Corporate culpability, stepping stones and Mariner – contention surrounding directors’ duties where the company breaches the law

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1. Introduction

A number of matters recently reported in the press have highlighted the contentious issue of the appropriate nature and extent of directors’ liability where a company is in breach of the law. These include alleged kickbacks paid by a major listed company, an alleged emissions cheating scandal and allegations of widespread industrial law breaches within a major convenience store chain. These scenarios raise policy issues as to whether imposing liability on directors (in addition to, or instead of, the company) is a more effective deterrent than fining the company involved. In terms of criminal sanctions, companies cannot be incarcerated and any fines imposed ultimately impact on shareholders and other stakeholders such as creditors and suppliers. Where the risk of liability is slight and the punishment light such fines may also be seen as the cost of doing business, thus lessening the deterrent value of liability. The imposition of liability on individuals has been argued to be more effective in this respect.

Another policy issue concerning the liability of individual officers where the company breaches the law surrounds the question of whether shareholder complicity is relevant – does it make a difference whether shareholders know (or ought to know) that the company is breaching the law? For example, should an investor who buy shares in a company named ‘Poached Pets Ltd’ with the slogan ‘No animal so rare we can’t snare’ be taken to assume the risk that the company could be penalized for breaching the law so that the imposition of a fine on the company (and consequent diminution of the value of the investor’s shares) is seen to be justifiable in policy terms? Is this different to buying shares in an international transport company that happens to be paying bribes to foreign officials without any hint of this being evident to the investing community?

Although in policy terms there appears to be a difference in terms of whether the imposition of a fine on the company (instead of the imposition of penalties on the directors or officers involved) is justifiable in these two examples, the underlying issues are not straightforward. Measuring shareholder complicity clashes with core company law precepts such as the separate legal entity and limited liability doctrines, which reduce the need for shareholders to monitor the company’s performance and therefore encourage investment and entrepreneurialism. In addition stakeholders such as creditors, suppliers and employees are also affected by the imposition of fines on companies and may have no means of detecting wrongdoing and the risk of penalties.
There are currently a number of ways in which directors may be liable in situations in which the company breaches the law. In some cases direct liability (including strict liability) is imposed on directors via statute.¹ Directors and officers may also be liable as accessories,² although this requires proof of knowledge of the essential facts which constitute the contravention. Liability may also be imposed by the ‘stepping stone’ model of liability, which is discussed below. The arguments against imposing liability on directors and officers include concerns that directors are becoming too focused on compliance and that able people are being deterred from taking up, or continuing, directorships.

There is also the issue of when a company will be liable for breaches of the law where fault-based liability is imposed. In some areas, the law looks to persons who form the ‘directing mind and will of the company’ in assessing such liability (or in assessing the availability of defences).³ A relatively recent model has seen the imposition of liability linked to ‘corporate culture’.⁴ The Australian Securities and Investments Commission has in fact recently proposed an extension of this model as a means of imposing liability to penalise individual company officers in situations where poor business culture leads to poor business performance.⁵

Australia is somewhat unique in relation to liability of directors and officers concerning unlawful or illegal acts of companies. This is because there is no illegality defence in this jurisdiction. In some other jurisdictions such as the United Kingdom this defence may prevent recovery against directors or officers in certain circumstances.⁶ Objections have been raised to this

Personal Liability for Corporate Fault Reform Act 2012 (Cth) and state legislation such as the Miscellaneous Acts Amendment (Directors’ Liability) Act 2012 (NSW).
² See, eg, Corporations Act 2001 (Cth) s 79.
⁴ See, eg, Criminal Code Act 1995 s 12.3(2)(c), which provides for deeming a corporation to have authorized the commission of an offence on proof that ‘a corporate culture existed within the body corporate that directed, encouraged, tolerated or led non-compliance with the relevant provision.’ For comment see Robert Baxt, ‘The Importance of a Culture of Compliance!’ (2013) 41 ABLR 106.
⁶ See, eg, Tinsley v Milligan [1994] 1 AC 340; Safeway v Twigger [2010] EWCA Civ 1472; cf Jetivia v Bilta [2015] UKSC 23. Also known as the ex turpi causa defence, the rule (which has narrow and wide forms) prevents a claimant from using the courts to obtain compensation for loss which he or she has suffered as a result of his or her own illegal or immoral act – for outline see Anna Morfey and Conall Patton, ‘Safeway Stores Ltd v Twigger: The Buck Stops Here’ [2011] Comp Law 57. For critique see Ernest Lim, ‘The Illegality Defence and Company Law’ (2013) 13 JCLS 49; Wai Yee Wan, ‘Corporate Claims against Directors or Officers following the Company’s Unlawful Conduct’ (2016) Hong Kong University Law Review (forthcoming).
defence, such as the need for deterrence and the inappropriateness of punishing innocent shareholders and stakeholders. To an Australian observer the illegality defence seems questionable – why should a director or officer escape personal liability in situations in which they caused or allowed the company to engage in illegal activity on the basis that the activity was illegal?

2. Stepping stones

Against this background it is instructive to consider the ‘stepping stones’ approach, which has been the subject of considerable academic commentary. Originally coined by Abe Herzberg and Helen Anderson following the judgment of Keane CJ in ASIC v Fortescue Metals Group Ltd, the stepping stones approach refers to the imposition of liability on directors and officers in circumstances where the company has breached a provision of the Corporations Act 2001 (Cth) (or some other law) which the directors failed to prevent. The first stepping stone involves an action against the company for breach of the Corporations Act or some other law; the second stepping stone is that the director breached the duty of care in exposing the company to risk of prosecution or liability. Under the stepping stones model, a breach of directors’ duties may be found based on a company’s contravention without proof of ‘involvement’ in the company’s breach.

The need for caution has, however, been sounded in the application of this approach. In ASIC v Maxwell Brereton J said

\[It is a mistake to think that ss 180, 181 and 182 are concerned with any general obligation owed by directors at large to conduct the affairs of the company in accordance with the law generally or the Corporations Act in particular; they are not. They are concerned with duties owed to the company.\]

\[2011] FCAFC 19 [10].

\[2010\] 77 ACSR 69 the Federal Court found that where a director allows a company to make a statement which constitutes misleading and deceptive conduct in breach of s 1041H of the Corporations Act, a director could be found to have breached the duty of care in respect of the same conduct. For cases in which the stepping stones approach has been employed see ASIC v Sydney Investment House Equities Pty Ltd (2008) 69 ACSR 1; ASIC v Maxwell (2006) 59 ACSR 373; ASIC v Warrenmang Ltd (2007) 63 ACSR 623; ASIC v Macdonald (No11) (2008) 256 ALR 199; ASIC v Elm Financial Services Pty Ltd (2005) 53 ACSR 533; Morley v ASIC (2010) 274 ALR 205; ASIC v Citrofresh International Ltd (No2) (2010) 77 ACSR 69; ASIC v Fortescue Metals Group (2011) 190 FCR 364; ASIC v Healey (No2) (2011) 196 FCR 364; ASIC v Narrain (2008) 169 FCR 211.

10 (2006) 59 ACSR 373 [104].

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8 [2010] 77 ACSR 69 [10].
These comments highlight the fact that directors are not automatically liable for breach of the duty of care if the company breaches the law. Courts are reluctant to treat s 180 as a general obligation on the directors to conduct the affairs of the company in accordance with the general law or the Corporations Act. Brereton J in Maxwell concluded that ‘ss 180, 181 and 182 do not provide a backdoor method for visiting on company directors accessorial civil liability for contraventions of the Corporations Act in respect of which provision is not otherwise made.’\(^{11}\) In other words it does not flow automatically from a finding that an entity has contravened the Corporations Act that the officers must have contravened their duty of care to the company. This accords with Herzberg and Anderson’s observation that the stepping stones approach does not mean that directors who authorized or permitted a company’s contravention automatically breach s 180 (or ss 181-2) – rather breach depends on an analysis of the particular duty in the circumstances.\(^{12}\) This arguably represents a desirable balance between the need for accountability and undesirable consequences of overburdening directors with liability.

Such caution is particularly necessary concerning the use of s 181 of the Corporations Act 2001 (Cth) in instances where liability is sought to be imposed on directors and officers for allowing the company to breach the law.\(^{13}\) At general law the duties in s 181 continue to be classified as fiduciary meaning that, upon proof of breach, a transaction can be set aside and liability can be imposed on third parties based on the rule in Barnes v Addy.\(^{14}\) In addition, s 181(2) imposes liability on persons involved in a contravention of s 181 and criminal liability may be imposed under s 184 in relation to reckless or intentionally dishonest breaches of s 181.

As readers would be aware, the Australian Institute of Company Directors has queried the appropriateness of the stepping stones approach and of the proliferation of liability being imposed on directors in the context of companies breaching the law.\(^{15}\) In the Institute’s view this is resulting in an excessive focus on compliance and is also deterring suitable candidates from taking up directorships. As is many areas of corporate law there is therefore a tension between various policy objectives – here these can be enunciated as ensuring compliance with high standards in the corporate sphere and not overburdening directors. The AICD has also expressed concern, echoing Bednall and Hanrahan, that the penalties which may be imposed on a director

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11 Ibid [110].  
12 See also Black, above n 1.  
13 In this respect the approach to determining breach of s 181 in ASIC v Maxwell (2006) 59 ACSR 373 [99]-[101] is arguably, with respect, open to question. In that case Brereton J thought that s 181 was contravened only where a director engages deliberately in conduct, knowing that it is not in the interests of the company. A more appropriate approach is to look at whether the director subjectively believed the decision or course of action was in the best interests of the company and whether it was a decision that no reasonable director would consider to be in the interests of the company – see Rosemary Teele Langford and Ian Ramsay, ‘Directors’ Duty to Act in the Interests of the Company: Subjective or Objective’ (2014) Journal of Business Law 173; Austin and Ramsay, above n 3, [8.070.3].  
14 (1883) LR 23 Ch D 654, 671.  
as a result of the stepping stones approach may be higher than the penalty for the company’s original contravention.\textsuperscript{16}

3. Mariner

The stepping stones approach was recently considered by Beach J in the case of ASIC v Mariner Corp Ltd.\textsuperscript{17} In that case the Federal Court dismissed claims brought by ASIC that Mariner Corporation Ltd and its three directors contravened ss 180, 631(2)(b) and 1041H of the Corporations Act 2001 (Cth) in relation to an off-market takeover bid by Mariner for all of the issued capital of Austock Group Ltd.\textsuperscript{18} The allegation concerning s 180 was that the directors had breached their duties to act with due care and diligence by making a decision that Mariner would announce a takeover bid for Austock and causing Mariner to act unlawfully. ASIC sought pecuniary penalties and disqualification orders against the individual directors.

The focus of this note is on Beach J’s findings that the directors did not contravene s 180. Beach J commenced by confirming uncontroversial matters such as that the content of the duty is affected by the circumstances of the company and the particular director.\textsuperscript{19} The point of difference between the parties in this case was the extent to which a director should be taken to have contravened s 180 by reason of being involved in a contravention by the company of another provision of the Act. In this respect Beach J stated:

The duty owed under s 180 does not impose a wide-ranging obligation on directors to ensure that the affairs of a company are conducted in accordance with law. It is not to be used as a back-door means for visiting accessorial liability on directors. Further, it is not to be used in a contrived way in an attempt to empower the court to make a disqualification order under s 206C by the artificial invocation of s 180 (a civil penalty provision), when such a route is not otherwise available directly.\textsuperscript{20}

This last sentence is notable in that Hanrahan and Bednall have pointed out that liability may be imposed under the stepping stones approach in circumstances in which liability would not be made out directly or via the involvement approach.

Beach J then quoted from Brereton J’s judgment in Maxwell, including the points extracted above. In addition to Brereton J’s judgment in Maxwell, the

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\item \textsuperscript{16} But see Black, above n 1, 520.
\item \textsuperscript{17} (2015) 106 ACSR 343.
\item \textsuperscript{18} The allegation in relation to s 631(2)(b) was that Mariner publicly proposed to make a takeover bid for Austock, reckless as to whether it would be able to perform its obligations relating to the takeover bid at 10.5c per share if a substantial proportion of the offers under the bid were accepted. The allegation in relation to s 1041H was that, by making the announcement, Mariner engaged in conduct that was misleading or deceptive or likely to mislead or deceive because it was not permitted to make a takeover bid for shares in Austock at a price of less than 11c per share.
\item \textsuperscript{19} See (2015) 106 ACSR 343, 421 [440]-[442].
\item \textsuperscript{20} See ibid 421 [444].
\end{itemize}
fact that s 180 (and ss 181 and 182) do not impose a ‘backdoor method of visiting on company directors a form of accessorial civil liability for contraventions of the Corporations Act for which provision is not otherwise made’ has also been reiterated in cases such as \textit{ASIC v Warrenmang Ltd} and \textit{ASIC v Rich}, from which Beach J quoted. Beach J then honed in on the need to balance the foreseeable risk of harm to the company flowing from the contravention with the potential benefits that could reasonably be expected to have accrued to the company from the conduct. His Honour continued:

After all, one expects management including the directors to take calculated risks. The very nature of commercial activity necessarily involves uncertainty and risk taking. The pursuit of an activity that might entail a foreseeable risk of harm does not of itself establish a contravention of s 180. Moreover, a failed activity pursued by the directors which causes loss to the company does not establish a contravention of s 180.

Applying these principles to the facts of the case, Beach J found that the directors had not contravened s 180. Notably his Honour also found that the business judgment rule in s 180(2) was made out and that two of the directors had satisfied the requirements of reasonable reliance in s 189. These findings are significant given that these sections have proved hard to make out in practice.

The purpose of this note is not to comment on this balancing approach (except to note that it is consistent with cases such as \textit{Permanent Building Society v Wheeler}, \textit{Adler v ASIC} and \textit{Vines v ASIC}) or on the application of this approach to the facts of the case. Rather its focus is on Beach J’s comments on the liability of directors where the company breaches the law. His Honour’s approach allays some of the concerns that have been expressed in relation to the stepping stones approach in focusing attention on

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\item (2007) 63 ACSR 23 [22]-[23].
\item (2009) 236 FLR 1 [7238].
\item At (2015) 106 ACSR 343, 422 [448] Beach J stated: ‘No contravention of s 180 would flow from such circumstances unless there was actual damage caused to the company by reason of that other contravention or it was reasonably foreseeable that the relevant conduct might harm the interests of the company, its shareholders and its creditors (if the company was in a precarious financial position) …’
\item See ibid 422 [450]. At ibid 422 [451] Beach J said: ‘Not only must the court consider the nature and magnitude of the foreseeable risk of harm and degree of probability of its occurrence, along with the expense, difficulty and inconvenience of taking alleviating action, but the court must balance the foreseeable risk of harm against the potential benefits that could reasonably be expected to accrue from the conduct in question.’
\item Ibid 422 [452].
\item See, eg, ibid 427-30 [483]-[495].
\item See, eg, ibid 434 [528]-[534], 438 [557].
\item See, eg, AICD, above n 15; Angela Gibbs and Jon Webster, ‘Delegation and Reliance by Australian Company Directors’ (2015) 33 CSLJ 297.
\item (1994) 11 WAR 187.
\item (2003) 179 FLR 1
\item (2007) 25 ACLC 448.
\end{itemize}
the elements of the relevant duty (in this case s 180) and whether that duty was breached in the circumstances of the case. It arguably demonstrates the ability of the stepping stones approach to achieve an appropriate balance between motivating directors to fulfill their duties in managing or monitoring the management of the company without being so harsh as to deter people from becoming directors or making directors overly risk averse, as articulated by Herzberg and Anderson.

Beach J’s findings on the application of the business judgment rule are also noteworthy, particularly in light of the AICD’s concerns that the business judgment rule will not necessarily be available to defend an allegation of breach of the duty of care in such circumstances. Beach J found that each of the directors had satisfied the elements of the business judgment rule and was entitled to its exculpatory operation. Although this indicates a greater willingness to apply the business judgment rule than has previously been observable, it would not alleviate the AICD’s concerns in relation to the rule not applying to many compliance issues. The restricted application of the business judgment rule in Australia as compared to that of its counterpart in the United States highlights the need for circumspection in adopting American approaches to corporate law issues such as the liability of directors and officers where the company breaches the law or the content and extent of directors’ fiduciary duties.

4. Conclusion

In conclusion, the Mariner case sounds a note of caution concerning the imposition of ‘stepping stones’ liability on directors and officers where the company is found to have breached the law. As with all allegations of breach of directors’ duty, the requirements of the relevant duty (generally s 180 in the stepping stones context) need to be carefully considered and applied to the relevant circumstances. The stepping stones approach does, however, arguably represent a more balanced approach to liability than strict liability models which impose liability on directors automatically where the company is found to have breached the law. It is certainly more measured than the corporate culture model recently propounded by ASIC. This proposed liability model appears to extend more widely than necessarily intended, particularly in light of the problems in defining and measuring culture and the associated difficulties in compliance. There will, however, no doubt be renewed interest in this proposal in light of very recent newspaper articles on the ‘toxic culture’ at one on Australia’s top banks.

33 The AICD’s particular concern relates more specifically to the fact that ensuring the company’s compliance with a statutory provision is not considered by the courts to be a ‘business judgment’ – see ASIC v Fortescue (2011) 190 FCR 364 [197]. In this respect see also ASIC v Mariner (2015) 106 ACSR 343, 428 [486].
34 See (2015) 106 ACSR 343, 429 [495], 436 [550].