of Law 134 at 135.

82 See Chris Bowen "MINCO Agrees on Principles for Reform of Directors Liability Provisions" (Treasury press release, Australia, 6 November 2009) <www.treasurer.gov.au>; Nick Sherry "Minister Welcomes COAG Decision on Directors' Liabilities" (Treasury press release, Australia, 18 December 2008) <www.treasurer.gov.au>.

83 See Australian Institute of Company Directors "COAG Reform Council exposes failure of director liability reform" (press release, 11 February 2011); Council of Australian Governments (COAG) Reform Council *National Partnership Agreement to Deliver a Seamless National Economy: Performance report for 2009-10* (Report to the Council of Australian Governments, 23 December 2010) at ch 26.

expressed in Australia.[84] New Zealand would also be well advised to assess with care the proposed criminalisation of s 135 and s 136 of the Companies Act 1993.

The Minister has indicated that the New Zealand provision will cover intentional insolvent trading. It will criminalise both dishonest and reckless insolvent trading. Since the official heading of s 135 reads "reckless trading", the proposed changes might thus cause confusion and some immediate concern that all reckless trading will become criminal. Based on the current wording of the provisions, the potential coverage of the new criminal offence provision is too wide. There is a danger that the criminal sanctions will not just encompass those who cause the company to engage in the conduct but also those who allow or agree to that happening. The Minister is unlikely to intend that the criminal sanctions be applied that widely but the extension from dishonest to reckless does mean that the new provision will have a wider ambit than the Australian equivalent.

There is risk in criminalising reckless trading without fixing up the inconsistency between the name of the section and its content. As Professor Watts pointed out recently:[85]

> "Reckless trading in its true sense is not the taking of substantial risks of causing serious loss to creditors, but the incurring of liabilities heedless as to whether there is any prospect of their being met. The lack of congruence currently between the section heading and the content of s135 has become the subject of debate amongst the judiciary: see Peter Watts *Directors' Powers and Duties*.[86] But even the school of thought that takes the more benign view of s 135, usually associated with Justice William Young, admits that it can only reach that state of affairs by departing from the language of the section. See, for example, *Re South Pacific Shipping Ltd*;[87] affirmed sub nom *Löwer v Traveller*.[88] Do we want a criminal provision that cannot be understood on the face of the section? Surely, we must first fix s135, so that it is a reckless trading provision in its own terms."

In Australia, the Corporations Act 2001 (Cth) imposes a statutory duty to prevent insolvent trading on directors.[89] Section 588G(1) outlines the scope of the duty: it generally applies where a person is a director of a company when the company incurs a debt; and the company is insolvent at that time, or becomes insolvent by incurring that debt; and at that time, there are reasonable grounds for suspecting that the company is or will become insolvent. The section is therefore broadly similar to the reckless trading provision in s 135 of the Companies Act 1993.

Section 588G(2) contains a civil penalty provision for directors who fail to prevent the company from incurring these debts. A contravention can result in a pecuniary penalty of up to AUS$200,000 under s 1317G(1).[90] As outlined before, there is currently no intention to introduce an equivalent

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84 See for instance David Goldman "Directors beware! Creditor protection from insolvent trading" (2005) 23 C&SLJ 216; Michael Murray "The criminal offence of insolvent trading" (2002) 2 INSLB 169.

85 Peter Watts "Criminal penalties and professional negligence" [2011] CSLB 51.

86 Peter Watts *Directors' Powers and Duties* (LexisNexis, Wellington, 2009) at ch 10.

87 *Re South Pacific Shipping Ltd* (2004) 2 NZCCLR 8 (HC) at [128]–[130].

88 *Löwer v Traveller* [2005] 3 NZLR 479 (CA).

89 See Corporations Act 2001 (Cth), s 588G. This duty contains the specifics of the duty to prevent insolvent trading, but it needs to be seen in conjunction with the more general duties contained in ss 180 and 181 of the Corporations Act 2001 (Cth) (to act with care and diligence and in good faith). See David Goldman "Directors beware! Creditor protection from insolvent trading" (2005) 23 C&SLJ 216 at 217.

90 Compensation orders are also possible under ss 1317H, 588J of the Corporations Act 2001 (Cth). See also RP Austin and IM Ramsay *Ford's Principles of Corporations Law* (14th ed, Lexis Nexis Butterworths Australia, Chatswood, 2010) at [20.150].

provision into New Zealand law. In addition, as in New Zealand, a court also has the power to disqualify a director from managing a corporation for an appropriate period of time.[91] Section 588G(3) creates a criminal offence where the failure to prevent the company from incurring the debt was dishonest, with a penalty of up to AUS$220,000 or imprisonment for five years, or both being possible.[92]

Another concern about the criminalisation of the insolvent trading provisions involves the level of misconduct by the director. Breaches of the insolvent trading provisions are more often than not brought about due to the directors' incompetence or their blind faith that they will be able to turn things around and save the company.[93] The Australian decision *R v Timothy Rhys Hawker Williams*[94] is an example of a case where the misconduct of a director was not motivated by malicious intent but where the director was nevertheless convicted.

Williams' original position in Cotech Pty Ltd, a furniture and internal fit-outs company, was as production manager with a background in furniture design and production. He had to take over the director role, including the financial management, in addition to his other duties when his business partner left the company in 1998. He was overwhelmed by the unreasonable share of responsibility, while at the same time not being sufficiently competent in the area of financial business administration. With the business being undercapitalised from the outset, the company's situation became dire when the company kept on trading for nine more months after its precarious financial position was obvious, thereby causing substantial losses to creditors. The situation was aggravated by William's misjudgement about the impact of changes in the tax legislation.

The Court accepted that Williams was a person of good character: he faced up to his responsibilities towards the creditors — even personally repaying part of the loss suffered, he showed genuine remorse and tried to rebuild his life, which has otherwise been exemplary. It was also acknowledged that Williams did not obtain any direct personal benefit from his action and was clearly not motivated by greed.

Despite these aspects in his favour, the Court considered that it could not ignore that Williams was aware of the financial situation of the company when committing the misconduct. It was the conclusion of the Judge that the misconduct was predominantly triggered by Williams' "blinkered commitment to Cotech and to those involved with the company. Quite wrongly, he was willing to act dishonestly in an endeavour to stave off Cotech's failure."[95] The Court held that Williams' personal circumstances were outweighed by the purpose of general deterrence of the criminal offence. Despite his guilty plea,

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91 Corporations Act 2001 (Cth), s 206C. In the case of repeated company insolvencies, the courts also have the possibility of disqualification an officer (includes directors) from managing a corporation for up to 20 years, where the officer was involved in two or more failed corporations pursuant to s 206D of the Corporations Act 2001 (Cth).

92 The penalty fine is determined according to s 1311 and sch 3 of the Corporations Act 2001 (Cth), in conjunction with s 4AA(1) of the Crimes Act 1914 (Cth). A conviction under s 588G (3) of the Corporations Act 2001 (Cth will also trigger an automatic disqualification of the director for five years under s 206B of the Corporations Act 2001 (Cth). Compensation orders to the company are also possible under s 588K of the Corporations Act 2001 (Cth). See RP Austin and IM Ramsay *Ford's Principles of Corporations Law* (14th ed, Lexis Nexis Butterworths Australia, Chatswood, 2010) at [20.150].

93 Compare *Nippon Express (New Zealand) Ltd v Woodward* (1998) 8 NZCLC 261,765 (HC); *Mason v Lewis* [2006] 3 NZLR 225 (CA).

94 *R v Timothy Rhys Hawker Williams* SC Tasmania (unreported case) 24 June 2004. The facts were obtained from the COPS report.

95 Ibid.

Williams was convicted under s 588G(3) and sentenced to 15 months in prison.[96] When determining the sentence for Williams, Evans J took into consideration that Williams substantially assisted ASIC with its further investigations against two other persons in the case.

Alarming though the facts and outcome in *Williams* may be to directors in New Zealand, the criminal sanctions applied in the *Williams* case do not seem to reflect the typical enforcement measures employed by ASIC in cases of insolvent trading. A review of ASIC's annual reports shows a negligible number of criminal proceedings for directorial breaches of the insolvent trading provisions; civil penalty proceedings have been a far more common enforcement mechanism.[97] This enforcement situation also demonstrates that the *Williams* case did not initiate a policy of tougher punishment of directors for insolvent trading. The case may rather represent a hard line attitude by a particular Tasmanian Judge. Nevertheless, the existing lower standard of proof in New Zealand and the watchful eye which the Court of Appeal[98] has cast over New Zealand directors who allow companies to engage in reckless trading do mean that concern expressed about potential liability of directors if the reckless trading provisions are criminalised may, for once, not be overstated.

At the very least the Australian experience shows us that bringing successful criminal proceedings for dishonest insolvent trading will be difficult due to the higher standard of proof.[99] Particularly in relation to breaches of the insolvent trading provisions, the Government may want to rethink its position on civil penalties, as civil penalties may better achieve deterrence and punishment objectives without being overly harsh on hapless directors like Williams. Civil penalties are discussed in s 6 below.

The introduction of criminal sanctions raises further concerns about an overlap with other, already existing, criminal offences. The relationship of the new offences with the criminal offence of carrying on a business fraudulently with the intent to defraud creditors of the company (or any other person) contained in s 380 of the Companies Act 1993 is of particular concern. The creditor focus in both provisions will likely lead to both types of criminal sanctions being applicable.[100] If the intended criminalisation of the insolvent trading provisions progresses further, careful consideration needs to be given to all these aspects.

96 Ibid. The charges against Williams also included two counts of offences under s 592(6) of the Corporations Act 2001 (Cth) – for knowingly being concerned in a company engaged in an act with the intent to defraud creditors or others – to which he pleaded guilty. A further director has been discharged from allegations of dishonestly failing to prevent insolvent trading. See Australian Securities and Investments Commission "Tasmanian director charged" (press release 07-153, 4 June 2007) <www.asic.gov.au>.

97 The authors' review of cases found that a total of three directors were imprisoned for breaching s 588G(3) of the Corporations Act 2001 (Cth). See Australian Securities and Investments Commission "A Year of Consolidation: ASIC Annual Report 08-09" (Annual Report for the year ended 30 June 2009); Australian Securities and Investments Commission "Building Confidence in Financial Markets: ASIC Annual Report 03-04" (Annual Report for the year ended 30 June 2004). See also Stephen Mayne "Everyone ASIC Has Ever Jailed" (27 June 2011) The Mayne Report <www.maynereport.com>. Compare also figures provided in Paul James, Ian Ramsay and Polat Siva "Insolvent trading – An empirical study" (2004) 12 Insolv LJ 210 at 222–223; Anna MacFarlane "Safe harbour reforms – should insolvent trading provisions be reformed?" (2010) 18 Insolv LJ 138 at 144–146.

98 *Mason v Lewis* [2006] 3 NZLR 225 (CA).

99 See also Paul James Ian Ramsay and Polat Siva "Insolvent trading – An empirical study" (2004) 12 Insolv LJ 210 at 223.

100 See for instance *Lion Nathan Ltd v Lee* (1997) 8 NZCLC 261,360 (HC); *Gray v Wilson* (1998) 8 NZCLC 261,530 (HC).

5 *FELTEX* AND *CENTRO* — TWO JURISDICTIONS, ONE SET OF FACTS, TWO VERY DIFFERENT OUTCOMES

In New Zealand, unlike Australia, the decision has been made not to introduce civil penalty provisions at this stage. It was considered that cases being judged on the balance of probabilities would result in too great a risk of people being deterred from taking on directorships. Also, regulators would need to second-guess directors' business decisions.[101] The downside of not including civil penalty provisions is that conduct by directors that is not dishonest and egregious but nevertheless causes significant harm may not in fact be penalised, even if the provisions are in place that make this possible.

In *Ministry of Economic Development v Feeney*,[102] the directors of Feltex were charged under s 36A of the Financial Reporting Act 1993 in relation to the accuracy of Feltex's interim financial statements. The section required that the statements comply with any applicable financial reporting standards; the Feltex statements did not. Every director was therefore potentially liable on summary conviction to a fine not exceeding $100,000. It was a criminal offence.

Section 40 of the Financial Reporting Act 1993 provides a defence for directors if they take all reasonable and proper steps to ensure that the applicable requirement of the Act was complied with. The directors appointed an internal management team to prepare the accounts and appointed Ernst & Young to provide advice on the interim financial statements. The Ministry of Economic Development (MED) argued that the directors should have taken further steps. These included looking at the accounting standards themselves; an argument rejected by Judge Doogue.[103] The MED also argued that the directors should have asked Ernst & Young if the classification of its bank facility was correct and advised the auditors that it was in breach of a number of its banking covenants.[104] These arguments were also rejected by Judge Doogue,[105] even though Ernst & Young were engaged in a review.[106] In a review, as opposed to an audit, auditors primarily rely on management representations.[107] It appears that management's assurance to the auditors about the supportiveness of the bank with regard to the loan facilities might have coloured the view formed by Ernst & Young on the issue.[108] It is beyond the scope of this article to analyse the auditors' responsibilities to conduct further inquiries or to obtain independent external confirmation from the bank with regard to Feltex's loan facilities. However, as pointed out in the Securities Commision's report on the financial reporting in Feltex, the directors failed to pay appropriate attention to the breaches of the ANZ loan facilities.[109] In the context of a review as opposed to an audit it was at least arguable that the directors should have clarified the situation for the auditors and, that by not doing so they may have fallen short of taking all reasonable

101 Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [206].

102 *Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264,715 (DC) [*Feltex*].

103 Ibid, at [140], [164].

104 Ibid, at [140].

105 Ibid, at [165]

106 Ibid, at [103].

107 See also Securities Commission New Zealand "Feltex Carpets Limited IPO Prospectus, Financial Reporting and Continuous Disclosure (2010) Just Accounting <www.justaccounting.co.nz/seccomfeltex2.html> at [160].

108 Compare *Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264,715 (DC) at [76].

109 See Securities Commission New Zealand "Feltex Carpets Limited IPO Prospectus, Financial Reporting and Continuous Disclosure (2010) Just Accounting <www.justaccounting.co.nz/seccomfeltex2.html> at [108], [117].

and proper steps to ensure that the requirements of the Financial Reporting Act 1993 had been complied with.

Judge Doogue gave great weight to s 138 of the Companies Act 1993; the provision that allows directors to rely on information and advice received from their professional advisers and employees. Much of the judgment was devoted to showing supposed links between the Companies Act 1993 and the Financial Reporting Act 1993 in an effort to show that s 138, which is a defence for directors who breach their Companies Act duties, applies to breaches of the Financial Reporting Act 1993. With respect, when there is a statutory reasonable steps defence available to directors in s 40 of the Financial Reporting Act 1993, it is difficult to see how s 138 could apply. It is a defence provision for a different piece of legislation — the Companies Act 1993. The Financial Reporting Act 1993 applies not just to companies but to other entities. The argument by counsel and supported by the Judge that the two pieces of legislation came into force at the same time does not strengthen, but in fact weakens, the argument that the defence provision in one Act can apply in the other: if Parliament had intended this, they simply would have included a s 138 equivalent in the Financial Reporting Act 1993.

The Feltex case in New Zealand can be contrasted with the case of *Australian Securities and Investments Commission v Healey*,[110] known as the *Centro* case, where the board of directors also faced charges for non-compliance with the Australian financial reporting requirements. The financial statements of two companies of the Centro group as approved by directors failed to account properly for about AUS$2 billion of short-term liabilities.[111] The issue arose from not classifying these short-term liabilities as *current* liabilities although this was required by the accounting standards.[112] Further, the statements also failed to disclose significant guarantees related to short-term liabilities worth about US$1.75 billion (about AUS$2.1 billion) entered into after the balance date.[113]

The directors were charged with failing to take all reasonable steps to comply with the financial reporting requirements set out in the Corporations Act 2001 (Cth), a duty contained in s 344(1) of the Corporations Act 2001, as well as not properly exercising their powers and discharging their duties with the care and diligence required by s 180(1) of the Act.[114] In contrast to the Feltex case, these provisions were all enforced by way of civil penalty proceedings, which can lead to the disqualification of directors and/or a pecuniary penalty order of up to AUS$200,000.[115] The Judge in the *Centro* case

110 *Australian Securities and Investments Commission v Healey* [2011] FCA 717 [*Centro*].

111 Ibid, at [9]. Compare ibid, at [89]–[90].

112 Ibid, at [42]. In Australia, a system change from GAAP to the IFRS reporting standard likewise took place. The Judge, however, did not place too much weight on this matter, as the misconduct by the directors was not significantly affected by this transition. The directors were in possession of all the relevant information and received clear definitions with regard to current liabilities and post balance date events. Ibid, at [388]–[393].

113 Ibid, at [9]. Events occurring after the reporting period need to be disclosed where they have a significant financial impact on the company. Compare ibid, at [44], [47].

114 See ibid, at [583]–[584]. By not ensuring that the declaration by the Chief Executive Officer and Chief Financial Officer in relation to the financial statements of a listed entity met the requirements under s 295A of the Corporations Act 2001 (Cth), the directors committed a further breach of ss 180(1) and 344(1). See ibid, at [524]. That means that s 295A of the Corporations Act 2001 (Cth) places an additional obligation on Australian directors of listed companies, which goes beyond the responsibilities imposed on New Zealand directors in the financial reporting process. Similarly, a contravention of s 601FD (3) of the Corporations Act 2001 (Cth) was invoked relating to a contravention of the directors' responsibilities with regard to being officers of responsible entities operating a management investment scheme. See ibid, at [191].

115 See Corporations Act 2001 (Cth), ss 1317E, 1317G, 206C.

explicitly noted that the proceedings against the directors did not involve any question of dishonesty,[116] which therefore excluded any criminal proceedings pursuant to s 344(2) Corporations Act 2001 (Cth).

In deciding whether the directors had complied with the abovementioned obligations regarding the financial reporting requirements, the crucial question that the Court needed to answer was:[117]

> "whether directors of substantial publicly listed entities are required to apply their own minds to, and carry out a careful review of, the proposed financial statements and the proposed directors' report, to determine that the information they contain is consistent with the directors' knowledge of the companies affairs, and that they do not omit any material matters known to them or . . . that should be known to them."

The Judge answered in the affirmative. In its reasoning, the Court acknowledged that the directors are generally entitled to "seek assistance in carrying out their responsibilities, and may rely on others" with regard to their obligations under s 344 of the Corporations Act 2001 (Cth).[118] However, Middleton J held that "there is a core, irreducible requirement of directors . . . to take all reasonable steps to be in position to guide and monitor".[119] By requiring the directors to form an opinion about the financial situation of the entity and verify the financial statements as true and fair (s 295(4) of the Corporations Act 2001 (Cth)), the law thereby puts the ultimate responsibility for the financial reporting process in the hands of the directors, which means that they cannot abdicate or discharge this duty by way of delegation.[120] The Judge concluded that the Centro directors had not taken all reasonable steps and showed the required care and diligence when attending to their duties in the financial reporting process. The main argument in the judgment leading to this conclusion was that the directors, although they knew about the substantial short-term liabilities and provided guarantee, failed carefully to examine and question the financial statements before them.[121] The Judge pointed out that the directors, "whilst not an auditor, should still have a questioning mind".[122]

Addressing the issue of whether the standard for discharging the directors' financial reporting responsibilities was being too high, Justice Middleton found that he personally:[123]

> "do[es] not consider this requirement overburdens a director, or . . . would cause the boardrooms of Australia to empty overnight. Directors are generally well remunerated and hold positions of prestige, and the office of director will continue to attract competent, diligen[t] and intelligent people."

What do these decisions mean for New Zealand directors, in particular in light of the imposition of criminal liability on the directors in Nathans, albeit on different facts? The recent judgment by Heath J in *Nathans Finance*[124] shows that the Court has recognised the final guardian role of directors, at least in relation to offer documents. Three of Nathans' directors were charged with several counts of

116 Compare *Australian Securities and Investments Commission v Healey* [2011] FCA 717 at [8], [290].

117 Ibid, at [13].

118 Ibid, at [20], [129].

119 Ibid, at [16].

120 Compare ibid, at [139], [141], [142], [125], [175].

121 Compare ibid, at [583].

122 Ibid, at [17].

123 Ibid, at [15].

124 *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 [*Nathans Finance*].

breaching s 58 of the Securities Act 1978.[125] The breaches related to the distribution of various offer documents (such as investment statements, prospectus and other advertisements) including untrue statements, either as misleading statements or by omissions of a material aspect.[126] Misstatements about the extent and handling of Nathans' loan advances to its parent company VTL (and to other VTL subsidiaries) and the corresponding inter-company debts, the financial situation of Nathans and its deteriorating liquidity constituted the focus of the contraventions.[127] These breaches of the Securities Act 1978 are criminal offences and impose strict liability on the issuer.[128] Accordingly, intent or dishonesty by the accused directors was not relevant here; the Judge did, however, point out that "no allegation of dishonest conduct is made against the accused".[129]

Heath J also elaborated on the extent the directors were allowed to rely on others, referring to s 2B of the Securities Act 1978 and s 138 of the Companies Act 1993, when determining whether the defence of the directors having reasonable grounds to believe that the statements in the offer documents were true is applicable in this case.[130] While the reliance provisions could not by themselves provide a defence to the criminal charges, the Court seems to accept that they can inform the decision about the adequacy of the actions taken by the directors in discharge of their obligations under the Securities Act 1978.[131] Along the lines of argumentation in *Centro*, the Judge established, however:[132]

> "The statutory duty for ensuring that offer documents go into the market without misleading statements rests on directors of the issuer.[133] Directors have a non-delegable duty to form their own opinions on that issue, in reliance on information provided by others that they have no reason to suspect may be wrong. The problem for the directors, in this particular case, is that they, in effect, purported to delegate to senior management the task of determining whether the investment statement and prospectus were 'compliant' with regulatory requirements and failed to bring independent minds to bear on the topic."

The Court further held that any beliefs of the directors regarding the truth of the statements in the offer documents could not have been held on reasonable grounds. Based on their individual knowledge about the business practices and financial situation of Nathans, even a "cursory" analysis of the narrative of the offer documents should have indicated the discrepancies with the real position of the finance company.[134] A further aspect emphasised in the judgment considers the expectations on directors of finance companies. These directors should have a fundamental financial literacy enabling

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125 It should also be noted that s 56 of the Securities Act 1978 contains a civil penalty provision for misstatements in offer documents. The Minister highlighted in the recent cabinet paper that the distinction between ss 56 and 58 is unclear and will be addressed in the reform process. See Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [190].

126 Ibid, at [41].

127 Compare ibid, at [24]–[25], [315]–[321].

128 Ibid, at [39]–[40].

129 Compare ibid, at [6], [39].

130 Ibid, at [71], [81].

131 Ibid, at [81]. The Judge highlighted, however, that for the reliance on external advisers, the extent of any reliance depends on the information provided to them in the first place. Ibid, at [100].

132 Ibid, at [420].

133 Securities Act 1978, ss 58(1), 58(3).

134 *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 at [429].

them to understand financial statements including the classification of assets and liabilities.[135] A lack of such skills impedes leading and properly monitoring the business of the company.[136]

Nathan provides an important benchmark for the standard of misconduct where directors might expect to face criminal liability. *Nathan* involved breaches of securities legislation, the Securities Act 1978. Because that Act regulates entities that obtain money from the public, the standard expected of directors might be higher. The Judge made it clear that a higher standard could be expected of directors of finance companies. For those reasons, the more general applicability of the standard for a breach of a criminalised directors' duty is not yet clear. The facts in *Centro* and *Feltex*, although they did not involve breaches of directors' duties in Companies Act 1993 or the Corporations Act 2001 (Cth), are probably more relevant and therefore give potentially more guidance about when criminal liability might be imposed. It is interesting therefore that, although the underlying situation was very similar in both *Centro* and *Feltex*, the outcomes could not differ more. While the reliance[137] by directors on others played a role in both cases, the Australian decision also focused on the limitations of such reliance, outlining a more elevated standard of expectation of directors when discharging their duties. This specified standard focuses particularly on the financial reporting duties of directors in large publicly listed companies.[138]

The expectations placed on the Centro directors reflect the crucial role of the board as the "final guardian" of the company. Due to this central position in the structure of a company, it does not seem unreasonable to require directors to possess a general financial literacy, which should be then used to question or inquire into the financial statements and situation of the company.[139] Applying this Australian standard for directors to the *Feltex* case, the directors might have been expected to have at least questioned or inquired from those preparing their accounts about the proper treatment of the ANZ loan facilities. The bank letters and other information before the Court showed that the directors were aware of the problems in relation to the ANZ loan agreements. Moreover, given that Feltex was in the midst of a substantial financial restructuring as well as a reporting system change, a more cautious approach to the signing off of the financial statements may have been warranted.

On the facts the Judge decided that the directors had taken all reasonable steps to ensure compliance, although it is suggested that this finding may have been coloured by her willingness to allow reliance on professionals in terms of s 138 of the Companies Act 1993. The Judge said:[140]

> "There is overwhelming evidence that these directors are all honest men and that they conducted themselves at all times with unimpeachable integrity. There is not one skerrick of evidence to suggest any intention by them to mislead the regulatory authorities, market, shareholders, creditors, potential investors, or any other person."

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135 Ibid, at [83].

136 Ibid, at [84], [85].

137 It appears, however, that the Australian provision on directors' reliance in s 189 of the Corporations Act 2001 (Cth) is more detailed in comparison to its New Zealand counterpart, s 138 of the Companies Act 1993. Section 189(b)(ii) of the Corporations Act 2001 (Cth) specifically requires the directors to make an independent assessment of the information and advice received based on their knowledge of the company.

138 One of the reasons put forth by Justice Middleton for such a focus relates to the potential number of investors affected by erroneous financial statements and the corresponding possibility for class action in the case of a breach. See *Australian Securities and Investments Commission* v *Healey* [2011] FCA 717 at [522].

139 Compare ibid, at [14], [23].

140 *Ministry of Economic Development v Feeney* (2010) 10 NZCLC 264,715 (DC) at [9].

Be that as it may, these facts have not a skerrick of relevance in terms of the provision. Unless the directors could show that they took all reasonable steps to ensure the accuracy of the interim financial statements, if the interim statements were incorrect in terms of s 36A (which they were) the directors committed an offence. Honesty is irrelevant. A similar honest director defence was used by the board in Enron. The Americans describe it as the empty head, pure heart defence. As was pointed out in the New Zealand Law Journal by an American commentator on the *Feltex* case, "rather than faulting the board for failing to assure that the Feltex financial statements relied upon by the investors were 'true and fair' – the most fundamental IFRS principle – the Judge in Feltex faulted the advisers."[141]

It is suggested that, in terms of the Financial Reporting Act 1993, s 138 of the Companies Act 1993 did not apply and the board could not rely on Ernst & Young as the advisors. The directors' only defence could be that they took all reasonable steps to ensure compliance in terms of s 40 of the Financial Reporting Act 1993. But it is also suggested that the outrage felt by the Judge and the directors in the *Feltex* case was brought about because honest men were facing criminal charges when they had not acted dishonestly. And therein lies a potential problem with the decision not to include civil penalties in the revisions to the Companies Act 1993. The equivalent provision to s 36A of the Financial Reporting Act in the Australian legislation creates a civil penalty if directors fail to ensure compliance (Corporations Act 2001 (Cth), s 344(1)). The breach is only an offence if the contravention is dishonest. The understandable unwillingness by the Minister to include civil penalties may have the unintended consequence that Judges will be unwilling to convict those who are honest but who fail to meet a required standard by a substantial degree. In the new legislation, criminal conviction will be possible not just for egregious dishonest conduct but for egregious reckless conduct. The outcome of the *Feltex* case and the later decision by the Judge to award the directors actual costs of $952,000 may deter the regulators from bringing actions in all but the most very extreme of cases and may affect its likelihood of success if they do bring an action.[142]

Whether the introduction of civil penalties within the enforcement regime, as seen in Australia, would actually result in a better enforcement of directors' duties and a more appropriate treatment of directors in cases of misconduct in particular where there is no dishonesty, is a problematic question in itself. The next section will address the issue of civil penalty proceedings and their potential in the New Zealand context.

6 CIVIL PENALTIES AND THEIR POTENTIAL AS A MIDDLE GROUND SOLUTION

6.1 The Australian Developments

The Australian corporate enforcement regime relies on a system including civil remedies, civil penalties as well as criminal sanctions.[143] The civil penalty regime was introduced in 1993 following the recommendations made in the Cooney Report.[144] The regulatory concept of "responsive

141 Ashley Burrowes and John Karayan "Feltex and Enron bankruptcies" [2010] NZLJ 406.

142 See Duncan Bridgeman "Excessive Feltex Costs May Hinder Future Cases – Crown" *The National Business Review* (Auckland, 19 April 2011); Jenni McManus "Feltex Directors get $952,000" (22 December 2010) Business Day <www.stuff.co.nz>.

143 Part 9.4 and 9.4B contain the general provisions relating to criminal offences and civil penalties under the Corporations Act 2001 (Cth).

144 Senate Standing Committee on Legal and Constitutional Affairs *Company Directors' Duties* (Australian Government Publishing Series, Canberra, 1989) [*Cooney Report*] at [13.15]. See also Peta Spender "Negotiating the third way:

regulation"[145] and the related "pyramid of enforcement"[146] provide the primary rationale for the inclusion of civil penalties.[147]

Pecuniary penalties provide a complementary enforcement measure that becomes important in cases where the misconduct does not reach the level required for a criminal prosecution. In other words, it may be appropriate where directors do not meet the required statutory standard, but are not dishonest. Also, it would be less draconian for the affected directors as they can avoid the stigma of a criminal conviction. Courts may also be more willing to impose the penalties where there might otherwise be a reluctance to impose criminal liability on those who have not been dishonest.[148] Furthermore, civil penalty provisions allowing for pecuniary penalties could provide for more flexibility in less severe cases.[149] The aspect of flexibility also relates to the idea of responsive regulation; Civil penalties are part of a cooperative approach between ASIC and the directors with the primary goal of achieving compliance rather than punishment.[150] With the right procedural structure in place, imposition of civil penalties should also be quicker and less costly, corresponding with the aforesaid objective of responsiveness.[151]

The theory of responsive regulation argues that regulators will use civil penalties over criminal sanctions and reserve the latter sanctions for the most severe cases, where both enforcement mechanisms are available.[152] Currently, the Australian system allows for a potential overlap between

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Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 251; Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 372.

145 See generally Ian Ayres and John Braithwaite "Responsive regulation: Transcending the deregulation debate" (Oxford University Press, New York, 1992).

146 See comments by Brent Fisse in Senate Standing Committee on Legal and Constitutional Affairs *Company Directors' Duties* (Australian Government Publishing Series, Canberra, 1989) at [13.13]. See also Ian Ayres and John Braithwaite "Responsive regulation: Transcending the deregulation debate" (Oxford University Press, New York, 1992); John Braithwaite and Brent Fisse *Corporations, Crime and Accountability* (Cambridge University Press, Cambridge, 1993).

147 Compare Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 251; Vicky Comino "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) MULR 802 at 810–811; Vicky Comino "The Challenge of Corporate Law Enforcement in Australia" [2009] UQLRS 1 at 2–3.

148 Similar experiences were made in Australia, at the time when there were only criminal sanctions available for breaches of directors' duties. Compare Antoinette Sernia and Mei-Ling Barkoczy "Directors Beware: Corporate Sanctions and Defences, a Matter for Review?" (2009) 16 Murdoch University Electronic Journal of Law 134 at 135.

149 Compare Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 380.

150 Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 250–251.

151 Compare Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 251; Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 380. See also ibid at 377, citing John Coffee "Paradigms Lost: The Blurring of the Criminal and Civil Law Models – And What Can Be Done About It" (1992) 101 Yale LJ 1875 at 1891–1892.

152 John Braithwaite "To Punish or Persuade: Enformance of Coal Mine Safety" (Oxford University Press, 1985) and Ian Ayres and John Braithwaite "Responsive regulation: Transcending the deregulation debate" (Oxford University Press, New York, 1992) at 19–21, both cited by Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 376.

civil penalties and criminal sanctions, as ASIC is generally empowered to initiate criminal proceedings after the civil penalty proceedings.[153]

In academic literature, opinions diverge on the potential of civil penalties to lead to more effective enforcement of directors' duties. Some commentators question whether civil penalty proceedings will actually prevail over criminal proceedings.

Coffee argues that the incentives for regulators to bring criminal actions are linked to the publicity that surrounds a criminal prosecution.[154] This publicity provides for a higher degree of deterrence as well as for credibility of the enforcement authorities, which will not be matched by successful civil penalty proceedings.[155] The effectiveness of civil penalty proceedings is further doubted where the proceedings are lengthy, difficult and costly; and thus do not provide an improved process compared with criminal proceedings.[156] Despite ASIC's growing track record of civil penalty proceedings,[157] criticism about the use of civil penalties does not subside. One part of this ongoing debate is targeted at ASIC for either not making enough use of the still existing criminal sanctions for serious misconduct by directors or for still underutilising the civil penalty enforcement tool.[158] The other, in terms of the potential effectiveness of civil penalty proceedings, more pressing issue is the procedural hurdles faced in the context of civil penalty proceedings.[159]

These problems emanate mainly from the fact that civil penalties are a hybrid of the traditionally existing civil remedies and criminal sanctions. This means that the rules for civil proceedings and hence the lower standard of proof of the balance of probabilities apply, while the determination of the resulting penalty order is based on the seriousness of a misconduct rather than on the damage caused by it.[160] The first aspect arising from this procedural outset is the application of the civil standard of proof. The case law on civil penalty proceedings has developed the so-called Briginshaw standard. That standard requires "reasonable satisfaction" of the court when affirming an alleged contravention, which

153 Compare Corporations Act 2001 (Cth), s 1317P.

154 John Coffee "Paradigms Lost: The Blurring of the Criminal and Civil Law Models – And What Can Be Done About It" (1992) 101 Yale LJ 1875 at 1888–1889 as cited by Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 376.

155 Ibid; Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428 at 437–438.

156 Compare Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 380; Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 249; Vicky Comino "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) MULR 802 at 810.

157 See Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428 at 436 referring to Michelle Welsh "Eleven Years On – An Examination of ASIC's Use of An Expanding Civil Penalty Regime" (2004) 17 Australian Journal of Corporate Law 175 at 187. See also Vicky Comino "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) MULR 802 at 809–810.

158 Compare Vicky Comino "The Challenge of Corporate Law Enforcement in Australia" [2009] UQLRS 1 at 25; Michelle Welsh "Civil Penalties and Responsive Regulation: The Gap Between Theory and Practice" (2009) 33 MULR 908 at 921.

159 See generally Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249; Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428; Vicky Comino "The Challenge of Corporate Law Enforcement in Australia" [2009] UQLRS 1.

160 RP Austin and IM Ramsay *Ford's Principles of Corporations Law* (14th ed, Lexis Nexis Butterworths Australia, Chatswood, 2010) at 91–92.

includes considering the "nature and consequences of the . . . facts to be proved".[161] Accordingly, the seriousness of the misconduct inherent in civil penalty proceedings needs to be accounted for in the assessment of the applicable burden of proof, which potentially elevates the general civil standard of proof in the case of civil penalty proceedings.[162]

The second, and more disputed, issue also emerges as a result of the greater seriousness of the alleged contraventions. Australian courts have granted several defendant directors privilege against exposure to penalties.[163] Such penalty privilege allows directors to limit their indication of pleadings and potential defences to a minimum of information in contrast to what would usually be required in civil proceedings. This in turn, substantially aggravates ASIC's task of successfully making its case in front of courts.[164] A number of cases where the penalty privilege was granted have been delayed or ended in favour of the directors after fruitless attempts by ASIC to obtain a substantial pleading by the defendants.[165] The courts acknowledge the rights of the individual and the potential severity of the sanctions and thus revert to elements of criminal procedure. Tension is thereby created with the rationales and functioning underlying the civil penalty regime.[166] Such complication of the civil proceedings and the lengthening of their duration, which also increases their associated costs, works towards making civil penalties a less desirable and efficient enforcement mechanism than they might otherwise be.[167] The current situation does not resonate with the original purpose and idea behind the implementation of civil penalties; namely achieving better compliance in a less intrusive and burdensome manner.[168]

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161 *Briginshaw v Briginshaw* (1938) 60 CLR 336 at 362, [1938] ALR 334 (HCA). See for instance *Australian Securities and Investments Commission v Healey* [2011] FCA 717 at [100]–[102]; Vicky Comino "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) MULR 802 at 820, Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 253.

162 Compare also Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 253; Vicky Comino "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) MULR 802 at 820.

163 RP Austin and IM Ramsay *Ford's Principles of Corporations Law* (14th ed, Lexis Nexis Butterworths Australia, Chatswood, 2010) at 95; Vicky Comino "Civil or criminal penalties for corporate misconduct: Which way ahead?" (2006) 34 ABLR 428 at 437. Compare Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 254–256, providing an analysis of cases where the penalty privilege has been granted, for example, *Australian Securities and Investments Commission v Mining Projects Group Ltd* [2007] FCS 1620, (2007) FCR 32; *Macdonald v Australian Securities and Investments Commission* [2007] NSWCA 304.

164 Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 256.

165 See ibid, at 254–256 for an analysis of cases such as *Australian Securities and Investments Commission v Mining Projects Group Ltd* [2007] FCS 1620, (2007) FCR 32; *Macdonald v Australian Securities and Investments Commission* [2007] NSWCA 304; *Adler v Australian Securities and Investments Commission* [2003] NSWCA 131, (2003) 179 FLR 1. See also Vicky Comino "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) MULR 802 at 814–829 discussing the penalty privilege with reference to other cases such as *Australian Securities and Investments Commission v Rich* [2009] NSWSC 1229, 236 FLR 1.

166 Compare Vicky Comino "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) MULR 802 at 814–815, 829; Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 249.

167 See Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 380.

168 Compare Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 250–251.

Legislation has partially dealt with the problems surrounding the penalty privilege in civil penalty proceedings. Although s 1349 of the Corporations Act 2001 (Cth) prevents the invocation of the penalty privilege for some civil penalty proceedings, such as disqualifications, there are other relevant sanctions available, like pecuniary penalty orders against contravening directors under s 1317G(1) of the Corporations Act 2001 (Cth).

The basis of reform ideas is a recognition that the civil penalty regime does not fit comfortably in the traditional civil-criminal dichotomy of legal regulation.[169] One reform idea involves determining the procedural standards on the two axes of "balance of powers" and the "severity of the sanction".[170] This approach is particularly concerned with the balance or imbalance of power between individuals and entities (large companies) as parties to a proceeding.[171] The role of directors within that classification appears problematic, as the director of a large public listed company is an individual, but at the same time there is an impact on public interest due to the role of the director as part of the board and hence within the corporate structure. More in line with government recommendations, another proposal would be to establish separate procedural roles for civil penalty proceeding to counteract the problems experienced in recent years.[172]

Despite the procedural issues of the regime, civil penalties have shown their potential as an effective enforcement mechanism in the area of breaches of directors' duties in Australia.

6.2 Ramifications for New Zealand

Civil penalties are potentially an important additional enforcement mechanism for New Zealand. There is a need to assess properly the viability of civil penalties as part of the available pyramid of enforcement mechanisms. This holds true especially with respect to providing more flexibility for enforcement authorities due to a broader and detailed range of available mechanisms in cases where a criminal threshold is not reached. For now Commerce Minister Simon Power has rejected civil penalties as part of the enforcement reform in the area of directors' duties.[173] The main reasons given include a "too great risk of people being deterred from taking on directorships" and "putting the regulator in the position of second-guessing the soundness of directors' business decisions".[174] But the new powers of the FMA under s 34 of the Financial Markets Authority Act 2011 are alone unlikely to provide an enforcement mechanism comparable to civil penalties. Besides their primary focus being on

169 See Vicky Comino "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) MULR 802 at 830–832; Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 250, 257–258; and for a detailed account on the traditional civil-criminal dichotomy see generally Issachar Rosen-Zvi and Talia Fisher "Overcoming Procedural Boundaries" (2008) 94 Virginia Law Review 79.

170 Issachar Rosen-Zvi and Talia Fisher "Overcoming Procedural Boundaries" (2008) 94 Virginia Law Review 79 at 133 ff; also discussed by Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 257–258 and Vicky Comino "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) MULR 802 at 830–832.

171 Issachar Rosen-Zvi and Talia Fisher "Overcoming Procedural Boundaries" (2008) 94 Virginia Law Review 79 at 134–138.

172 Compare Peta Spender "Negotiating the third way: Developing effective process in civil penalty litigation" (2008) 26 C&SLJ 249 at 256–257 citing Australian Law Reform Commission *Principled Regulation: Federal Civil and Administrative Penalties in Australia* (ALRC 95, 2002) at 25 and The Treasury *Review of Sanctions in Corporate Law* (Content ID 1182, Corporations and Financial Services Division, Canberra 5 March 2007).

173 Office of the Minister of Commerce *Cabinet Paper to the Chair of the Cabinet Economic Growth and Infrastructure Committee: Securities Law Reform* (February 2011) at [206].

174 Ibid.

financial market participants and their applicability being where the public interest is affected, their purpose is different from a civil penalty regime. A civil penalty regime, in addition to its deterrence function through more visible enforcement, also includes a punitive element to sanction misconduct by the director.

An important consideration here is that civil penalties would enable the regulator to more effectively enforce directors' misconduct that does not involve intentional dishonest behaviour. It needs to be considered that a staggered approach to enforcement already exists, and will be generally maintained, in the area of securities legislation. The argument against deterrence has been similarly raised in the context of the introduction of criminal sanctions for breaches of directors' duties.[175] The recent past has shown that impact on the public interest of breaches of directors' duties can be considerable, even if no criminal blameworthiness is existent. Of course it might be argued that the lower standard of proof based on the balance of probabilities will expose the affected director more easily to liability.[176] However, such exposure already exists under the current private enforcement system; the civil penalties might rather allow for better enforcement against such misconduct.

The empirical evidence obtained from directors in Australia is mixed and does not provide clear evidence that directors actually feel deterred from taking up directorships due to the risk of civil or criminal liability.[177] One survey from the Australian Institute of Company Directors indicated widespread concern among directors about their exposure to civil and criminal liability.[178] Similarly, a Federal Treasury survey from May 2008, in which 100 directors of S&P/ASX-200 companies participated, showed that the risk of liability was perceived as deterring factor, which made a significant number of persons decline directorships or led them to retire from a director position.[179] The survey by Chartered Secretaries Australia (CSA) in 2006 on the other hand suggested that potential ramifications of corporate sanctions have little impact on influencing whether a person would take up a directorship — 87 per cent of CSA members who responded were unaware of any cases where qualified directors had turned down an offer of a directorship because of the potential risk of liability associated with the position.[180]

The deterrence factor alone should not be decisive in a debate about the introduction of civil penalties; weight should also be given to the enforcement benefits associated with them, particularly the potential of achieving better compliance by directors from the outset. Also, reinforcing Middleton J's statement in *Centro*, boardrooms are unlikely to empty overnight and competent people will still want directorships.[181] New Zealand should therefore continue to discuss the feasibility of a staggered enforcement approach for companies legislation as well as securities legislation.

175 Ibid, at [205].

176 Compare Michelle Welsh "The regulatory dilemma: The choice between overlapping criminal sanctions and civil penalties for contraventions of the directors' duty provisions" (2009) 27 C&SLJ 370 at 373.

177 It should be noted that the insurance and indemnification provisions in ss 199A–199C of the Corporations Act 2001 (Cth) generally prohibit or considerably limit the potential for exemption of directors with regard to civil penalty liability.

178 Australian Institute of Company Directors "Impact of Legislation on Directors" (Survey Report, November 2010) at 34. See also Australian Institute of Company Directors "Liability laws damaging the economy director survey reveals" (press release, 1 November 2010) <www.companydirectors.com.au>.

179 Compare Antoinette Sernia and Mei-Ling Barkoczy "Directors Beware: Corporate Sanctions and Defences, a Matter for Review?" (2009) 16 Murdoch University Electronic Journal of Law 134 at 137.

180 Compare ibid, at 136–137.

181 Compare *Australian Securities and Investments Commission v Healey* [2011] FCA 717 at [15].

7 CONCLUSION

The current debate about the adequate enforcement of breaches of directors' duties initiated by the securities law reform is to be welcomed. The Government's expressed intention to introduce criminal sanctions for certain serious breaches of specified directors' duties in the Companies Act 1993 is a clear change in direction from the current system. The criminalisation of these duties requires a careful assessment of the appropriate threshold for criminal liability. The potential pitfalls set out in this article highlight that the proposed duties will need to be crafted with care and consideration given to whether liability should extend beyond dishonesty to recklessness. At the same time some of the existing criminal sanctions may need to be re-examined for their appropriateness, especially in light of the *Feltex* case.

The debate over civil pecuniary penalties appears to have been closed off for now but it is a debate worth having. The Australian experience has shown that the fundamental idea of having a civil penalty regime is sound. The appropriate applicable procedures are, however, crucially important for its effectiveness. Regulators should likewise take into account that the effectiveness of a legislative regime is not determined on the basis of successful proceedings alone. The lack of a need for enforcement due to increased compliance must be one of the primary goals. Civil penalties, if designed properly, can foster a greater compliance via a more flexible approach to the consequences of misconduct. The possibility of civil pecuniary penalties should therefore be reconsidered as they can provide a flexible middle ground enforcement and compliance mechanism.

While the enforcement of directors' duties is the focal point, the article has also shown that this debate cannot be held without accounting for the obligations of directors as such. The analysed cases of *Feltex* and *Centro* highlight the different expectations placed on the standard of performance by the directors in New Zealand and Australia. Clarification of these duties, as well as better communication and education about these performance standards is also needed if widespread compliance is to be achieved. This need for improved guidance becomes even more relevant given the low threshold set for incorporating a company in New Zealand.[182] The position of the board of directors as the final guardian of the company makes it appropriate that there be high performance expectations; in particular where directors are part of a publicly listed company and relevant misconduct can therefore have wide reaching consequences.

Recent case law has also indicated broader consequences of a criminalisation of directors' duties. The *Feltex* case in particular provides a good example of an apparent reluctance by the courts to impose criminal sanctions on directors who have not acted dishonestly when carrying out their duties. Where only criminal sanctions are available to address behaviour arguably lacking a criminal level of blameworthiness, a reluctance by the courts to convict might deter the regulator from bringing cases to prosecution, as the outcomes are uncertain and the costs for the tax payer potentially substantial.

The discussion in this article highlights the need for change of the current enforcement regime, but also the potential pitfalls faced in the reform process. A piece meal importation of the Australian enforcement regime is risky; the possible unintended consequences of the decision not to introduce civil penalties need to be carefully considered. There is considerable challenge in getting this reform right.

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182 See Companies Office "Applying to incorporate a company" (5 August 2010) Companies Office New Zealand <www.business.govt.nz>.