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Regulatory Enforcement of Directors' Obligations

Aspects of proceeding against, and defending, directors in regulatory proceedings

RCA Higgins SC*

1. In *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291, at [14], Justice Middleton described the role of a director in these terms:

> A director is an essential component of corporate governance. Each director is placed at the apex of the structure of direction and management of a company. The higher the office that is held by a person, the greater the responsibility that falls upon him or her. The role of a director is significant as their actions may have a profound effect on the community, and not just shareholders, employees and creditors.

2. The social significance of the director's role has long been recognised by statute in Australia.

3. Australia's was the first common law jurisdiction to legislate for directors' duties, in 1896. It was, likewise, the first to introduce the public enforcement of those duties in 1958.[1]

*Barrister, Banco Chambers, Sydney; Fellow, Australian Academy of Law.

[1] *Companies Act 1896* (Vic); Hedges *et al*, "The Policy and Practice of Enforcement of Directors' Duties by Statutory Agencies in Australia: An Empirical Analysis" (2017) 40(3) *Melbourne University Law Review* 905 at 911; R McQueen, "Limited Liability Company Legislation — The Australian Experience" (1991) 1

4. In his paper, Justice Jackson has addressed certain aspects of the civil penalty regime introduced into Australia, in 1993, which marked a departure in the enforcement of directors' duties in this country.

5. Prior to that regime, enforcement typically took the form of criminal proceedings commenced by the Commonwealth Director of Public Prosecutions, seeking custodial sentences, compensation orders and the remedies otherwise available under the *Crimes Act 1914* (Cth). Automatic disqualification followed a criminal conviction.

6. The current regime, set out in Part 9.4B of the *Corporations Act 2001* (Cth), has expanded beyond an application merely to directors' duties, to encompass the manifold civil penalty provisions identified at s 1317E of that Act.

7. With the introduction and augmentation of that regime, criminal, civil and administrative proceedings can be available in respect of essentially the same conduct by a director. The sanctions available range from custodial sentences to enforceable undertakings and stand-alone disqualification orders. This expanding jurisdiction has typically involved sanctions that supplement, as opposed to supplanting, existing ones. There are exceptions, such as the decriminalisation, in 1999, of the duty to exercise reasonable care and diligence. But the trend has overwhelmingly been one of expansion and not contraction.

8. This widening legislative horizon means that—both for regulators considering commencing proceedings against directors and advisors acting for directors—a once somewhat prosaic legal context, now appears more like a mosaic.

Australian Journal of Corporate Law 22, 36ff; Keay and Welsh, "Enforcing Breaches of Directors' Duties by a Public Body and Antipodean Experiences" (2015) 15 *Journal of Corporate Law Studies* 255.

9. The focus of my comments will be on certain forensic and ethical aspects of commencing and conducting proceedings enforcing the regulatory obligations of directors. I propose to view this in turn from the different perspectives of advising a plaintiff regulator and a defendant director.

10. I will begin, as we must, with the law. The most basic matter, both in bringing and defending proceedings, is a correct analysis of the legal relation between a director and a corporation, situated in the factual substratum of the impugned conduct.

11. I will then turn to the issue of representing directors in pre-trial investigations. Almost all regulatory proceedings begin as investigations. Many of those are commenced by notices that in terms contemplate the several possibilities of criminal, civil or administrative proceedings. Acting for directors in such investigations gives rise to several complex legal and ethical issues.

12. I will then come to forensic and ethical aspects of commencing a proceeding for a plaintiff regulator.

13. Finally, I will consider certain strategic and forensic issues that arise in the conduct of a civil penalty proceeding for a defendant director.

The Legal Relation

14. When a corporation does things, it involves an actual, physical extension of conduct. Physical extensions of conduct may be any of the things done by a corporation. That involves four relational aspects:

    a. between an act of wrongdoing and a natural person;

    b. between that natural person and a corporate person;

c. between the wrongdoing and the person(s) against whom the wrong is done;

d. between the thing done and a sanction that is meaningful.[2]

15. The physical extension of conduct is usefully conceived as a combination of all of the human actions and engagements that bring it about. However, it must ultimately resolve in the practical attribution of acts among legal persons.

16. That practical process began some time ago with the attribution, to corporations, of legal personhood, via a fiction.[3] Mid-20th century jurisprudence saw the emergence of the "operating mind" or "identification theory" of corporate liability. The search here was for the "operating mind" of the corporation. That theory found its central expression in *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153 at 170-171 (Lord Reid). The *Tesco* principle was accepted by the High Court in *Hamilton v Whitehead* (1988) 166 CLR 121. *Hamilton v Whitehead* also took up the idea, in the civil penalty context, of holding a corporation liable as principal with directors liable as aiders and abettors, or of being "knowingly concerned" in the corporation's conduct. And so the High Court said (at 128) that: "the company, being a legal entity apart from its members, is also a legal person apart from the legal personality of the individual controller of the company, and [the controller] in his personal capacity can aid and abet what the company speaking through his mouth or acting through his hand may have done."

17. The *Tesco* theory of attribution has limitations. One is the inadequacy of the scope of conduct actually caught. There are others, including, significantly, the problem

[2] See, generally, A Somek, *The Legal Relation: Legal Theory After Legal Positivism* (Cambridge: Cambridge University Press, 2017); C Wells, *Corporations and Criminal Responsibility* (Second Edition) (Oxford: Oxford University Press, 2005).

[3] See further, *Salomon v A Salomon & Co Ltd* [1896] UKHL 1.

that the liability of the corporation will, in any given case, depend upon the actual structure and size of the corporation.

18. The Privy Council corrected much of this in *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500. That decision attributed the knowledge of an officer of a corporation to that corporation without finding that the officer was its "directing mind and will". The decision involved consideration of three sets of rules (at pp. 506-507):

    a. primary rules of attribution contained within company instruments, such as the company constitution or articles of association;

    b. general rules of attribution, including those that apply equally to natural persons, such as the principles of agency;

    c. specific rules of attribution, such as the organic or "directing mind and will" theory and rules of attribution based on statute.

19. *Meridian* extended the acts, and states of mind, of a corporation to a person; such as a Chief Information Officer, in the matter of criminal liability in notifying changing asset interests to the regulator. This is the "attribution" theory of liability. This liability was direct and essentially an extension of *Tesco*. The two could, and do, stand side by side.

20. Theories of "aggregation" or accretion have emerged, which essentially involve a process of essentially adding up all the physical acts and the mental states engaged.

21. It can thus be seen that the points of intersection between the conduct of a corporation and its directors are myriad.

22. A common case will be one of alleged ancillary liability of a director for a contravention or offence in which the corporation acts as principal. This could include a director aiding and abetting a corporation in its crime, according to the criterion set in *Hamilton v Whitehead*.

23. In certain cases, the corporation and its director may both be named as principal contraveners of statutory provisions.

24. Recent jurisprudence suggests a developing interaction between a corporation's continuous disclosure obligations and directors' duties of care and diligence. For example, in *ASIC v Vocation Ltd (in liq)* [2019] FCA 80, Justice Nicholas held that Vocation had contravened the continuous disclosure obligations prescribed by s 674 of the Corporations Act and the prohibition on misleading or deceptive conduct in s 1041H of that Act, in its answers to a due diligence questionnaire in respect of the private placement. Vocation's chief executive officer had contravened the duty of care and diligence under s 180 of the Act in causing or permitting Vocation's contravention of both provisions. So too, Vocation's chief financial officer and company secretary had contravened s 180 of the Act in respect of representations made to the underwriter in response to the due diligence questionnaire. Similar reasoning can be seen in the recent case of *ASIC v Big Star Energy Ltd (No 3)* (2020) 148 ACSR 334 (Banks-Smith J). [4]

25. There will be cases where multiple plaintiffs may present themselves for a suit: claims for breach by a director of his or her of fiduciary duties at general law and of statutory duties may be brought by ASIC; by the corporation after a change of control

[4] See, the Hon. Justice A Black, "Some issues in enforcement of directors' duties" Paper delivered in LAW5357 Corporate governance and directors' duties Monash University, 29 October 2020.

or management, against a former director or employee, or by a liquidator. Possible too, are derivative claims, including under s 237 of the Corporations Act.

26. Inchoate offences or contraventions may also be alleged, derivative of primary breaches.

27. These questions of relational nexus, and attribution of acts, will be fundamental to framing and defending any claim involving alleged breaches of a director's duties.

28. It is convenient then to turn to the investigatory stage.

The Investigatory Stage

29. At the investigatory stage, it is commonplace for a law firm to be retained for a corporation, and for other law firms or individual barristers to be retained for officers and employees, if there is any apprehension of a possible conflict between that person and the corporation itself.

30. The solicitor or barrister acting for a director in such a context, confronts various issues. Some common, while not exhaustive, matters include the following.

31. *First*, it will be necessary to identify whether the officer or employee has an express or implied contractual duty to cooperate with the investigation, and what the proper limits of that duty are. In particular, it will be critical to assess whether such duties yield to, or override, any privilege against self-incrimination.

32. *Secondly*, regard must be had to the terms of any statutory duty to cooperate, such as those imposed by ss 19 and 30 of the *Australian Securities and Investments Commissions Act 2001* (Cth), and s 155 of the *Competition and Consumer Act 2010* (Cth); and any limits, protections, or obligations of confidentiality, that flow from these.

33. *Thirdly*, it will be necessary to identify any privilege against exposure to penalty, for example, s 1349 of the Corporations Act and s 68 of the ASIC Act.

34. *Fourthly*, it will be important to consider the implications of cooperating other than under a statutory obligation, such as in a voluntary interview, and the loss of protections this may entail for an individual director.

35. *Fifthly*, any limits on indemnities provided by the corporation to the director must be identified, such as that prescribed by s 199A of the Corporations Act.

36. Just as ascertaining the precise legal relation that underpins the attribution of acts will be basic to defending a proceeding, identifying and protecting the interests of a director from the very beginning of an investigation will be critical.

Commencing Proceedings

37. The decision to commence proceedings lies with the regulatory agency itself.

38. That decision will be informed by various policy and legal considerations.

39. The policy triumvirate that underpinned introduction of the civil penalty regime in 1993 can be discerned from the Cooney Report,[5] being that:

    a. civil enforcement be given primacy over criminal enforcement;

    b. sanctions should be imposed according to a pyramid model of enforcement, being a model with:

[5] "Company Directors' Duties", Report by Senate Standing Committee on Legal and Constitutional Affairs, November 1989.

i. a prescriptive aspect: i.e., a regulator should consider a spectrum of sanctions and regulatory strategies ordered according to their degree of intervention into affairs;

ii. a predictive aspect: i.e., if a regulator complies with the prescriptive aspect of the model, the severity of the sanction will be inversely correlated to the frequency with which it is applied;

c. setting sanctions at a sufficient level to deter corporate misconduct.

40. These principles have aged well, and have been supplemented with other priorities, including the increased regulatory urgency issuing from the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*.

41. It is difficult to understate the seriousness of a decision criminally to prosecute an individual. The seriousness of civil pecuniary penalty proceedings is objectively lesser; but, nonetheless, utterly serious.

42. And the rigour that should be brought to that decision cannot be understated.

43. In his recent book, *Doing Justice*,[6] Preet Bharara, the former U.S. Attorney for the Southern District of New York, recalls an episode where Judge Learned Hand, testifying before the United States Congress, endorsed a phrase attributed to Oliver Cromwell in 1650 (in a quite different context). It was, Judge Hand suggested, a phrase that should be "written over the portals of every church, every school, and every courthouse of every legislative body in the United States." The phrase was: "I beseech ye, in the bowels of Christ, think that ye may be mistaken".

[6] *Doing Justice: A Prosecutor's Thoughts on Crime, Punishment and the Rule of Law* (London: Bloomsbury, 2019), at p. 46.

44. Intelligent self-doubt and rigour are critical in the process of advising decision-makers. Once a fully informed decision has been made, it should be pursued with vigour, but until that point, it should be tested in every respect.

45. The role of a professional advisor will often be directly circumscribed by guidelines such as the *Prosecution Policy of the Commonwealth*, applicable to the making of decisions in the prosecution process.

46. As that Policy identifies, at [2.4], the initial consideration in the exercise of the discretion to prosecute or not prosecute is whether the evidence is sufficient to justify the institution or continuation of a prosecution. A prosecution should not be instituted or continued unless there is admissible, substantial and reliable evidence that a criminal offence known to the law has been committed by the alleged offender. Put negatively, a prosecution should not proceed if there is no reasonable prospect of a conviction being secured. In determining whether there is sufficient evidence to prosecute a case, the CDPP must be satisfied that there is prima facie evidence of the elements of the offence and a reasonable prospect of obtaining a conviction. In addition, it must be evident from the facts of the case, and all the surrounding circumstances, that the prosecution would be in the public interest.

47. In other civil regulatory contexts the standard will be either one of reasonable grounds or reasonable prospects of success.

48. Reasonable grounds will require a conclusion that the case to be brought is logically rational, coherent, plausible and fairly arguable having regard to what is presently known and what might reasonably transpire by way of future fact-finding.

49. The standard for reasonable prospects is familiar, and requires that sufficient material is available for a practitioner to have a reasonable belief that “provable facts”

and the law justify commencing proceedings.[7] There is a continuing obligation to ensure that a claim or a defence is not so lacking in merit or substance as to be not fairly arguable.

50. Assuming that each defendant to a proceeding has been properly joined, the composition of the proceedings may then be significant both to how they are conducted and the prospect that they will be resolved before hearing.

51. As to the conduct of the proceeding, the presence of director defendants maintaining the privilege against penalty may present procedural and substantive interruptions in a regulatory proceeding; although a regulator plaintiff will almost always the benefit of having exercised compulsory powers before commencing.

52. As to resolution, a proceeding against a corporate entity and one of its current senior officers may be less likely to settle than one against a corporation and a former officer able to be designated as in some respect rogue in his or her conduct.

53. The more the incentives of related defendants nest within each other, the less likely resolution may be, particularly if the personal and professional consequences for an individual are stark.

54. So too, a proceeding against multiple corporate or individual defendants may produce divergent incentives for separate entities, keen to optimise discounts on penalty by settling early in proceedings, and where the principle of parity might properly be applied by the Court on penalty.

[7] *Firth v Latham and Ors* [2007] NSWCA 40 (Santow JA, McClellan CJ at CL and Hoeben J).

Conducting Civil Penalty Proceedings

55. We can come then to the proceeding itself, and assume again the position of an advisor to a defendant director.

56. As Justice Jackson has identified, the salient protections currently conferred by penalty privilege are:

    a. A defendant is not obliged to give discovery.[8]

    b. A defendant is relieved against the requirements to plead a defence in accordance with the civil pleading rules.[9]

    c. A defendant is relieved against the requirements to disclose evidence to be relied upon before trial.[10]

57. If the defendant director maintains the penalty privilege:

    a. The ability to cross examine the plaintiff's witnesses is preserved.[11]

    b. The maintenance of the privilege does not affect the defendant's ability to run a positive defence *after* the plaintiff closes its case, which has not been raised on the pleadings.[12]

    c. As a corollary, the regulator plaintiff may obtain leave to file further evidence, file a case in reply or be granted an adjournment.[13]

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[8] *ASIC v Rich* (2004) 220 CLR 129 (Gleeson CJ, McHugh, Gummow, Hayne, Callinan and Heydon JJ, Kirby J dissenting).

[9] *MacDonald v ASIC* (2007) 73 NSWLR 612 (Spigelman CJ, Mason P and Giles JA).

[10] *ASIC v Berndale Capital Securities Pty Ltd* [2019] FCA 595 (O'Bryan J).

[11] *ASIC v Rich* (2009) 75 ACSR 1; (2009) 236 FLR 1 at [44]-[49] (Austin J).

[12] *ASIC v Mining Projects Group Ltd & Or*s (2007) 164 FCR 32 (Finkelstein J).

[13] *ASIC v Rich* [2005] NSWSC 1187, [3] and [30] (Austin J).

58. Significantly, the rule in *Jones v Dunkel* will apply to proceedings for a civil penalty where penalty privilege has been claimed.[14] While a defendant is not required to give evidence, inferences can be drawn, within the familiar parameters, from the failure to do so.

59. Also of significance, is the fact that the assertion of the privilege is a position that must be maintained across the entirety of the conduct of the proceeding.

60. A critical consequence of this, is that *any conduct* that advances a positive case or defence is capable of being inconsistent with maintenance of the privilege against penalties, and forfeit it, consistent with the basic principle in *Mann v Carnell* (1999) 201 CLR 1.

61. An example of this consequence flowing from cross-examination can be found in *Chong & Anor v CC Containers Pty Ltd & Ors* (2015) 49 VR 402. There, at [200] Redlich JA (Santamaria and Kyrou JJA agreeing) said this:

> …the manner in which the defence of Neale was conducted constituted the advancement of a positive defence inconsistent with the maintenance of the privilege, assuming that it had been validly claimed. It may therefore be characterised as a waiver of his privilege. As observed in *Reid v Howard*,[15] privilege against self-incrimination may be waived. Fairness is central to the question whether a party's conduct should be construed as waiving their privilege.[16] If a party by his or her conduct expressly or

[14] *Adams v Director of the Fair Work Building Industry Inspectorate* (2017) 351 ALR 379 at [147] ((2017) 351 ALR 379); *Adler v ASIC* (2003) 46 ACSR 504 (Mason P, Beazley and Giles JJA); *Communications, Electrical, Electronic, Energy, Information, Postal, Plumbing and Allied Services Union of Australia v ACCC* (2007) 162 FCR 466 (Weinberg, Bennett and Rares JJ); *ASIC v Fortescue Metals Group Ltd (No 5)* (2009) 264 ALR 201 (Gilmour J).

[15] (1995) 184 CLR 1 12.

[16] *Attorney-General (NT) v Maurice* (1986) 161 CLR 475.

impliedly discloses or makes an assertion about matters to which privilege would apply, fairness to the other party may dictate that the party's conduct should be taken as a waiver of any privilege attaching to that matter. In *Mann v Carnell*,[17] Gleeson CJ, Gaudron, Gummow and Callinan JJ stated, in the context of legal professional privilege**,** that it is 'inconsistency ... between the conduct of the client and maintenance of the confidentiality' which effects a waiver of the privilege.[18] The making of express or implied assertions about the content of the subject matter of the privilege while at the same time seeking to maintain the privilege gives rise to the inconsistency.[19] Had Neale wished to preserve the benefit of his claim of privilege, and in due course object to answering particular questions, his counsel would have been entitled to inform the judge that he would undertake no cross-examination of witnesses that involved advancing any affirmative case. That he did not do but rather, by the means we have referred to, sought to place his affirmative case before the trial judge. His reliance upon the privilege was impliedly waived.

62. Counsel acting for an individual defendant must be awake to each forensic choice taken throughout the proceeding and whether it trespasses upon the fair maintenance of the privilege.

63. Finally, if a defendant director waives the penalty privilege, in relation to the facts for which the penalty was waived, the defendant may be compelled to give evidence:

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[17] (1999) 201 CLR 1.

[18] *Ibid* 13, [29].

[19] *Council of the NSW Bar Association v Archer* (2008) 72 NSWLR 236, 250–2 [46]–[48] (Hodgson JA, with whom Campbell JA agreed).

a. In *Australian Securities and Investments Commission v Mining Projects Group Ltd & Or*s (2007) 164 FCR 32, at [22]-[24], Justice Finkelstein concluded that a person who has made a statement before trial can be compelled to repeat that statement in Court. However, a defendant who admits a particular fact in his defence does not thereby waive his right to claim the privilege for all other facts. That is to say, the waiver goes no further than what has been admitted or asserted.[20]

b. In *Fair Work Ombudsman v Hu* [2017] FCA 1081, Justice Rangiah found that the defendant had waived the penalty privilege in respect of admissions and positive assertions of fact made in the defence. The result of this waiver was that the defendant "could be compelled to provide affidavits dealing with the matters in respect of which privilege has been waived" (at [23]). However, the defendants were otherwise not required to provide affidavits or submissions dealing with factual issues prior to the close of the applicant's case, as there had been no waiver at large ([38]).

64. My comments have necessarily provided only an overview of an area that should always be travelled with great care and precision, irrespective of whether one acts for a plaintiff regulator or a defendant director.

[20] See further, P Spender, "Negotiating the Third Way: Developing Effective Process in Civil Penalty Litigation - Case Notes; *Macdonald v ASIC*; *ASIC v Mining Projects Group Ltd*" (2008) 26(4*) C&SLJ* 249; D Lussier and A Tsacalos, "Two Kinds of Privilege: Self-incrimination Privilege and Legal Professional Privilege - Case Note; *ASIC v Mining Projects Group Ltd* (2008) 5(6) *CPNN* 64; V Comino, "Effective Regulation by the Australian Securities and Investments Commission: The Civil Penalty Problem" (2009) 33 *Melbourne University Law Review* 802.