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The Efficacy of Civil Penalty Sanctions Under the Australian Corporations Law

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This report is a summary of a detailed research report prepared by the authors titled Regulating Directors' Duties—How Effective are the Civil Penalty Sanctions in the Australian Corporations Law?
Although civil penalties for enforcement of directors' duties have been available to Australian securities regulators since 1993, they are rarely used. The authors identify four reasons for these developments including resource constraints, relations with other regulatory agencies, availability of alternative sanctions, and concerns about the utility of civil penalties.

Adam Graycar
Director

The regulation of directors' duties in Australia is primarily governed by the Corporations Law which is administered and enforced by the Australian Securities and Investments Commission (ASIC). The Corporations Law is the principal statute regulating Australian corporations.

The regime of sanctions relevant to directors' duties was fundamentally reformed in 1993 with the introduction of new measures centred on civil penalty mechanisms. These measures drastically reduced criminal law oversight of directors' duties. Previously, contraventions of the statutory duties of directors were criminal offences, punishable by criminal sanctions. Now, only the most serious contraventions merit criminal sanctions and the vast majority of contraventions attract civil penalty sanctions. The new regime implemented the recommendations contained in the 1989 report of the Senate Standing Committee on Legal and Constitutional Affairs. The report criticised the former regime—considering its criminal sanctions as too severe, and its fines system too lenient. In the Committee's view, law-breakers were not sufficiently deterred and the system lacked credibility with both the regulated and regulators.

Civil penalties are hybrid sanctions combining both civil and criminal remedies. Civil penalties as they apply to directors' duties in Australia are given force by Part 9.4B of the Corporations Law, ss 1317DA to 1317JC. The civil penalty provisions in the Corporations Law include the basic duties of directors and other officers of companies, such as the duty to:

- **act honestly;**
- **exercise reasonable care and diligence;**
- **not make improper use of information or position; and**
- **not have the officer's company trade while it is insolvent.**

Other civil penalty provisions include contraventions in relation to company accounts, certain share capital transactions, and

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management of managed-investment schemes. The focus of this report is on the civil penalty provisions that apply to directors' duties.

Where a civil penalty provision in the Corporations Law is breached, the consequences include the court:

- **disqualifying the person who breached the civil penalty provision from managing a corporation for a specified period of time; and/or**
- **imposing a pecuniary penalty on the person for an amount not exceeding $200,000.**

Where the person breached the civil penalty provision knowingly, intentionally or recklessly, and (i) was dishonest and intended to gain an advantage or (ii) intended to deceive or defraud someone, criminal sanctions can apply. These sanctions are a fine of up to $200,000 and / or imprisonment for up to 5 years.

The breach of a civil penalty provision allows the company to sue the person who contravened the provision for any loss suffered by the company, or for any profit made by the person or anyone else.

The civil penalty regime was debated at length by the Senate Standing Committee and there were high expectations about its prospective utility to Australian regulators and potential deterrent effect in the marketplace. The regime arose from two key recommendations of the Senate Standing Committee. These were that:

- **criminal liability under company law not apply in the absence of criminality; and**
- **civil penalties should be provided for breaches by directors where no criminality is involved (Senate Standing Committee Report 1989, pp. 190–91; Bird 1996; Gething 1996).**

Civil penalties have been in place for 6 years now, so it is timely to evaluate the relative success of the regime and engage those responsible for its application in that process of analysis.

Research

The research examined how the ASIC uses civil penalties as an enforcement tool against company directors. It aimed to identify, and critically evaluate, the factors that impact upon the ASIC enforcement decisions regarding civil penalties and to understand how the civil penalty regime is perceived by those involved in applying the Corporations Law.

The research was underpinned by strategic regulation theory, employed widely by researchers in the fields such as occupational health and safety (see, for example, Haines 1997; Gunningham and Johnstone 1999) and environmental regulation (Richardson, Ogus and Burrows 1983; Hawkins 1984).

This research project involved a series of semi-structured interviews with senior ASIC enforcement personnel from regional offices around Australia. The underlying structure of the interviews was provided by a designated interview schedule constructed by the research team. All the interviews were conducted at the Victorian Regional Office of ASIC by members of the research team. Six of the respondents were interviewed in a face-to-face situation and the other 8 using ASIC's tele-conferencing network facilities. The duration of the interviews ranged from 90 to 180 minutes and they all permitted substantial discussion of the issues under review. Following transcription, research team members undertook a data collation process and identified the key factors which influence how ASIC uses and perceives the civil penalty regime. These factors are:

- **ASIC's enforcement philosophy and culture;**
- **ASIC's resource constraints, including financial, geographical and personnel constraints;**
- **ASIC's relationship with other regulatory agencies, including the DPP and the courts;**
- **the availability of alternative enforcement mechanisms to civil penalties; and**
- **legal issues, including the unclear nature of parts of the Corporations Law and its regulatory praxis.**

The effects of these factors are discussed below.

Theoretical Influences on the Study

Strategic regulation theory provides a macro perspective on the role of enforcement sanctions in securing regulatory compliance. The theory advocates regulatory compliance as best secured by persuasion rather than legal enforcement. For persuasion to be effective, generally a threat of punishment must lie behind the regulator's conciliatory actions or gestures. The threat of punishment should take the form of a set of integrated sets of sanctions which can be threatened by the regulator where contravention takes place. The sanctions should escalate in severity in response to more serious contraventions of the law, with incapacitation at the apex of the enforcement pyramid (see Figure 1). This process is usually represented by a pyramid model, formulated and developed by Braithwaite (see, for example, Braithwaite 1985; Ayres and Braithwaite 1992).

The goal of the pyramid is to stimulate maximum levels of regulatory compliance. The rationale of strategic regulation theory and its pyramid model is that those regulated will comply sooner or later through a combination of normative desire and instrumental deterrence. Pursuant to strategic regulation theory

and especially in the context of directors' duties, sanctions should serve two functions. They should:

- **impose punishments against persons committing contraventions of the law (the enforcement function); and**
- **deter people from contravening the law (the preventative function).**

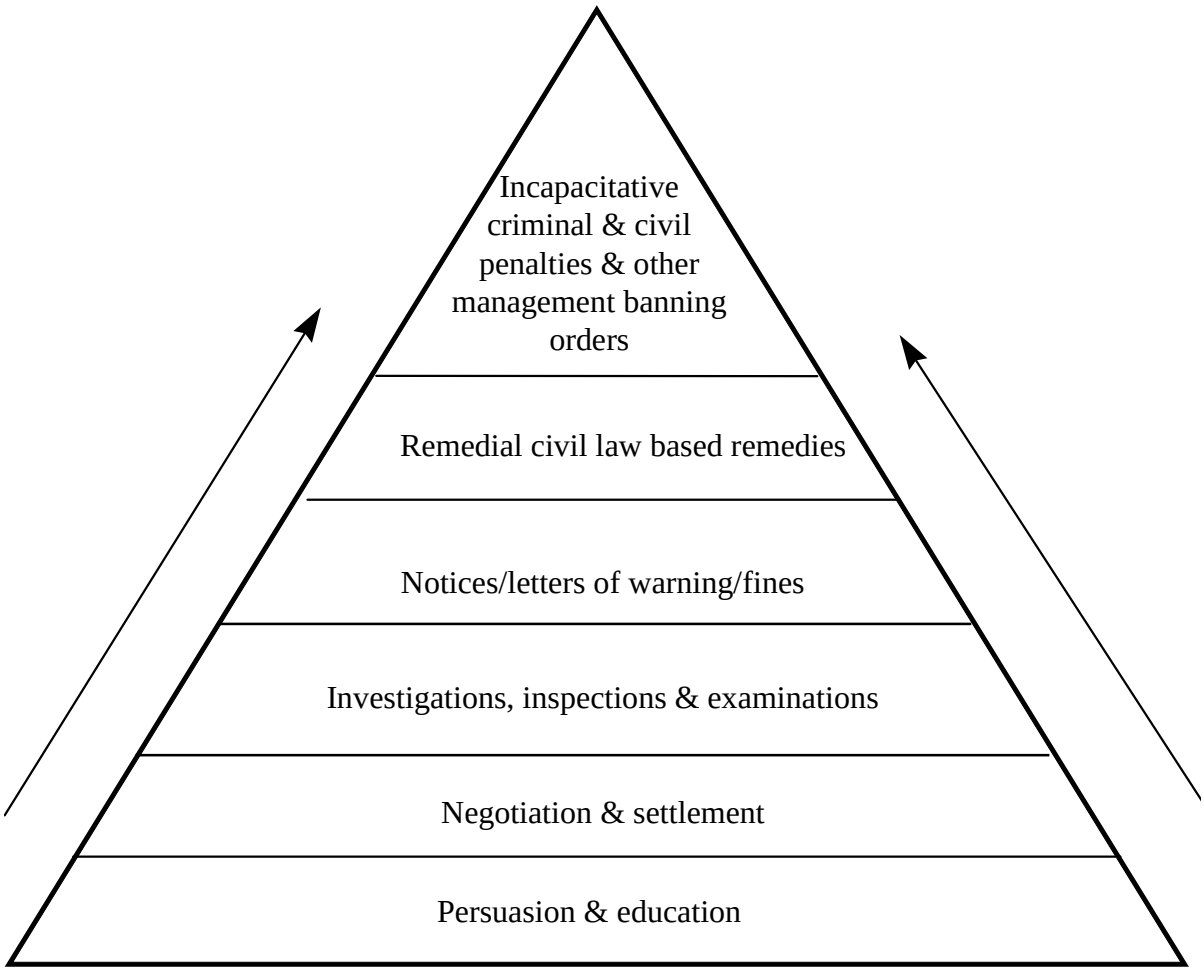
The research project tested, amongst other things, whether the use of civil penalties by ASIC is consistent with these desired regulatory outcomes. Figure 1 represents how directors' duties are enforced under the Corporations Law.

The lower levels of an enforcement pyramid typically consist of a series of incentives or "carrots" which encourage compliance and avoid unnecessary antagonism between the regulator and persons regulated (Gunningham and Johnstone 1999, p. 117). The base level is usually sufficient for most of those regulated, including those who commit minor acts of non-compliance. The remaining levels are necessary when dealing with others such as the incompetent, the irrational, and the rational calculating citizens who believe that it is not in their self-interest to comply and only respond when the costs outweigh the benefits (Ayres and Braithwaite 1992).

The penalties at the lower levels involve sending out notices / letters of warning / fines to mark the shift from "carrots" to "sticks", albeit that they are small sticks intended in most cases as only a "tap on the shoulder" rather than to impose a punitive sanction (Gunningham and Johnstone 1999, p. 122). These are followed by civil penalties and other civil legal mechanisms, and continued failure to comply or more egregious contraventions will activate criminal sanctions. The severity of a sanction is graphically represented by its proximity to the apex of the pyramid (Grabosky 1997, pp. 195–96). Civil penalties should inhabit the middle to lower-upper levels of the pyramid and in ideal conditions will be closely integrated with other regulatory sanctions.

A key feature of the Corporations Law enforcement pyramid is the presence of civil law based remedies. The Corporations Law, assisted by the ASIC Act, harnesses the natural potency of civil remedies and turns them into enforcement tools available for use by ASIC. The summit of the Corporations Law enforcement pyramid is a com-

Figure 1: *Enforcement pyramid regarding directors' duties under the Corporations Law.* This representation of the enforcement pyramid is adapted from the work of Ayres and Braithwaite (1992); Fisse and Braithwaite (1993, p. 142); Dellit and Fisse (1994).



plex mix of quasi-incapacitation orders in the form of 3 sets of management banning sanctions which arise under sections 230, 599, and 600 of the Corporations Law; and incapacitation through the civil and criminal penalties found in Part 9.4B of the Corporations Law.

The enforcement pyramid is very much a two-dimensional model which assumes smooth practical interaction between the regulator and the regulated depicted by the various tiers of enforcement response. There is a large question mark over whether the reality which is the 'rough and tumble' of commerce and its regulation by the Corporations Law delivers such measured and desirable outcomes. The reality of enforcement suggests a far more complex pyramid than the one depicted. To understand the fuller picture, it is necessary to examine the activities of the many players in the ongoing drama of regulatory compliance (not least the regulator, the regulated, the media, and intervening professional actors such as accountants, lawyers, liquidators, the Director of Public Prosecutions (DPP), courts, specialist tribunals, and the police).

It is the effect of the interaction (both systematic and random) of the intervening elements in the regulatory mix which is both a theoretical and a practical goal of this and other ongoing research projects. The aim is to highlight some of the three-dimensional background of the regulatory pyramid of strategic regulation theory as it exists in the context of corporate regulation in Australia. The canvas for this attempted three-dimensional picture is one specific tier in the enforcement pyramid—civil penalties in relation to the enforcement of directors' duties with the objective of discovering what actors and processes constitute the interplay of its regulatory profile. This theoretical stance is influenced by notions of regulatory tripartism, a theory of regulation which advocates a system of regulation involving three institutional forms; the government, the regulated entities, and third parties representing public interest concerns and causes (Ayres and Braithwaite 1992).

ASIC's Enforcement Practices and Civil Penalties

ASIC follows standardised procedures in its enforcement decision-making processes and one respondent believed that all ASIC enforcement personnel would agree that:

"The major criterion is regulatory effect. [ASIC] does not merely have an investigation orientation, it is very committed to campaign-based enforcement, with both a simultaneous specific and general deterrence motivation."

The collective desire for regulatory effect was evident in the view of the respondents that civil penalties are, in theory, a positive initiative in the enforcement of the Corporations Law. However, ASIC media releases indicate that it has commenced only 14 civil penalty applications relating to 10 case situations since 1993. This figure is surprisingly low—many of those interviewed were not aware of what the national total might be. Of particular interest was the fact that up to the date of the interviews the New South Wales office of ASIC (the largest and most active office in enforcement terms accounting for approximately 40% of total activity) had not launched a single civil penalty action.

It appears that the actual experience of civil penalties, in practice, has not matched their enforcement potential or the desire of the regulators themselves to implement them. The responses to interview questions reveal that the disparity between the intrinsic enforcement capability of civil penalties and the enthusiasm of the regulators who apply them on the one side, and the low incidence of civil penalties on the other, is due to a complex set of interrelated operational factors discussed shortly.

This relative uncertainty about the incidence of civil penalties is a reflection of the ambiguity that surrounds them in general. The general view on the effectiveness of civil penalties can be seen from this response:

"The effectiveness of civil penalties is limited, because the initial concerns of investigators are on practical matters such as ascribing responsibility and tracing assets in a matter, and civil penalties are not especially useful in such issues. Investigators are more likely to be thinking in terms of injunctive strategies rather than civil penalties. In addition, most matters that might suit a civil penalty response would have also a potential criminal law character so they would be passed on to the DPP for evaluation. There is also some doubt amongst [ASIC] personnel about the efficacy of lower courts [Magistrates Court in a committal proceeding, County Court in a criminal trial], ruling on civil penalty contraventions and those decisions not being re-argued at length in a Federal or Supreme Court—this raises commercial/resource issues for [ASIC]."

On this point, a number of themes emerged from the responses of those interviewed:

- **The over-riding rubric of pragmatism under which all ASIC personnel must function. They and their organisation have finite resources, investigators utilise the most practical tools and other civil strategies are of more proven enforcement value than civil penalties.**
- **The potential criminal element of civil penalties and the fact that the requirements (actual or potential) of the DPP have ramifications for any decision made by ASIC personnel about civil penalties.**

- **There is a sense of uncertainty within ASIC about how the judiciary will deal with civil penalty actions and this impacts upon decision-making processes.**
- **Amongst ASIC personnel, there is some uncertainty about: "...what the directors' duties provisions actually mean..." and this has compounded the ambiguity about civil penalties.**

These issues are substantial and mutually inhibit the incidence of civil penalty actions. Civil penalties are one enforcement tool that is often looked at by ASIC enforcement personnel. However, despite this attention, civil penalties are rarely used because, given the factors noted above, they seldom fit the circumstances of various matters. The interviews and the low number of civil penalty actions show that the *Catch-22* of civil penalties' minimal public profile in turn reduces their perceived worth as a deterrent. This places further doubt in the mind of a regulator about using civil penalty provisions when there are more proven deterrent options readily available.

Research Findings

A key aspect of the research project was the identification of reasons why, since civil penalties for the enforcement of directors' duties were introduced in 1993, there have been so few actions commenced by ASIC. The research revealed that the civil penalty regime is perceived by ASIC as serving only a limited enforcement function. The factors nominated by those interviewed as being primarily responsible for this state of affairs are ASIC's:

- **resource constraints, including financial and personnel constraints;**
- **relationships with other regulatory agencies, such as the DPP and the judiciary;**
- **recourse to alternative sanctions; and**
- **concerns about the limited utility of civil penalties and the unclear nature of the civil penalty regime in the Corporations Law and its regulatory praxis.**

Several of these factors warrant particular attention:

First, there are a number of alternative remedies which, from the investigator's point of view, appear to be more viable, such as injunctions and management banning orders. For example, injunctions provide a "real time" remedy and have the additional advantage that the public can see the direct effects within a short time of injunctions freezing assets and shutting down rogue companies. This makes it difficult for more complex and time-consuming strategies such as civil penalties to be positioned at the forefront of ASIC enforcement strategies. Civil penalties are not as swift, decisive and obvious in their effect as many alternative civil remedies. Another viable remedy is section 600 of the Corporations Law which allows ASIC to impose a management banning order upon a person in certain circumstances. It does not require ASIC to bring court proceedings although the person banned may challenge the ASIC banning order in court. There are significant differences among the regional offices of ASIC in the use of section 600. However, as the respondents made clear, management banning orders can effectively "take offenders out of the action". Although the civil penalty regime does allow for the obtaining of management banning orders, these must be imposed by the court and necessarily involve complex litigation.

Second, a number of those interviewed expressed reservations about the delays associated with use of the courts in the area of enforcement and some difficulties of interpretation that resulted from certain judgments. These uncertainties in the interpretation of basic statutory provisions regulating directors' duties (which are civil penalty provisions) reinforce the trend to use alternative enforcement mechanisms such as management banning orders.

Third, there was some indication that many of those in the enforcement section of ASIC come from a criminal law background and, therefore, have a tendency to prefer criminal actions rather than civil penalties. This has changed over time with the recruitment of a considerable number of lawyers with civil litigation experience.

Fourth, those interviewed indicated that the requirement to liaise with the DPP over significant enforcement matters impacts on the use of civil penalties. The consequences of this requirement include:

- **the DPP effectively has a veto over the use of civil penalties;**
- **the need for the DPP to satisfy itself that there is no criminal element in a matter may result in delay that can impact on the opportunity for a civil penalty action; and**
- **a limitation on the likelihood of civil penalties being pursued because the ASIC and the DPP have different enforcement objectives. The role of the DPP is to prosecute criminal breaches of the law while ASIC has broader objectives which include using civil remedies.**

Fifth, limiting the use of civil penalties is an unclear drafting of the civil penalty provisions; particularly regarding the elements that have to be proved to satisfy the court that a breach of a civil penalty provision has occurred.

Sixth, some respondents observed that where the same conduct of the offender may breach both the Corporations Law and a State Criminal Code, there is an incentive to frame legal action as a breach of the

State Criminal Code because it may be easier to prove a breach of the Code given some of the uncertainty that surrounds the civil penalty provisions of the Corporations Law. In addition, some respondents expressed the view that courts tend to hand down more severe penalties for breaches of State Criminal Codes than for breaches of the Corporations Law. Again, this is an incentive to frame the legal action as a breach of the State Criminal Code.

Seventh, civil penalties were seen by respondents as having only limited utility. For example, where a director who has breached a civil penalty provision is bankrupt, a civil penalty action offers little to ASIC unless it believes that the offender's actions are so serious as to warrant criminal prosecution. This is because the two civil penalty sanctions are a pecuniary penalty and/or a management banning order. Imposing a pecuniary penalty upon an offender who is already bankrupt may serve little purpose and a bankrupt is automatically prohibited from managing a corporation so that resort to a civil penalty action is not needed to achieve this objective. This highlighted the need expressed by many respondents for ASIC to have at its disposal a broad range of enforcement tools.

Finally, a number of those interviewed were of the opinion that under-utilisation of civil penalties has had the effect of undercutting the deterrent function of this enforcement tool. The low public profile of civil penalties reduces their perceived worth as a deterrent and this places further doubt in the minds of enforcement personnel about using civil penalties when there are more proven enforcement options available.

Civil penalties are based upon strategic regulation theory whereby integrated sanctions escalate in response to more serious contraventions. Civil penalties should inhabit the upper level of regulation with criminal law at the apex of the enforcement pyramid and methods of persuasion and education at the lower level. An initial analysis suggests that civil penalties should be reasonably widely used in relation to the enforcement of directors' duties. However, as our research indicates, there are some significant reasons why this has not occurred.

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