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## White Paper

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# The rise of severe punishment for corporate wrongdoing

## Abstract

*The US Department of Justice announced in October 2006 that the former Enron Chief Executive Officer Jeffrey K. Skilling was sentenced "to 24 years and four months in prison on conspiracy, securities fraud and other charges related to the collapse of the Enron Corporation". He was convicted "of 12 counts of securities fraud, one count of insider trading, conspiracy and five counts of making false statements to auditors." Also, Mr Skilling "was ordered to forfeit approximately \$45 million to be applied towards restitution for the victims of the fraud at Enron."*

*Compliance with the Corporations Act and other laws imposing liabilities on corporate officers is essential not only for good corporate governance but also for avoiding wrongdoing. It is no longer acceptable for corporate officers to rely totally on advisers, assume no one is looking or that frauds are undetectable. Corporate officers must know the law and their legal advisers must ensure that their corporate clients comply with the law and know their duties as corporate officers.*

*This paper provides analysis of the warning echoed in the USA for corporate officers to operate legally and avoid the temptations of self interests and ignoring their duties as corporate officers. As corporations are more global the opportunities for wrongdoing are more present the consequences of being caught and dealt with in more than one country is ever present.*

*The penalties for corporate wrongdoing are explored including comparing the penalties applying to terrorist acts where the terrorist acts indiscriminately. This indiscriminate feature is not dissimilar to the wrongful acts of corporate officers. They do not think about the person they will hurt by their wrongful actions.*

*Ultimately, corporate officers must exercise care and diligence to avoid wrongdoing, to detect wrongdoing and to promote good corporate governance.*

## Mr Skilling is sentenced to 24 years and 4 months

The experience of Mr Skilling, former Enron Chief Executive Officer, under the law of corporations and securities in the United States has implications for corporate directors and executives in Australia. At the moment, penalties applied for criminal activity may not be as severe as those imposed on Mr Skilling. But the courts are treating “corporate crime” or “white collar crime” as serious and imposing what they consider to be appropriate penalties. I have examined this development in previous conference papers<sup>1</sup>.

Mr Skilling was convicted on “12 counts of securities fraud, one count of insider trading, conspiracy and five counts of making false statements to auditors”, according to the statement by the US Department of Justice<sup>2</sup>. The US Securities and Exchange Commission (**SEC**) described the charges as:

“Mr Jeffrey K. Skilling, Enron Corp’s former President, Chief Executive Officer and Chief Operating Officer with violating, and aiding and abetting violations of, the antifraud, lying to auditors, periodic reporting, books and records, and internal controls provisions of the federal securities laws.”<sup>3</sup>

The US SEC sought the “disgorgement of all ill-gotten gains, civil money penalties, a permanent bar from acting as a director or officer of a publicly held company, and injunctions against future violations of the federal securities laws.” The action brought by the SEC was coordinated with criminal charges filed by the Department of Justice Enron Task Force<sup>4</sup>. The litigation documents can be viewed on the SEC’s website at [www.sec.gov](http://www.sec.gov)<sup>5</sup>.

The factual allegations detailed in the SEC’s Amended Complaint of July 2004 show that the objectives of the scheme to defraud included:

- to falsely present Enron as a profitable successful business
- to report recurring earnings that falsely appeared to grow by approximately 15 to 20 percent annually
- to meet or exceed the published expectations of industry analysts forecasting Enron’s reported earnings-per-share and other results
- to maintain an investment-grade credit rating
- to conceal the true magnitude of Enron’s losses, growing debt and other obligations
- to artificially inflate Enron’s stock price
- to personally profit from the unlawful conduct, including gains from the sale of inflated Enron stock.

The SEC’s Amended Complaint also said:

“As a result of the scheme to defraud carried out by defendants and others, the descriptions of Enron’s business and finances in public statements by defendants and others were false and misleading, and bore no resemblance to its actual performance and financial condition.”

Mr Skilling and others signed employment or consulting agreements with the company where they acknowledged that they owed a fiduciary duty to the company and its shareholders and

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<sup>1</sup> These conference papers can be viewed as white papers on [www.iantunstall.com](http://www.iantunstall.com).

<sup>2</sup> US Department of Justice, *Media Release*, Monday, 23 October 2006.

<sup>3</sup> US Securities and Exchange Commission, “SEC Charges Jeffrey K. Skilling, Enron’s Former President, Chief Executive Officer and Chief Operating Officer, with Fraud”, Litigation Release No. 18582/February 19, 2004 ; Accounting and Auditing Enforcement Release No. 1959/February 19, 2004; *Securities and Exchange Commission v. Richard A. Causey and Jeffrey K. Skilling*, Civil Action No. H-04-0284 (Harmon) (S.D. Tx.) (February 19, 2004) (Amended Complaint).

<sup>4</sup> US SEC, *Securities and Exchange Commission v. Richard A. Causey and Jeffrey K. Skilling*, Civil Action No. H-04-0284 (Harmon) (S.D. Tx.) (February 19, 2004) (Amended Complaint).

<sup>5</sup> See also Superseding Indictment, *United States of America v. Jeffrey K. Skilling and Richard A. Causley*, Cr. No. H-04-25 of 1 February 2004 at US Department of Justice website [www.justice.gov/opa/pr/2004/February/04\\_crm\\_099.htm](http://www.justice.gov/opa/pr/2004/February/04_crm_099.htm), [superseding indictment](#).

that they would act solely in the best interests of the company and shareholders<sup>6</sup>. They also agreed that they had a duty of trust and confidence in the company. Mr Skilling's gains from the sale of shares in Enron amounted to \$62,626,401.90 between April 2000 and September 2001. He also signed off documents filed with the US SEC in relation to financial reporting<sup>7</sup> that was misleading and false.

It is interesting to note that a former Chief Financial Officer, Mr Andrew Fastow, entered a guilty plea and was a witness against Mr Skilling and Mr Kenneth Lay (who later died and had his conviction vacated<sup>8</sup>). There were also other former employees who were witnesses for the prosecution such as Mr Koenig, former Director of Investor Relations, and Mr Kopper, former assistant to Mr Fastow. These persons received reduced sentences for assisting the prosecution. A further point of interest is that Mr Fastow was convicted for six years and he is serving his time at the Oakdale Federal Correctional Complex, Louisiana, where Mr Bernard Ebbers, former Chief Executive Officer of WorldCom, is serving a 25 year sentence. Mr Ebbers was not successful on appealing his conviction where his claim amounted to arguing that 25 years was unreasonable for a non-violent conviction<sup>9</sup>. The United States Court of Appeals for the Second Circuit said:

"the Guidelines reflect Congress' judgment as to the appropriate national policy for such crimes, *United States v. Rattoballi*, --- F.3d ---, 2006 WL 1699460, at \*5 (2d Cir. June 21, 2006) (stating that the court will 'continue to seek guidance from the Sentencing Commission as expressed in the Sentencing Guidelines and authorized by Congress.')(citation omitted), and Ebbers does not argue otherwise.

Moreover, the securities fraud here was not puffery or cheerleading or even a misguided effort to protect the company, its employees, and its shareholders from the capital-impairing effects of what was believed to be a temporary downturn in business. The methods used were specifically intended to create a false picture of profitability even for professional analysts that, in Ebbers' case, was motivated by his personal financial circumstances. Given Congress' policy decisions on sentences for fraud, the sentence is harsh but not unreasonable."<sup>10</sup>

The charges brought against Mr Skilling are peculiar to his case and they attracted what the U.S. District Court considered appropriate penalties<sup>11</sup>. Despite these convictions, Mr Skilling protested his innocence claiming ignorance of any misdeeds<sup>12</sup> as he was ignorant of the wrongdoings<sup>13</sup>. A news report expresses the claim of innocence:

"At a hearing on Monday where Jeffrey Skilling continued to proclaim his innocence, U.S. District Judge Sim Lake of Houston sentenced Skilling, the former chief executive officer of Houston's Enron Corp., to more than 24 years in prison.

Lake denied Skilling's request to remain free on bail pending his appeal, but the judge allowed Skilling to remain in home confinement until the U.S. Bureau of Prisons orders him to report to prison. Lake

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<sup>6</sup> *Securities and Exchange Commission v. Richard A. Causey and Jeffrey K. Skilling*, Civil Action No. H-04-0284 (Harmon) (S.D. Tx.) (February 19, 2004) (Amended Complaint).

<sup>7</sup> *Securities and Exchange Commission v. Richard A. Causey and Jeffrey K. Skilling*, Civil Action No. H-04-0284 (Harmon) (S.D. Tx.) (February 19, 2004) (Amended Complaint).

<sup>8</sup> Sim Lake, United States District Judge, *Memorandum of Opinion and Order*, *United States of America v. Kenneth L. Lay* Criminal Action No. H-04-0025. The Memorandum of Opinion and Order can be viewed at <http://www.txsd.uscourts.gov/notablecases/enron/404cr25/laydismissal.pdf>.

<sup>9</sup> Mr Ebber's indictment can be viewed at <http://www.txsd.uscourts.gov/notablecases/enron/404cr25/judgment.pdf>, <http://f11.findlaw.com/news.findlaw.com/nytimes/docs/worldcom/usebbers504ind3s.pdf>, and appeal at [http://www.ca2.uscourts.gov:8080/isy/native/RDpcT3BpbnNct1BOXDA1LTQwNTktY3Jfb3BuLnBkZg==/05-4059-cr\\_opn.pdf](http://www.ca2.uscourts.gov:8080/isy/native/RDpcT3BpbnNct1BOXDA1LTQwNTktY3Jfb3BuLnBkZg==/05-4059-cr_opn.pdf).

<sup>10</sup> A footnote to the decision in relation to the conviction given to Mr Ebbers states: "U.S. Sentencing Guidelines Manual § 2B1.1 (2005) (setting the offense level of 28 for a loss of \$200 million or more, 6 levels for a crime involving 250 or more victims, and 4 levels for being the officer of a publicly traded company); § 3B1.1 (2005) (adding 4 levels for leading a criminal activity with five or more participants); Sentencing Table (2005) (setting the sentence at thirty years to life for an offense level of 42 for an offender in criminal history category I)." The Federal Sentencing Guideline manual can be viewed at <http://www.ussc.gov/2006guid/tabcon06.htm>.

<sup>11</sup> United States District Court, Southern District of Texas, Holding Session in Houston, Judgment in a Criminal Case, *United States of America v. Jeffrey K. Skilling*, Case No. 4:04 CR0025-02, October 23, 2006, can be viewed at <http://www.txsd.uscourts.gov/notablecases/enron/404cr25/judgment.pdf>.

<sup>12</sup> "Former Enron CEO Jeffrey Skilling Sentenced to 24 Years in Prison", *Law.Com*, October 24, 2006, <http://www.law.com/jsp/article.jsp?id=1161606924042>.

<sup>13</sup> Mr Skilling's claim of ignorance can be seen in his Motion for a Judgment of Acquittal filed 20 June 2006 at [http://lawprofessors.typepad.com/whitecollarcrime\\_blog/files/skilling\\_acquittal\\_motion\\_june\\_2006.pdf](http://lawprofessors.typepad.com/whitecollarcrime_blog/files/skilling_acquittal_motion_june_2006.pdf).

granted a defense motion that Skilling serve his time in the Butner Federal Corrections Complex in Butner, N.C.”

Later in the news report, Mr Skilling’s comments were recorded:

“In relatively brief remarks in a jam-packed courtroom, Skilling said it’s ‘just the furthest thing from the truth’ for people to think he is not remorseful for what happened to Enron.

It’s been very hard on me. ... It’s been incredibly hard on my family. It’s been very hard on the employees of Enron Corp.,” he said.

However, he said, ‘I am innocent of these crimes,’ and noted that he will pursue his constitutional right to an appeal.”

This cry of innocence of crimes due to Mr Skilling’s ignorance is seriously refuted by the US SEC.

### **SEC’s description of Mr Skilling’s plea of innocence**

The SEC’s Director, Division of Enforcement, said<sup>14</sup>:

“Mr. Skilling was quick to take credit for the ‘innovations’ behind Enron’s spectacular rise and its apparent transformation into a ‘new economy’ powerhouse. He was also quick to take credit for putting in place the corporate culture that made these ‘innovations’ possible.

Of course, many of these so-called ‘innovations’ were, in truth, nothing more than fraudulent business practices.

And, when Mr. Skilling realized that the fraud he had perpetrated was no longer sustainable, he was just as quick to abandon Enron, to sell massive amounts of his Enron stock, and to disclaim responsibility for the harms visited on Enron’s shareholders.”

In relation to Mr Skilling’s claim of ignorance, the Director said:

“In this scandal as in others, we are by now all too familiar with the phenomenon of executives who put themselves at the center of what would appear to be great corporate achievements, but who then loudly proclaim their ignorance when the appearance of success gives way to the reality of corruption. Let there be no mistake that today’s enforcement action against Mr. Skilling places accountability exactly where it belongs.”

The Director made an important statement in relation to compliance by corporate officers to the law:

“No matter how comprehensive our laws and regulations, there will always be individuals who believe - whether because of arrogance, greed or a failure of integrity - that the rules do not apply to them or that they won’t get caught if they break them. As our enforcement efforts in the Enron matter reflect, these individuals should think again.”

As stated earlier, the work of the prosecution in the Enron matter involved the US SEC working with an Enron Task Force that was formed in January 2002 and involves multiple agencies including the Federal Bureau of Investigation and the Internal Revenue Service. It is part of the President’s Corporate Fraud Task Force<sup>15</sup>. The Enron Task Force has been successful although it has spent millions of dollars but it has gone through millions of documents and its staff has worked thousands of hours<sup>16</sup>.

### **Australia’s corporate cases**

The situation in Australia is not dissimilar with the situation in the United States except, perhaps, the size and scale of fraud committed. Corporate officers in Australian companies in recent years have demonstrated a similar disregard for the law. Consequently, the authorities are pursuing

<sup>14</sup> Cutler SM, Director, Division of Enforcement, US Securities and Exchange Commission, “Statement Regarding SEC Action Against Ex-Enron Officer Jeffrey K. Skilling”, February 19, 2004, Washington, D.C.

<sup>15</sup> The President’s Corporate Fraud Task Force was created by Executive Order #13271 on July 9, 2002. This can be viewed at <http://www.whitehouse.gov/news/releases/2002/07/20020709-2.html>.

<sup>16</sup> Department of Justice, *Media Release*, Thursday, May 25, 2006, 06-330.

similar courses to uncover fraud and other wrongdoings of corporate directors and other company officers. The government is prepared to fund investigations that consume many hours and perusing many documents to discover the path to wrongdoing.

Similar processes using taskforces are underway in Australia in relation to recommendations of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme<sup>17</sup>. Work by the Australian Securities and Investments Commission (**ASIC**) in relation to charges being brought against former officers of James Hardie Industries Limited has specific funding support from the Commonwealth Government to undertake investigations involving a complex corporate structure spanning three countries and involving “about 348 billion documents, 72 examinations and the issuing of 284 notices to obtain evidence.”<sup>18</sup> ASIC has commenced proceedings in the Supreme Court of New South Wales<sup>19</sup>.

### Enforcement of corporate laws

On 25 May 2006 the US Department of Justice issued a media release<sup>20</sup> following the convictions of Mr Skilling and Mr Lay saying:

“The message of today’s verdict is simple: our criminal laws will be enforced just as vigorously against corporate executives as they will be against street criminals. No one—including the heads of Fortune 500 companies—is above the law.”

This pronouncement follows the success of systematically tracking down those persons responsible for the Enron Corporation’s demise. It seems that this fervour is evident within ASIC as it announced on 15 February 2007 that legal proceedings had commenced against a number of current and former directors and executives of James Hardie Industries Limited<sup>21</sup>. These proceedings relate to matters identified by the Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation<sup>22</sup>.

### Benefits of inquiries of corporate wrongdoing and failures

Reports from recent inquiries into the actions of directors and other company officers and their responding behaviours, are interesting. They usually discuss the law and apply it to the circumstances and matters arising from the investigations on which they report. The approach is not dissimilar to the task of legal practitioners who advise clients in relation to their particular circumstances. Also, at times interesting evidence is obtained by inquiries that raise interesting issues including the quality of advice provided by practitioners in the matters under investigation<sup>23</sup>.

### Directors’ duties of care and diligence

Directors have statutory duties and general law duties that have evolved over time. They must have a degree of care and diligence in exercising their powers and discharging their duties similar to a director in a corporation with similar circumstances. This duty not only applies to directors but also to other officers of a corporation<sup>24</sup>. It is an important basic duty of directors as it involves the personal integrity and ability of individuals performing these roles in a corporation. The degree of care and diligence is a change from the prescription of former statutory duties of care where a director was required “at all times to act honestly and use reasonable diligence in the

<sup>17</sup> The Attorney-General, “Cole Inquiry Task Force Established”, *Media Release 254/2006*, 20 December 2006.

<sup>18</sup> Australian Securities & Investments Commission, *Media Release 07-35*, “ASIC commences proceedings relating to James Hardie”, Thursday 15 February 2007.

<sup>19</sup> The James Hardie Industries Statement of Claim filed by ASIC can be obtained on ASIC’s website at [http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=James\\_Hardie\\_Statement\\_of\\_Claim\\_pdf](http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=James_Hardie_Statement_of_Claim_pdf).

<sup>20</sup> Department of Justice, *Media Release*, Thursday, May 25, 2006, 06-330.

<sup>21</sup> Australian Securities & Investments Commission, *Media Release 07-35*, “ASIC commences proceedings relating to James Hardie”, Thursday 15 February 2007.

<sup>22</sup> *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation*, September 2004.

<sup>23</sup> This can be seen in *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation*, September 2004.

<sup>24</sup> *Corporations Act 2001*, s 180(1).

discharge of the duties of his office.”<sup>25</sup> While honesty is still a required duty for directors, diligence has become linked with the person’s exercise of care when performing duties. These duties have evolved to be expressed in *Corporations Act 2001*, s 184(1) that expresses the criminal aspect of the dishonesty and reckless disregard of care and diligence:

“(1) A director or other officer of a corporation commits an offence if they:  
(a) are reckless; or  
(b) are intentionally dishonest;  
and fail to exercise their powers and discharge their duties:  
(c) in good faith in the best interests of the corporation; or  
(d) for a proper purpose.”

There are other duties such as honesty and avoiding conflicts of interest and not misusing corporate information for personal gain. But these go to the integrity of the person and their ability to properly perform the functions and duties as directors. For example, in relation to avoiding a conflict of interest, a director, as a fiduciary, must not put themselves in a position where their personal interest and duty to the corporation conflict. Lord Herschell in *Bray v Ford*<sup>26</sup> said that this duty is founded on “principles of morality”. Lord Herschell thought that the duty is “based on the consideration that, human nature being what it is, there is a danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than duty, and thus prejudicing those whom he was bound to protect.” The HIH Royal Commission Report<sup>27</sup> referred to this statement and said that this is true today. Referring to the HIH Insurance Ltd’s board of directors, the HIH Royal Commission Report says:

“The lackadaisical approach to conflicts of interest of some members of the HIH board encouraged this culture to spread through various sections of the management of the company. This was inimical to good corporate governance.”

Good corporate governance, according to the HIH Royal Commission Report, required the “board and in particular the chairman should have taken the lead in ensuring that all situations which might involve or give rise to a conflict of interest were fully disclosed and ventilated so that none of the other directors could be under any misapprehension concerning the relevant circumstances.”<sup>28</sup> It is not easy to give a prescription for this disclosure but all directors including the chair and other executives including those reporting to and advising the board have a duty to avoid a conflict. As the HIH Royal Commission report says<sup>29</sup>:

“It is not appropriate to prescribe a precise formula for dealing with this topic. It will depend on the circumstances. Directors should be open and frank with one another on this as on all issues concerning the board.”

As the HIH Royal Commission Report says<sup>30</sup>:

“The failure of a company does not in itself establish a failure of governance.”

But in the case of HIH Insurance Limited, the company suffered from corporate governance deficiencies<sup>31</sup>. The deficiencies identified were:

- decisions on major transactions and acquisitions were made without due deliberation or analysis
- audit committee processes did not give separate, closer consideration to audit issues
- apparent failure to appreciate the importance of the group’s single biggest liability being its provision for outstanding claims.

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<sup>25</sup> *Companies Act 1958* (Vic), s 107(1).

<sup>26</sup> *Bray v Ford* (1896) AC 44 at 51-2.

<sup>27</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 1* (April 2003) at 6.2.7.

<sup>28</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 1* (April 2003) at 6.2.7.

<sup>29</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 1* (April 2003) at 6.2.7.

<sup>30</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 3* (April 2003) at 23.2.

<sup>31</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 3* (April 2003) at 23.2.

These deficiencies arose from the observation that the company's corporate governance "was not based on openness, integrity and accountability."<sup>32</sup> There seems to be a lack of care and diligence exercised by directors and this is a major consideration of the duty of directors.

*Corporations Act 2001*, s 180(1) expresses the duty of care and diligence required as:

- "(1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
- (a) were a director or officer of a corporation in the corporation's circumstances; and
  - (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer."

This standard of care and diligence required of directors and other officers is determined in part by the responsibilities that a person has in performing their duties and the personal qualities of the person. It is the individual's personal qualities, qualifications and experience that are important in assessing the person's care and diligence in the exercise of powers and conduct of duties<sup>33</sup>. This will depend on whether the person is an executive director or a non-executive director. Also, if the person is the chair, this will be an issue for the courts in determining the degree of care and diligence that the person should have exercised<sup>34</sup>. Each individual's circumstances will be assessed by the courts as they will be different for each person in the role of director<sup>35</sup> and the penalty applied in each case will be influenced by these circumstances. But there may be other considerations taken into account by the courts when determining what penalty to apply after assessing each individual's degree of care and diligence.

### Participating on board committees

In a speech<sup>36</sup> delivered by Justice Austin of the Supreme Court of New South Wales, reference was made to an earlier speech given by the Hon Andrew Rogers QC saying that "the Court has yet to decide whether participation on a board committee affects the statutory and general law liabilities of a company director. By taking an appointment on the audit committee, for example, the director arguably undertakes (sometimes for additional remuneration) additional work, suggesting additional responsibility. On the one hand, if the director is a non-executive director, the nature of his or her office arguably limits the responsibility that can be fairly attributed to the director, even as a member of a board committee." In addition there is the director who relies on a board committee's recommendations following the committee's work on a matter. The discussion then referred to the AWA case that said "directors must approach their work with an inquiring mind." But he raised another interesting issue about "what enquiries might reasonably be expected of the director who receives a competent report by a board committee on a complex matter."

Justice Austin said that he expected "that the answers to these questions will evolve gradually, through the traditional mechanisms of judicial decisions. However, the volume of corporate litigation involving the duty of care of directors has increased over recent times, and that trend is likely to continue. This is because questions of breach of the duty of care typically arise after a corporate collapse". Also, Justice Austin observed that "ASIC is now using its powers under the civil penalties provisions of the Corporations Act quite frequently."

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<sup>32</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 3* (April 2003) at 23.2.

<sup>33</sup> See *ASIC v Rich* (2003) 44 ACSR 341 and *ASIC v Rich* (2004) NSWSC 836.

<sup>34</sup> *ASIC v Rich* (2003) ACSR 682; *Rich v ASIC* (2004) 220 CLR 129.

<sup>35</sup> *Rich v ASIC* (2004) 220 CLR 129 per McHugh J referring to Bryson J in *Re One Tel Ltd (in liq)*; *ASIC v Rich* (2003) ACSR 682.

<sup>36</sup> Justice R P Austin, "Directors Duties and Financial Responsibilities, University of New South Wales, Faculty of Law, *Directors Duties and Financial Responsibilities*, Tuesday 26 November 2002.

## Directors bringing skills to the board

Litigation raising allegations of a director's care and diligence is usually combined with breaches of other duties of directors<sup>37</sup>.

The individual's care and diligence is what they bring to the board of directors of a corporation. The director contributes to the board their skill to ensure that the board carries out its role for the corporation's governance. The board is ultimately responsible for governance. It does not involve the directors in the daily operations of the corporation but it does delegate responsibilities to executives and employees. The HIH Royal Commission Report says that the board "must decide where the lines of authority lie. The board should set clearly defined delegations of authority to the chief executive and have a well-understood policy on matters that are reserved to it."<sup>38</sup> The interaction between the board and management must be effective as it is essential for good corporate governance.

### *Duties of incoming directors and degree of skill*

In their performance on the board, directors must exercise care and diligence in everything they do. They "have a responsibility to request more information where necessary to fulfil their duties. They cannot simply rely upon the information presented by management."<sup>39</sup> The Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation<sup>40</sup>, considered whether the duties applying to directors should apply to the same degree to incoming directors. The Report states the Commissioner's views:

"It may be unfortunate that some matters were not pursued more vigorously by the incoming directors...However, in the circumstances...I do not consider that the incoming directors could realistically have been expected to do more than in fact they did to ensure that the Foundation was adequately funded."

The issue of time pressure was considered in the Report as it related to incoming directors. The reasons for the time pressure are important as they assist in establishing the nature of these pressures in influencing the degree of care and diligence exercised by the incoming directors. However, the Report says about the time pressure:

"It is sufficient to note here that the time pressure was effectively the product of a decision by [James Hardie Industries Limited], in pursuit of its public relations strategy, to attempt to mute the story of the creation of the Foundation by announcement at the time of announcement of the third quarter results."

The reason for this apparent rush to make an announcement by James Hardie Industries Limited was based in the information to be disclosed. The Report states<sup>41</sup>:

"Even the introduction of ED88<sup>42</sup>, it may be noted, did not give rise to any pressing need for the creation of the Foundation, other than the existence of the apprehension that, if it were not established and the asbestos liabilities separated, [James Hardie Industries Limited] might have to disclose information it would rather not disclose."

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<sup>37</sup> Justice R P Austin, "Directors Duties and Financial Responsibilities, University of New South Wales, Faculty of Law, *Directors Duties and Financial Responsibilities*, Tuesday 26 November 2002.

<sup>38</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 1* (April 2003) at 6.2.

<sup>39</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 1* (April 2003) at 6.2.12.

<sup>40</sup> *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation*, September 2004 at 322.

<sup>41</sup> *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation*, September 2004 at 321.

<sup>42</sup> EB88 is Exposure Draft for a new Australian accounting standard.

The Report comments further on the actual time pressure placed by the company on incoming directors saying<sup>43</sup>:

“20.67 The actual time pressure imposed on the incoming directors was significant. They were left with very little opportunity to consider the Trowbridge report or the Cash Flow Analysis which they received on 13 February 2001. They had even less chance to consider the amended Cash Flow Analysis or the transaction documentation which they received on the evening of 15 February 2001. Had they been given more time to consider the February Trowbridge report and the Cash Flow Analysis, the incoming directors may have been able to identify the deficiencies in them. At a minimum, their conduct needs to be considered in the light of the time pressure under which they were placed.”

These circumstances causing incoming directors to work under time pressure was compounded by the information given them by advisers. They tended to rely on the information they were given and they “placed a degree of trust in what they were told by [James Hardie Industries Limited]’s management about the funding of the Foundation.” Also, the incoming directors were misled by [James Hardie Industries Limited]’s management as to the likelihood that the Foundation would be able to fund asbestos claims for 15-20 years.”<sup>44</sup>

The law is not clear about the degree of care and diligence required of incoming directors and this may become clearer in time as matters are considered by the Supreme Court of New South Wales when the matter of James Hardie Industries NV, ABN 60 Pty Ltd (ACN: 000 009 263), Amaca Pty Ltd (ACN 000 035 512) and Amaba Pty Ltd (ACN 000 387 342)<sup>45</sup> is considered.

### **Role of chair and corporate governance**

The HIH Royal Commission Report shows that the role of the chair is important where the law, though not clearly articulated, is “beginning to crystallise” such that “commentary and case law make it clear that the chair’s role and responsibilities are different from and often greater than those of other directors.”<sup>46</sup> In particular, it is observed that “the chair has what is commonly referred to as a mentoring role in relation to the chief executive....The chair also has a responsibility to see that the board keeps its own role and performance under review and does not fall into a mode of ‘going through the motions’.”<sup>47</sup> To some extent, therefore, incoming directors should receive guidance and assistance from the chair and to a degree some reliance is made by incoming directors on the chair whose responsibilities include making sure incoming directors can perform their best on the board. But this does not detract from the responsibilities of incoming directors to exercise their own care and diligence in the circumstances following their appointment to the board.

Justice Austin<sup>48</sup> says that the “law of directors’ duties has not kept pace with the burgeoning literature of corporate governance.” In relation to judicial recognition of this literature, Justice Austin said that one “of the general questions confronting the Court is whether, assuming they are admissible as evidence, papers by expert corporate governance committee such as those chaired by Sir Adrian Cadbury and Mr Henry Bosch should be allowed to influence the Court’s determination of legal liability.” He observed that this literature on corporate governance tends to be directed towards best practice rather than legal liability. However, the discussion in this literature could “reflect changing community standards which might have an impact on the liability of directors.” Justice Austin said that “recourse to corporate governance literature might affect such issues (at any rate, in the case of a large public company) as

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<sup>43</sup> *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation*, September 2004 at 321.

<sup>44</sup> *Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation*, September 2004 at 322.

<sup>45</sup> Statement of Claim, Australian Securities & Investments Commission v. Peter Donald MacDonald and Others obtainable on ASIC’s website at [http://www.asic.gov.au/asic/asic.nsf/!kuppdf/ASIC+PDFW?opendocument&key=James\\_Hardie\\_Statement\\_of\\_Claim\\_pdf](http://www.asic.gov.au/asic/asic.nsf/!kuppdf/ASIC+PDFW?opendocument&key=James_Hardie_Statement_of_Claim_pdf).

<sup>46</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 1* (April 2003) at 6.2.1. The case law referred to is *ASIC v Rich* [2003] NSWSC 85.

<sup>47</sup> The HIH Royal Commission, *The failure of HIH Insurance: Volume 1* (April 2003) at 6.2.1.

<sup>48</sup> Justice R P Austin, “Directors Duties and Financial Responsibilities, University of New South Wales, Faculty of Law, *Directors Duties and Financial Responsibilities*, Tuesday 26 November 2002.

- whether the law should now accept that there are different standards for executive and non-executive directors;
- whether membership of a board committee such as an audit committee should carry additional legal responsibility;
- whether the chairman of the board has greater legal duties than other members of the board.”

These issues for the courts will be revealed in matters involving the care and diligence of directors. It is clear from Justice Austin’s views that the courts will be recognising the complexity of the work of corporate boards and the responsibilities of each director. This may flow into consideration of the liability of each director based on their role and extent of their participation in matters involving complex issues. In recent times one complex issue is identifying and dealing with misconduct of employees where they are involved in wrongdoing.

### **Directors’ duties in detecting misconduct or other wrongdoing**

Detecting and dealing with misconduct or the wrongdoing of corporate officers and employees is an important function of directors and executives. The responsibility imposed on them comes from their duties as directors.

The task of detecting misconduct begins with recognising that misconduct is possible and that areas or activities of the corporation’s business and operations can cause an employee to undertake activities of misconduct or participate in wrongdoing. Vulnerable areas and employees need to be identified. This is part of a process of risk management for a corporation’s corporate governance.

### **Duties of directors and risk management**

The duties of directors arise from a range of sources and evolve with the management of the corporation and shaped by the corporation’s business activities. The most important risk management issue for directors is to ensure the corporation’s solvency at all times. Good corporate governance policies and vigilance will ensure that the corporation remains solvent and that the business of the corporation and its management and administration is conducted in a legal and proper manner.

However, there are other duties and responsibilities for directors and senior company officers. The duties of directors under the *Corporations Act 2001* are reasonably well known. However, there are moments when we see that this assumption, that directors know their duties under the Corporations Act, is false. This can be seen in the reports of inquiries into scandals and corporate failures where it is often said by those caught that they did not think they were breaking the law or that they did things or omitted to do them according to their understanding of the law and their duties as directors.

Reading inquiry reports is useful to see the growing responsibilities placed on corporate directors and other executives. A recent development for directors is the responsibility to identify and make policies to manage the risk of corruption.

### **Risk of corporate corruption**

The recent inquiry into the business affairs of AWB Limited identified the risk of corruption. AWB Limited has a Corporate & Code of Conduct Policy<sup>49</sup> that deals with the management of corrupt activities. Countries in which AWB Limited staff operated involved corrupt activities in relation to doing business there.

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<sup>49</sup> This policy can be viewed with the exhibits tabled at the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme.

The Report<sup>50</sup> of the inquiry refers to a report prepared by Arthur Andersen in August 2000 saying:

“The ethics of AWB staff is critical to the reputation and integrity risks of AWB. Particular higher risk areas such as the marketing of products, shipping and finance were assessed at a high level through this review. We found incidents that created ethical questions such as the offer of gifts, entertainment and money were encountered by your employees. We found that the incidents while not frequent did cause *concern* to your staff. Reduction of these risks can be achieved through education, improved communication, a consistent AWB policy and the enforcement of that policy. Other methods can be implemented to review and prevent incidents such as rotation of staff, audits, awareness of ethical issues and dilemmas that may be encountered.”

Arthur Anderson recommended the following actions by AWB Limited:

- Conduct an assessment of the ethical culture at AWB.
- Create a transparent environment where employees are encouraged to report incidents, risks and improper conduct
- Construct controls that will prevent and deter illegal or improper conduct
- Educate staff in relation to risk, controls and expectations of AWB.

The *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme* notes that the “culture of AWB, and its employees, required review and attention, so far as ethical dealing was concerned.”<sup>51</sup>

The problem for AWB Limited and its officers was identified as a “failure in corporate culture”<sup>52</sup>. It is interesting to see the comments in the *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme*<sup>53</sup>:

“No one asked, ‘What is the right thing to do?’ Instead, much time and money was spent trying to determine if arrangements could be formulated in such a way as to avoid breaching the law or sanctions, whether conduct could be protected, by various subterfuges, from discovery or scrutiny, and whether actions were legal or illegal. There was a lack of openness and frankness in AWB’s dealing with the Australian Government and the United Nations. At no time did AWB tell the Australian Government or the United Nations of its true arrangements with Iraq. And when inquiries were mounted into its activities it took all available measures to restrict and minimise disclosure of what had occurred. Necessarily, one asks, ‘Why?’

The answer is a closed culture of superiority and impregnability, of dominance and self-importance. Legislation cannot destroy such a culture or create a satisfactory one. That is the task of boards and the management of companies. The starting point is an ethical base. At AWB the Board and management failed to create, instil or maintain a culture of ethical dealing.”

The directors and other senior officers should have conducted the company’s business according to high ethical standards. The reason for this view expressed in the *Report of the Inquiry into*

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<sup>50</sup> *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme*, Volume 1: Summary, recommendations and background, Commissioner The Honourable Terence RH Cole AO RFD QC, November 2006 at xxxvii.

<sup>51</sup> *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme*, Volume 1: Summary, recommendations and background, Commissioner The Honourable Terence RH Cole AO RFD QC, November 2006 at xxxix.

<sup>52</sup> *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme*, Volume 1: Summary, recommendations and background, Commissioner The Honourable Terence RH Cole AO RFD QC, November 2006 at xii.

<sup>53</sup> *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme*, Volume 1: Summary, recommendations and background, Commissioner The Honourable Terence RH Cole AO RFD QC, November 2006 at xii.

certain Australian companies in relation to the UN Oil-for-Food Programme is due to the nature of AWB Limited's monopoly position<sup>54</sup>:

"A government grant, by legislation, of a monopoly power confers on the recipient a great privilege. It carries with it a commensurate obligation. That obligation is to conduct itself in accordance with high ethical stands. The reason such an obligation is imposed is because, by law, persons are denied choice with whom they may deal."

It has been suggested<sup>55</sup> that boards need to actively consider and not neglect corrupt dealings within their policies concerning ethical issues. The significance of this consideration is to ensure that the corporation's annual report discloses the financial information of kickback deals or other deals that are converted into cash. The Australian Stock Exchange requires directors to ensure the corporation's integrity in financial reporting<sup>56</sup>:

"Presenting a company's financial and non-financial position requires processes that safeguard, both internally and externally, the integrity of company reporting (Principle 4), and provide a timely and balanced picture of all material matters (Principle 5)."

The integrity of reporting the corporation's performance is central to the duties of directors. The experience of Enron Corporation shown earlier demonstrates the need for this integrity. An essential element of reporting integrity is materiality of matters that are drawn on to prepare statements. The responsibility for ensuring materiality of matters for reports and statements rests with the directors and other executives including those advising the directors. The Corporations and Markets Advisory Committee discussed the role of corporate officers other than directors in *Corporate Duties Below Board Level* (September 2006). This discussion is interesting in identifying those persons in a corporation who should take responsibility for the integrity of a corporation's reporting performance.

### **Enforcing a corporate code of conduct**

Good corporate governance should include a code of conduct for company officers and employees. This code needs to be "enforced" within the company to ensure that officers and employees comply with the code at all times. "Enforcement" includes a well-drafted code that can be understood by all employees, training in the code's contents and requirements, and ultimate penalty of being dismissed for intended breaches. Lesser penalties could include warnings and other measures to allow the person to correct the action and resume responsibilities under supervision. Protection is needed for employees alerting managers to activity that could be corrupt.

AWB Limited had a code of conduct according to the former Managing Director (Mr Lindberg)<sup>57</sup>:

"It has become an essential element of good business practice for the Board and Executive of commercial organisations to provide a clear set of 'values' that emphasise a culture encompassing strong corporate governance, sound business practices and good ethical conduct.

...

At AWB we promote and demonstrate clearly that our business affairs and operations are at all times being conducted legally, ethically and in accordance with the highest standards of integrity and propriety. This is a fundamental principle of AWB's operations and business affairs.

...

Adherence at all times to these values and standards is essential. It will ensure that AWB maintains a reputation for high standards of business conduct, professionalism and integrity. We will ensure that AWB is

<sup>54</sup> *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme*, Volume 1: Summary, recommendations and background, Commissioner The Honourable Terence RH Cole AO RFD QC, November 2006 at xii.

<sup>55</sup> Bartos S, *Against the Grain: The AWB Scandal and Why It Happened*, UNSW Press, 2006 at 32.

<sup>56</sup> Australian Stock Exchange Corporate Governance Council, *Principles of Good Corporate Governance and Good Practice Recommendations: Exposure Draft of Changes*, 2 November 2006 at 6.

<sup>57</sup> This extract is from a letter from Mr Lindberg, Managing Director of AWB Limited as shown in *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme*, Volume 1: Summary, recommendations and background, Commissioner The Honourable Terence RH Cole AO RFD QC, November 2006 at 201-202.

proud of what it stands for as an organisation No employee should ever feel that his or her conduct could not survive the test of public scrutiny.”

The Code of Conduct will be examined to assess its quality and value.

### ***AWB Limited's Corporate & Code of Conduct Policy***

The Managing Director of AWB Limited issued the Corporate & Code of Conduct Policy to staff saying that “it has become an essential element of good business practice for the Board and Executive of commercial organisations to provide a clear set of ‘values’ that emphasise a culture encompassing strong corporate governance, sound business practices and good ethical conduct.” The code applied to all staff of AWB Limited, its contractors and any one that is associated with the company or acting on its behalf. This is a broad application of the code that had to be read and complied with by all concerned.

The Managing Director expressed the nature of the policy underlying the code:

“At AWB we promote and demonstrate clearly that our business affairs and operations are at all times being conducted legally, ethically and in accordance with the highest standards of integrity and propriety. This is a fundamental principle of AWB’s operations and business affairs.

Our Code of Conduct is based on this principle and provides the foundation for the dealings and relationships on which our reputation with customers, suppliers and stakeholders is based.

Adherence at all times to these values and standards is essential. I will ensure that AWB maintains a reputation for high standards of business conduct, professionalism and integrity. We will ensure that AWB is proud of what it stands for as an organisation. No employee should ever feel that his or her conduct could not survive the test of public scrutiny.

I will adhere to the values and standards in the Code of Conduct and I require all of you, whatever your position within AWB, to do the same. By doing so we can be proud of our achievements as individuals and as a successful agribusiness.”

It is apparent that AWB Limited was diligent about maintaining currency of its policies. This is evident from the Code of Conduct that says:

“In addition to this Code, AWB also has policies and procedures that apply and are updated from time to time.”

Employees were required to read and comply with the up-to-date policies and procedures. They were also required “to comply with any investigations into concerns about breach of the Code, and AWB’s policies and procedures.” Also, employees are warned: “Retribution against a person for reporting or supplying information about a Code or policy concern is prohibited.”

A further warning to employees was the individual’s conduct. The Code says:

“Any person who breaches the Code of Conduct (including by failing to report a suspected breach, or by victimising another for reporting a concern) may be subject to discipline (Which may include termination of employment).”

The code has two components:

1. Business Practices
2. Personal Conduct.

The business practices section of the code requires:

- Avoidance of deceptive, unfair practice, fraud, misrepresentation, improper personal gain or any behaviour which would reflect badly on AWB;
- Honesty and good faith in all dealings and relationships;

- Respect for the trust placed in you to take proper care and protection of AWB assets, resources and information; and
- Ensuring that neither Interpretations of AWB's perceived interests nor loyalty to other staff members should be allowed to compromise or override the law or appropriate standards of ethical behaviour.

The code dealt with agency payments which may be required in some countries for a service or a contract. The code says about these payments that they "must only be made strictly in accordance with the policy guidelines and have the prior approval of the member of the Executive Leadership Group of the appropriate Division. All payments must be recorded and reported to the Managing Director within one month of payment." Later in the code, it says that "payments or benefits can only be given in accordance with the Commonwealth Criminal Code as amended or replaced." Not all payments of this kind are illegal or illegal at the time they were made<sup>58</sup>.

The legality of facilitation payments was also addressed:

"It is not illegal under the Commonwealth Criminal Code to provide a small benefit to a foreign public official in order to facilitate routine government action of a minor nature such as the granting of a visa or a permit."

This situation is based on routine government action that does "not involve decisions about whether to award new business, continue doing business or the terms of doing business." Despite this assurance and guidance, employees were warned that facilitation payments may be prohibited under local laws and that "AWB opposes the making of facilitation payments to speed up routine administrative services that should be provided without additional payment." Consequently, employees were required to resist payment to foreign officials. Employees who were uncertain about facilitation payments and the application of the Criminal Code were required to consult General Council.

The personal conduct part of the code required employees and other persons to adopt values to:

- Have integrity;
- Strive to be innovative;
- Be excellent in all ways;
- Have a sense of urgency;
- Be accountable and responsible; and
- Have an open working style.

Underlying these values is the expectation "that employees and people associated with AWB will be law abiding and will conduct themselves as good and responsible citizens and will avoid any indiscrete or anti-social behaviour that could affect their performance or which could adversely reflect on AWB."

The code also covered disclosure or misuse of AWB information, futures trading of grain futures contracts, and insider trading. It required the company and its employees to comply with the *Trade Practices Act 1974* in dealings with external parties by avoiding misleading or deceptive statements and avoiding collusive and anti-competitive conduct.

Non-compliance with the Code of Conduct is a further section of the code where it is recognised that breaches of the code may occur but these breaches must be inadvertent and without intent. However, where serious breaches occur, the code states:

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<sup>58</sup> See "Outrage as AWB wins tax break on Iraq kickbacks", *Australian Financial Review*, Thursday 21 December 2006 at 1, 4. The report states: "AWB confirmed...that the Australian Taxation Office had ruled the bogus trucking fees it paid to Iraq in breach of United Nations sanctions in order to secure wheat contracts were not bribes and qualified as legitimate business expenses."

“Where breaches are considered to be of a serious nature, penalties may be imposed ranging from counselling to dismissal. On such instances AWB will act objectively, fairly and equitably and consistent with any applicable provisions or requirements in an employment contract.”

Under the code, AWB Limited reserved its right “to inform the appropriate authorities where it is considered that there has been criminal activity or an apparent breach of the law.”

AWB Limited’s Code of Conduct is an excellent expression of the company’s policy to maintain ‘values’ that “emphasise a culture encompassing strong corporate governance, sound business practices and good ethical conduct.”

The Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme observed AWB Limited’s Code of Conduct which, according to the Commissioner, “professed an open, frank and cooperative culture.”<sup>59</sup> The Commissioner then examined this culture in view of the earlier public scrutiny on four separate occasions. He observed a “closed corporate culture that did not accord with the statements in AWB’s Code of Conduct.”<sup>60</sup> The Commissioner concluded:

“Although AWB’s approach to the investigations and inquiries with which it was confronted might be indicative of a closed corporate culture and was plainly contrary to the spirit, if not the letter, of its own Code of Conduct, such approach and conduct did not constitute a breach of any Commonwealth, State or Territory law. Rather, it was reflective of an attitude, established at the highest level in the company, that bodies with a legitimate interest in whether AWB’s activities accorded with proper standards of commercial conduct should be resisted in their endeavours to inquire into that issue. Whilst AWB was entitled to take such steps as it regarded appropriate to protect its legitimate commercial interest, in determining what were proper steps to be taken in that regard AWB appears to have overlooked the reputational consequences of its approach.”

It is clear that good policies and a well written code of conduct cannot prevent the risk of corruption. Directors need to be vigilant in overseeing such policies and investigate suspicious activity. Often this will require reports and consultations with staff and to some extent this reliance is all that directors have in uncovering risks of corruption and other inappropriate conduct. The experience of Enron Corporation as observed by the SEC’s Director referred to earlier seems to ring true for AWB Limited. A comprehensive Code of Conduct was not adhered to by employees. Their reasons for not complying with the Code will no doubt come out in future matters in the courts.

The Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme recommended that criminal charges and breaches under the Corporations Act be investigated by the Commonwealth Government and its agencies. The Commonwealth Attorney-General announced<sup>61</sup> the establishment of the task force that was recommended. The task force includes the Australian Federal Police, the Australian Securities and Investments Commission, and Victoria Police. The Director of Public Prosecution of the Commonwealth and Victoria will advise the task force. The task force’s manager is Mr Peter Donaldson of the Australian Federal Police who has experience in serious fraud, corruption and organised crime investigations.

### **Penalties applying to wrongful activities of directors**

There are now a range of penalties that can be applied to breaches of the *Corporations Act 2001*. A brief summary of a few penalties is given in this section to give a feel for the types of penalties that can apply. The practitioner needs to identify the breach and the relevant provision of the Corporations Act and note the penalty or penalties. Also, other provisions may also apply particularly where there are more than one breach and where the breach is subject to civil and criminal penalties.

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<sup>59</sup> *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme*, Volume 1: Summary, recommendations and background, Commissioner The Honourable Terence RH Cole AO RFD QC, November 2006 at 201.

<sup>60</sup> *Report of the Inquiry into certain Australian companies in relation to the UN Oil-for-Food Programme*, Volume 1: Summary, recommendations and background, Commissioner The Honourable Terence RH Cole AO RFD QC, November 2006 at 202.

<sup>61</sup> The Attorney-General, “Cole Inquiry Task Force Established”, *Media Release 254/2006*, 20 December 2006.

The Australian Securities & Investments Commission (**ASIC**) has powers to commence civil penalty proceedings or criminal proceedings where there is recklessness or intentional dishonesty, and take administrative action to do such things as banning persons from holding office.

Criminal proceedings are concerned with recklessness and not with carelessness or negligence even though these elements may be involved. Criminal proceedings can commence under *Corporations Act 2001*, s 1317P even though civil proceedings were taken for substantially similar conduct.

Injunctions can be sought by ASIC under *Corporations Act 2001*, s 1323 to prevent the disposal or transfer of assets where the person is being investigated or where civil or criminal proceedings have commenced. This provision is also available to other aggrieved persons. An injunction can also be sought under *Corporations Act 2001*, s 1324 to prevent continuing the conduct.

Other penalties are obtainable for actions involving disclosures such as prospectuses and other information involving the financial markets.

### Penalties applied by the courts for corporate wrongdoing

I have addressed the penalties of “white collar” crime in a previous conference paper<sup>62</sup>. I examined the findings of the courts in matters where prison sentences were imposed and where persons were disqualified from acting as a director. The cases examined are *ASIC v Vizard*<sup>63</sup>, *Regina v Rivkin*<sup>64</sup>, *R v Howard*<sup>65</sup>, and *R v Cooper*<sup>66</sup>. There have been further cases in relation to the HIH Insurance Ltd such as *R v Williams*<sup>67</sup>, *R v Cassidy*<sup>68</sup> and *R v Adler*<sup>69</sup>. I will draw on a few cases to give a feel for the course of action taken by ASIC and the courts.

#### *Sentencing of Mr Howard and Mr Cooper*

Mr Howard was given a sentence of three years’ imprisonment obliging him to serve two years. In giving the sentence the court said that in view of Mr Howard’s undertakings of future assistance, the sentence was suspended for immediate release. Mr Howard assisted the prosecution and the Royal Commission taskforce and much time was saved by attention being directed to particular areas and transactions. Among other things, Mr Howard assisted counsel and gave evidence against Mr Adler, Mr Williams, and Mr Federora in proceedings before the Supreme Court and committed to assist in further prosecutions.

Mr Cooper by contrast received a 7 years’ prison term for crimes under s 249B(2)(b) of the *Crimes Act*. Mr Cooper was not cooperative and maintained his lifestyle “by driving expensive cars, living in a residential apartment at Balmoral, staying at Hayman Island and gambling large sums of money at casinos.”<sup>70</sup> A comparison was also made by the court between the sentencing of Mr Howard and the sentencing of Mr Cooper. While there is some degree of correspondence between some of the offences in both cases, the court pointed to other factors that distinguish the two cases. Mr Cooper did not plead guilty and was subject to different charges. Mr Cooper offered a bribe to Mr Howard rather than the bribe being solicited from Mr Cooper and his conduct was more serious than that of Mr Howard as he was complicit in the breaches of trust by Mr Howard.

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<sup>62</sup> The conference paper, *Wrongful Activities of Corporate Officers*, can be viewed as a white paper on [www.iantuninstall.com](http://www.iantuninstall.com).

<sup>63</sup> *ASIC v Vizard* [2005] FCA 88; *ASIC v Vizard* [2005] FCA 1037.

<sup>64</sup> *Regina v Rivkin* [2003] NSWSC 447.

<sup>65</sup> *R v Howard* [2003] NSWSC 1249.

<sup>66</sup> *R v Cooper* [2006] NSWSC 609.

<sup>67</sup> *R v Williams* [2005] NSWSC 315.

<sup>68</sup> *R v Cassidy* [2005] NSWSC 410.

<sup>69</sup> *R v Adler* [2005] NSWSC 274.

<sup>70</sup> *R v Cooper* [2006] NSWSC 609 at para 273.

## **Sentencing of Mr Suleman**

Recently, ASIC announced the sentencing of Mr Karl Suleman by “the New South Wales District Court to seven years and four months in prison with a non-parole period of five years and six months.”<sup>71</sup>

ASIC investigated the operations of Karl Suleman Pty Limited. Mr Suleman later pleaded guilty on 1 May 2006 to 26 charges relating to the making of false statements to investors who were induced by Mr Suleman to enter agreements and invest \$3,185,000 and using false documents to induce an investor to invest \$1 million in the business of Karl Suleman Pty Limited.

The Chairman of ASIC said that the “jailing of Mr Suleman sends a strong message that people who misuse investors’ funds will be pursued and punished. ASIC will always act against individuals who misrepresent information and deliberately mislead and deceive investors.”

## **Mr Vizard’s disqualification from holding office**

Mr Vizard was banned from holding office for a period of 10 years. The period determined by the court was longer but the court discounted the period for mitigating circumstances<sup>72</sup>. The court made the following observation about directors and their fiduciary duties<sup>73</sup>:

“On a daily basis, a director of a large public company will come across information that is not available to the public or even to the company’s shareholders. According to the common law a director is denied the ability to use such information for his or her own purposes. It does not matter that the director’s action causes no harm to the company or does not rob it of an opportunity which it might have exercised for its own advantage: *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134. This rule admits of few exceptions. Parliament realised that the common law was too often ignored. The temptation to make an improper profit was too great. So Parliament decided to act. The Companies Acts were amended to create an offence if a director misused information obtained by reason of his fiduciary position.”

The sentencing of offenders is important to maintaining a high standard for fiduciaries as it sends a message to other corporate officers. The principles underlying sentencing are used by the courts in guiding the determination of civil penalties. The court in *ASIC v Vizard*<sup>74</sup> said:

“For most offences...the punishment imposed by the court is the means by which society expresses its moral condemnation of the offender. It also affirms that the particular law is worthy of obedience. If the punishment is unduly lenient there is the risk that the court will be perceived as endorsing the offender’s conduct.”

Disqualification from office is a significant measure for deterrence. *Rich v Australian Securities and Investments Commission*<sup>75</sup> made it clear that “a disqualification order can be imposed not only to protect the company’s shareholders against further abuse, but also by way of punishment and, importantly, for general deterrence.”<sup>76</sup>

## **Courts’ approach to disqualification from office**

In *Rich v ASIC*<sup>77</sup> the High Court considered on appeal a matter concerning discovery in relation to contraventions of the *Corporations Act 2001* such as disqualification of persons from managing corporations that were claimed by the New South Wales Court of Appeal to be purely protective and not punitive.

The majority judgment of the High Court allowed the appeal saying that the relevant provisions of the Corporations Act are punitive although they may have a protective quality. Consequently,

<sup>71</sup> ASIC, *Media Release 07-14*, “Karl Suleman jailed for seven years”, Wednesday 24 January 2007.

<sup>72</sup> *ASIC v Vizard* [2005] FCA 1037 at para 49.

<sup>73</sup> *ASIC v Vizard* [2005] FCA 1037 at para 28.

<sup>74</sup> *ASIC v Vizard* [2005] FCA 1037 at para 30.

<sup>75</sup> *Rich v Australian Securities and Investments Commission* (2004) 50 ACSR 242.

<sup>76</sup> *ASIC v Vizard* [2005] FCA 1037 at para 35.

<sup>77</sup> *Rich v ASIC* (2004) 220 CLR 129; 209 ALR 271.

the privilege against exposure to penalties was found to apply. According to the majority decision, "the privilege against exposure to penalties is one of a trilogy of privileges that bear some similarity with the privilege against incrimination. (The other two privileges are the privilege against exposure to forfeiture and the privilege against exposure to ecclesiastical censure.)" The privilege against penalties began in equity in relation to discovery but according to *Pyneboard Pty Ltd v Trade Practices Commission*<sup>78</sup> the privilege is recognised by the common law. The privilege against exposure to penalties has evolved to the point that it "now serves the purpose of ensuring that those who allege criminality or other illegal conduct should prove it"<sup>79</sup>.

Despite the attention given by the majority in *Rich v ASIC* to the privilege against exposure to penalties and related issues, the judgment of McHugh J is more helpful to the issue of disqualification. His Honour's decision agrees with the majority decision but it gives more attention to the issue of disqualification from office and said<sup>80</sup>:

"Fixed periods of disqualification suggest punishment rather than protective in the same way that disqualification from driving for a period is a punishment rather than an act protective of the public."

The process identified in the decision of Mc Hugh J for the courts in matters involving disqualification from office involves:

1. assessing the factors taken into account to determine if an order is to be made
2. if an order is made for disqualification what period of disqualification is to be given
3. subtract from the period mitigating circumstances.

McHugh J referred to the propositions formulated by Santow J in *Re HIH Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler*<sup>81</sup> to determine the length of time that a person should be disqualified from holding office. McHugh J warned that these propositions assumed "that a disqualification order is protective, rather than punitive. But, when examined, they track the various matters that judges take into account in the criminal jurisdiction when sentencing offenders."<sup>82</sup> His Honour then goes on to list the 15 propositions and distinguishes those that are protective in nature and the occasional propositions that are punitive. By listing the propositions and dealing with them in this manner, McHugh J does not dismiss them or overrule them. So they are helpful in assisting the process of determining the period for disqualification.

In making an order for disqualification from office the criteria used to assess a period of time are:

- defendant's character
- nature of the breaches
- structure of the company or companies and the nature of its or their business
- interests of shareholders, creditors and employees
- risks to others from the continuation of the defendant as a director
- honesty and competence of the defendant
- hardship to the defendant and to his or her personal and commercial interests
- defendant's appreciation that future breaches could result in future proceedings.

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<sup>78</sup> *Pyneboard Pty Ltd v Trade Practices Commission* (1983) 152 CLR 328 at 336.

<sup>79</sup> *Rich v ASIC* (2004) 220 CLR 129 referring to *Trade Practices Commission v Abbco Iceworks Pty Ltd* (1994) 52 FCR 96 at 129 per Burchett J.

<sup>80</sup> *Rich v ASIC* (2004) 209 ALR 271 at 284.

<sup>81</sup> *Re HIH Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* (2002) 42 ACSR 80 at 90.

<sup>82</sup> *Rich v ASIC* (2004) 209 ALR 271 at 287. McHugh J refers to *Elliott v Australian Securities and Investments Commission* (2004) 48 ACSR 621 at 658 where the Court of Appeal of the Supreme Court of Victoria said: "Many of the propositions and factors listed by Santow J bear a similarity to sentencing principles. Matters going to aggravation and mitigation in relation to contraventions of s 588G [of the Corporations Law] need to be considered and accorded proper weight. But above all else protection of the public and deterrence, specific and general, must also be given appropriate consideration."

Other factors can be drawn from other cases such as *ASIC v Petsas*<sup>83</sup> and *Regina v I R Hall [No 2]*<sup>84</sup>.

The elements for assessing the period of disqualification relates to the length of time:

1. Periods over 25 years:

- large financial losses
- high propensity that the defendant may engage in similar activities or conduct
- activities undertaken in fields in which there was potential to do great financial damage such as in management and financial consultancy
- defendant's lack of contrition or remorse
- disregard for the law and compliance with corporate regulations
- dishonesty and intent to defraud
- previous convictions and contraventions for similar activities.

2. Periods from 7 to 12 years:

- serious incompetence and irresponsibility
- substantial loss
- fact that the defendant had engaged in deliberate courses of conduct to enrich himself or herself at others' expense, but with lesser degrees of dishonesty
- continued, knowing and wilful contraventions of the law and disregard for legal obligations
- lack of contrition or acceptance of responsibility, although that must be weighed against the prospect that the defendant may reform.

3. Periods up to 3 years:

- although the defendant had personally gained from the conduct, he or she had endeavoured to repay or partially repay the amounts misappropriated
- defendant had no immediate or discernible future intention to hold a position as manager of a company
- defendant had expressed remorse and contrition, acted on advice of professionals and had not contested the proceedings against him or her.

These propositions and elements for determining disqualification from office seem to afford corporate crime as a special type of crime or “white collar” crime. There is a risk that the courts will be lenient in cases because they are dealing with consequences of the wrongdoing rather than attending to the lack of consciousness for care and diligence or indeed the conscious determination of the wrongdoer to defraud others. Corporate officers must know that they are stewards and that their actions or inactions are for the benefit of the corporation and its owners and not for personal interests.

McHugh J was concerned about showing the disqualification from office provisions of the Corporations Act were punitive<sup>85</sup>:

“Both Santow J's list of propositions and the comments of the Victorian Court of Appeal indicate that the factors taken into account in the criminal jurisdiction – retribution, deterrence, reformation, contrition and protection of the public – are also central to determining whether an order of disqualification should be made under the *Corporations Act* and, if so, the appropriate period of disqualification. Those factors also support the conclusion that the jurisdiction exercised under this part of the *Corporations Act* cannot properly be characterised as purely protective.”

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<sup>83</sup> *ASIC v Petsas* [2005] FCA 88 at paras 18-19.

<sup>84</sup> *Regina v I R Hall [No 2]* [2005] 890 at para 88.

<sup>85</sup> *Rich v ASIC* (2004) 209 ALR 271 at 289.

It is not clear if McHugh J was consciously aware of the need to treat the criminal acts of corporate officers committed under the Corporations Act as crimes receiving appropriate criminal penalties and to not treat them as “white collar” crimes thus attracting a lighter sentence. Later in the decision, His Honour referred to the decision of Bryson J in *Re One.Tel Ltd (in liq); Australian Securities and Investments Commission v Rich*<sup>86</sup> where he said that “not much is to be gained from considering or attempting to classify periods of disqualification which have been imposed in other cases.”<sup>87</sup> Consequently, McHugh J said:

“Each decision is closely related to its own facts, which tend to be highly complex. Further, the circumstances of each defendant are special to that person<sup>88</sup>.”

The reason for this approach to determining disqualification from holding office is because “breaches of the *Corporations Act*, the circumstances of the breaches and the outcomes of the breaches, including the number of persons and the value of the interests affected, may take many forms. In addition, the personal circumstances of persons in breach vary greatly<sup>89</sup>.”

In *Re One.Tel Ltd (in liq); Australian Securities and Investments Commission v Rich*<sup>90</sup> Bryson J determined a 10 year period of disqualification for Mr Bradley Keeling and it is interesting reading the reasons given with emphasis given by McHugh J in *Rich v ASIC*:

“Severe though the expression is, I have to say that the admitted facts show incompetence. To be managing director of a public company, and not to know or find out, by a margin of tens of millions of dollars, its current cash position, or by a margin of hundreds of millions of dollars its need for cash, reveal incompetence of a high order. It is also important to say that the facts show nothing in the nature of dishonesty or other moral failing. His practical expressions of contrition and the financial remedy which he has submitted to favour amelioration of the disqualification, and favour selection of a period which will leave to him some prospect that, late in his career, he may again participate in the management of companies. I do not think it would be right to impose a term of disqualification which, in practical terms, would close off forever a return to the kind of management occupation he has followed for the last 2 decades.” (emphasis added)

Mitigating circumstances taken into account by Bryson J in reducing the period of disqualification included Mr Keeling “acknowledging his breaches, expressing appropriate contrition and agreeing to be subject to remedies including judgment for an enormous sum”.<sup>91</sup>

This approach to applying criminal law propositions to matters involving corporate wrongdoing needs to go further to acknowledge the underlying premise that corporate officers, when committing the wrongdoing, do not consider the consequences of their actions and ultimately the persons who are affected by the actions. This premise is akin to the wrongdoings of persons who commit terrorist acts. The action of terrorism does not include considering the persons who will be killed or injured. It is indiscriminate. Wrongdoings of corporate officers are similarly indiscriminate. It is this factor, the indiscriminate consequences of the actions of wrongdoers that should be the focus of the courts in applying sentences. This means that the maximum penalty should be imposed and then mitigating circumstances considered and weighed against the sentence.

## **A look at terrorist acts and penalties for terrorism**

The acts of terrorism have a major indiscriminate consequence for the persons who are harmed. On this basis a comparison might be made with the wrongful acts of corporate officers who fail to consider those who will be harmed by their criminal actions.

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<sup>86</sup> *Re One.Tel Ltd (in liq); Australian Securities and Investments Commission v Rich* (2003) 44 ACSR 682.

<sup>87</sup> *Re One.Tel Ltd (in liq); Australian Securities and Investments Commission v Rich* (2003) 44 ACSR 682 at 692.

<sup>88</sup> *Re One.Tel Ltd (in liq); Australian Securities and Investments Commission v Rich* (2003) 44 ACSR 682 at 691 per Bryson J, citing *Re HIH Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* (2002) 42 ACSR 80 at 97-99 per Santow J.

<sup>89</sup> *Re One.Tel Ltd (in liq); Australian Securities and Investments Commission v Rich* (2003) 44 ACSR 682 at 692 per Bryson J.

<sup>90</sup> *Re One.Tel Ltd (in liq); Australian Securities and Investments Commission v Rich* (2003) 44 ACSR 682.

<sup>91</sup> *Re One.Tel Ltd (in liq); Australian Securities and Investments Commission v Rich* (2003) 44 ACSR 682 at 693.



courts need to attend to the mind of the person at the time they contemplated the wrongful acts and not an after-event view in assessing mitigating circumstances.

### Corporate regulation and corporate compliance

Rather than concentrate on penalties for wrongdoing, corporate officers should focus on compliance with the law and ensuring good corporate governance of their corporations including providing an environment for employees to participate without the risk of corruption, misconduct or other wrongdoing. There is no doubt, given the increasing regulation of the *Corporations Act 2001* and other legislation that the actions of past corporate officers have introduced uncertainties into the management and regulation of corporations. The government needs a clear strategic approach to corporate regulation to avoid over-regulation and punishing many because of the errors of a few. There needs to be a response that encourages corporate officers to comply with the law and carry out their duties with care and diligence and to demonstrate publicly their compliance culture.

Comparing the corporate environment with that of the terrorist, similar issues arise. *Protecting Australia Against Terrorism*<sup>93</sup>, the White Paper on Terrorism, says:

“Terrorism has introduced new uncertainties to Australia’s security environment that requires us to maintain a clear strategic response, underpinned by robust and sustainable capabilities. However, we must also be capable of responding effectively to any threat that emerges quickly and unpredictably and affects our people and interests.”

A similar type of response could be given to ensure that corporate collapses are avoided as corporate officers would take sufficient care and exercise diligence to ensure good corporate governance. The Chairman of the Australian Securities & Investments Commission (**ASIC**) said in a speech<sup>94</sup> to the Australian Institute of Company Directors that ASIC’s approach to regulation is to start with the premise that directors are expected to comply with the law. The Chairman referred to “five foundation responsibilities for directors” that directors are expected to:

- comply with the statutory duty of due care and diligence – that is, discharge your duties with the degree of care and diligence that a reasonable person would exercise if they were a director of the company in the company’s circumstances and occupied the office held by and had the same responsibilities within the company as the director;
- exercise your powers and discharge your duties in good faith in the best interests of the company and for a proper purpose;
- not improperly use your position to gain advantage for yourselves or someone else or cause detriment to the company;
- not improperly use information you obtain as a director to gain an advantage for yourself or someone else or cause detriment to the company;
- disclose to other directors any material personal interest in a transaction.

The *Corporations Act 2001* provisions appear to be sufficient. The Corporations and Markets Advisory Committee (**CMAC**) has examined the duties of directors in recent times and reported that they are adequate and should be extended to persons other than directors and executives.

ASIC’s Deputy Chairman observed<sup>95</sup> that directors of large public companies “feel somewhat besieged by regulatory change, complexity and a perception that there is an ever increasing risk of personal liability. On these issues, perception is reality because what directors believe will affect the way they behave. In a number of areas, excessively cautious and risk-averse behaviour is creating regulatory challenges.” He also said:

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<sup>93</sup> *Protecting Australia Against Terrorism*, Commonwealth of Australia, 2004 at p 58.

<sup>94</sup> Lucy J AM, “Directors’ Responsibilities: The reality vs the myths”, Australian Institute of Company Directors, 17 August 2006, Melbourne Australia.

<sup>95</sup> Cooper J, “Working with Australian company directors”, Federal Court of Australia/Law Council of Australia Joint Corporations Law Seminar, Sunday 26 march 2006, Federal Court, Sydney.

“When it comes to company directors, ASIC is really in the behaviour management business. We are seeking to have directors comply with the law with the least possible intervention from us....There are, of course, times when we do take enforcement action directly against directors, such as in the *OneTel* proceedings, but this is where no other regulatory response is thought to be appropriate.”

The Deputy Chairman said<sup>96</sup> that one of the key areas for ASIC is to listen “more closely and intimately to what company directors think.” This involved establishing a consultative panel that meets three or four times a year. The panel is intended to operate on a confidential and informal basis. The panel complements other consultation mechanisms with industry bodies, professional associations and direct contact with corporations.

ASIC intends to get quick messages to the market where circumstances require such a response<sup>97</sup>.

These measures by ASIC should assist in encouraging a better approach by corporate officers to comply with the law and exercise care and diligence.

### Scoring 25 years for corporate fraud

It is possible for corporate officers to be given a prison sentence of 25 years or more if the propositions given by Santow J in *Re HIH Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler*<sup>98</sup> is a guide. However, it can be seen that each matter of corporate wrongdoing including fraud is considered on its merits as McHugh J said in *Rich v ASIC*.

The experience of the United States in dealing with corporate crime and other wrongdoings seems to be similar with the approach taken by the courts in Australia. Former corporate officers have received and continue to receive prison sentences. Other persons have been banned from holding office of corporations for periods of time. These persons and others have been imposed with civil penalties and requirements to pay sums for penalties and monies for disbursement to those who lost money in investments.

For corporate officers it is essential that they take care and exercise diligence in performing their duties. The general law duties are increasing as the general law identifies more duties in response to corporate collapses and scandals.

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<sup>96</sup> Cooper J, “Working with Australian company directors”, Federal Court of Australia/Law Council of Australia Joint Corporations Law Seminar, Sunday 26 march 2006, Federal Court, Sydney.

<sup>97</sup> Cooper J, “Working with Australian company directors”, Federal Court of Australia/Law Council of Australia Joint Corporations Law Seminar, Sunday 26 march 2006, Federal Court, Sydney, referring to “the results of the first wave of non-binding votes on remuneration reports”.

<sup>98</sup> *Re HIH Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* (2002) 42 ACSR 80 at 90.



**About Ian Tunstall**

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