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Unfinished business in corporations law reform

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Supreme Court of New South Wales

Legislative complexity

Let me start with a theme which I will not develop. In an article published in 1992, Sir Anthony Mason observed, of the unlikely combination of fox-hunting and the then *Corporations Law*, that

> "Oscar Wilde described fox-hunting as "the unspeakable in full pursuit of the uneatable". Oscar Wilde, the supreme stylist, would have regarded our modern *Corporations Law* not only as uneatable but also as indigestible and incomprehensible."[1]

We should not pause to seek an answer as to why Oscar Wilde would have been the best judge of that question or further detain ourselves with the vision of Oscar Wilde as a judge of the dishes on a kind of legislative Master Chef.

In a later article with the marvellous title, "Unlovely and Unloved: Corporate Law Reform's Progeny", Associate Professor Cally Jordan begins with the remarkable sentence:

> "There is no dispute. The Corporations Act 2001 (Cth) … is unlovely and unloved".[2]

I should pause to give you a moment to recover from your shock at such a sentiment. If Associate Professor Jordan's message was not clear enough from her title and her first sentence, she goes on to adopt Sir Anthony Mason's description of the *Corporations Act* as "indigestible and incomprehensible", and then turns to the question why consistency and coherence in business law is not valued in Australia. That question reflects that favourite tool of advocates, an unproven premise. Associate Professor Jordan goes on to argue that there should be a separate business corporations statute, that parallel streams of directors' duties under statute and general law should be eliminated (as has to some extent occurred in the United Kingdom) and to urge the development of a personal property security regime (which has now been introduced).

Sir Anthony Mason and Associate Professor Jordan are by no means alone in their views as to the complexity, and possibly the unattractiveness of the *Corporations Act*. Many years ago, in *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd* (1996) 20 ACSR 649, Justice Rolfe was equally unkind about the drafting of the prohibition on insider trading. In *Wingecarribee Shire Council v Lehman Bros Australia Ltd (in liq)* (2012) 301 ALR 1; [2012] FCA 1028, Justice Rares observed that:

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[1] Sir Anthony Mason, "Corporate Law: The Challenge of Complexity" (1992) 2 *Australian Journal of Corporate Law* 1.
[2] C Jordan, "Unlovely and Unloved: Corporate Law Reform's Progeny" (2009) 33 *Melbourne University Law Review* 626.

> “The repealed, simple and comprehensive s 52 of the Trade Practices Act 1974 (Cth) that prohibited corporations engaging in misleading or deceptive conduct in trade or commerce has been done away with by a morass of dense, difficult to understand legislation. Those Acts, that now deal with misleading and deceptive conduct, apply differently depending on distinctions such as whether the alleged misleading conduct is in relation to “a financial product or a financial service” (s 1041H(1) of the Corporations Act 2001 (Cth)) or “financial services ” (s 12DA(1) of the Australian Securities and Investments Commission Act 2001 (Cth)). Those apparently simple terms are nothing of the sort. … Obviously, there are differences in what each of these Acts and definitions cover — but why? The cost to the community, business, the parties and their lawyers, and the time for courts to work out which law applies have no rational or legal justification. The Parliament should consider returning to a simple clear two line long universal norm of conduct, as was contained in s 52, if it considers that misleading and deceptive conduct in trade or commerce ought be prohibited.”

I will not develop these themes further, other than to make four short comments. The first is that there is often (although not always) benefit in simplification and the Australian corporations legislation has benefited from at least one major simplification project in the past. The second is that whether reforms simplify, deregulate or reduce costs can be a matter of perspective. The third is that the complexity of some of these provisions, including the definitions of financial services in the *Corporations Act* and the insider trading provisions which have attracted unfavourable judicial comment, may reflect the complex policy objectives which the legislation is seeking to achieve. If one is to have a regime for regulating financial products and services, then it is necessary to draw boundaries as to what is in it and what is outside it, and that process is not necessarily a simple one. The fourth is that there is at least some benefit in continuity, including the ability to develop a body of case law over time. In insider trading, for example, whatever the complexity of the present provisions, they have now developed what seems to me to be a coherent jurisprudence.

Having now spent a significant part of the time allotted to me dealing with what I will not cover, let me now make some observations about several areas of, possibly, unfinished business in corporations law reform.

Business judgment rule

The business judgment rule, in its narrower and wider applications, has of course been at the centre of debates about the reform of corporations legislation for as long as many of us can remember, encouraged in part by the fact that real personal interests are at stake for directors who face personal liability under the provisions. Criticisms of the present form of the business judgment rule had achieved at least some traction in Treasury’s *Review of Sanctions in Corporate Law*, 2007 which identified an issue whether the regulatory framework stuck

> “an appropriate balance between promoting good behavior and ensuring directors are willing to take sensible commercial risks”.

Both Professor Baxt and Dr Austin have expressed concern as to the extent of regulation imposed on company directors, although that concern is not universally shared.[3]

A detailed proposal[4] released by the Australian Institute of Company Directors ("AICD") nearly two years ago sought to advance this issue. The AICD's proposed "honest and reasonable director defence" would apply both to acts and omissions; would require honesty, proper purpose and that a director had exercised the degree of care and diligence that the "director rationally believes" to be reasonable in the circumstances; and would exclude liability under or in connection with a provision of the *Corporations Act*, *Australian Securities and Investments Commission Act* or an equivalent liability in common law or in equity applying to a company director. AICD acknowledged that the standard which it proposed, as to the director's assessment of the reasonableness of the action or inaction, was a subjective test, although the rationality of the director's belief was to be determined objectively. Views may differ as to whether the requirement for rationality (requiring that the director's belief was not foolish, capricious or inexplicable) set the bar for directors' decision-making (or at least their potential liability) at an appropriate level. Although the rational belief standard has some resemblance with the standard applied under the US business judgment rule, the AICD proposal would have a much wider application in extending to acts and omissions that would not be treated as business judgments.

Dr Austin's proposal, advanced at about the same time, would have extended the business judgment defence beyond the *Corporations Act* and the *Australian Securities and Investments Commission Act*, by introducing a defence into Commonwealth, State and Territory interpretation statutes which would establish a rebuttable presumption that liability was not imposed for business judgments.[5]

The business judgment rule seems to have been given effective application, within its traditional scope, by Austin J in *ASIC v Rich* (2009) 75 ACSR 1 at [7248]ff, where that rule was treated as applying, inter alia, to decisions preparatory to making business decisions, allocation of responsibilities between the board and senior management and planning, budgeting and forecasting decisions, and the necessary element of rationality was treated as established (at [7289]) by the existence of some arguable reasoning process to support a decision. That rule was more recently applied in *Australian Securities and*

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[3] N Young, "Has Directors Liability Gone too far or not too far enough? A review of the standard of conduct required of directors under sections 180–184 of the Corporations Act" (2008) 26 *C&SLJ* 216 at 217; M Legg & D Jordan, "The Australian Business Judgment Rule after *ASIC v Rich*: Balancing director authority and accountability" (2014) 34 *Adelaide Law Review* 403, 426; J Ward, "Liability of Company Directors: Three Issues of Current Interest", Commercial Law Association June Judges Series of Seminars, 10 June 2016 above, [8].

[4] Australian Institute of Company Director, *A proposal for reform: The Hones and Reasonable Director Defence*, August 2014.

[5] See A Hargovan & J Du Plessis, "Re-Assessment of the Statutory Business Judgment Rule in Australia – The Case for Law Reform", Corporate Law Teachers Association – Briefing Parliamentary Joint Committee on Corporations and Financial Services, 27 October 2014.

Investments Commission v Mariner Corp (2015) 106 ACSR 343; [2015] FCA 589 at [483]ff.[6]

The courts also remain wary of the use of the statutory directors' duties provisions, and particularly s 180 of the *Corporations Act*, to impose liability for conduct which is not the subject of separate criminal or civil penalty liability under the *Corporations Act*. Justice Brereton delivered what seems to me to be the leading decision in that respect in *Australian Securities & Investments Commission v Maxwell* (2006) 59 ACSR 373; [2006] NSWSC 1052, where he rejected the proposition that the directors' duties provisions will necessarily be breached by a director permitting a company to breach another provision of the *Corporations Act*, so as to give rise to accessorial liability where the *Corporations Act* does not provide for it.[7] That decision was followed, inter alia, in *ASIC v Mariner Corp* above.

At this point, I should also address one question which I know has been on all your lips. Section 1324 of the *Corporations Act*, as a mechanism for individual shareholders to assert private causes of action for damages arising from contraventions of the *Corporations Act*, remains at risk, and Professor Baxt continues to provide it with support and comfort.[8]

Safe harbours from insolvent trading

In its Proposals Paper, *Improving Bankruptcy and Insolvency Laws* (April 2016), the Commonwealth Government raises the possibility of introducing two forms of safe harbor to limit the risk of personal liability for directors for insolvent trading, where a director is involved in restructuring efforts. The Proposals Paper identifies the rationale for the reform as that it would strengthen Australia's "start-up culture" by moving from a regime that penalises directors and stigmatises failure, so as to encourage entrepreneurship and assist start-ups in attracting experienced and talented board members. I note, in passing, that that rationale may seem somewhat distant from the bulk of insolvency matters dealt with by insolvency practitioners and the courts, which have little to do with start-ups, innovation or the new economy. It is likely that the proposed reforms would impact on a much larger number of cases dealt with by insolvency practitioners and courts which do not fall within their stated rationale.

The first proposed form of safe harbor ("Safe Harbour Model A") would provide a defence where a director has an expectation, based on advice received from an appropriately

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[6] For commentary, see Justice Ward, "Liability of Company Directors: Three issues of Current Interest", above.

[7] For commentary, see A Herzberg and H Anderson, "Stepping Stones – From Corporate Fault to Directors' Personal Civil Liability" (2012) 40 *Fed Law Rev* 181; T Bednall & P Hanrahan, "Officer's Liability for Mandatory Corporate Disclosure: Two Paths, Two Destinations?" (2013) 31 C&SLJ 474; A J Black, "Directors' statutory and general law accessory liability for corporate wrongdoing" (2013) 31 C&SLJ 511.

8 *McCracken v Phoenix Constructions Qld Pty Ltd* (2012) 289 ALR 710; [2012] QCA 129; *Re Colorado Products Pty Ltd (in prov liq)* (2014) 101 ACSR 233; [2014] NSWSC 789 at [391]ff; R Baxt, "Will Section 574 of the Companies Code Please Stand Up! (And Will Section 1323 of the Corporations Act Follow Suit)" (1989) 7 *C&SLJ* 388; "The versatility of s 1324 of the Corporations Act" (2012) 8(2) *Baxt Report;* "Qualified Ability for Courts to Award Damages under s 1324(10)" (2012) 8(3) *Baxt Report.*

experienced, qualified and informed restructuring adviser[9], that the company can be returned to solvency within a reasonable period of time and the director is taking reasonable steps to do so. The defence would only apply in respect of liability for insolvent trading, and not for all potential breaches of the *Corporations Act*. The risk of misuse of this defence would be reduced by the proposed requirement that the restructuring adviser be provided with appropriate books and records within a reasonable time from his or her appointment and then remains of the opinion that the company can avoid insolvent liquidation and is likely to be returned to solvency within a reasonable period of time. Those companies where the risk of abuse of this provision would be at its greatest may well be unable to comply with that requirement. The defence would also not be available were the company had failed to lodge multiple business activity statements or there was a significant failure to pay employee claims, PAYG tax or employer superannuation requirements and would also not prevent civil claims against directors relating to outstanding employee entitlements that accrued during the safe harbour period. The Government does not propose to relax continuous disclosure requirements in respect of entry into such an arrangement. There would be practical questions whether a listed company's reliance on the safe harbour would generally be disclosable and whether unsecured creditors will be reluctant to trade with a listed public company after such a disclosure.

An alternative form of safe harbour ("Safe Harbour Model B") would apply to particular debts incurred as part of reasonable steps to maintain or return a company to solvency within a reasonable period of time, where a person held an honest and reasonable belief that incurring the debt was in the company's best interests and creditors as a whole and incurring the debt did not materially increase the risk of serious loss to creditors. We should recognise that this approach appears to contemplate that the safe harbour is available where incurring the debt will expose a particular creditor to an increased risk of serious loss, provided that it does not increase the risk of serious loss to creditors generally. Where a company is large and its debts are substantial, a debt incurred to a particular creditor may be of real commercial significance to that creditor although it does not materially affect the position of the company's creditors generally. This alternative does not necessarily involve the retainer of an insolvency practitioner to provide restructuring advice, although expert advice would no doubt assist directors in establishing the existence of an honest and reasonable belief as to the relevant matters.

This proposal appears to have been generally welcomed by the insolvency profession. There are plainly arguments that are capable of being put each way. On the one hand, the Australian insolvent trading regime is significantly more onerous than comparable regimes in other developed economies[10], and there is a strong case that the insolvent

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[9] The restructuring adviser would be excluded from the definition of director so as not to be at risk of being held to be a shadow or de facto director, and would be required to report any misconduct that he or she identified to ASIC. The restructuring adviser would also be protected against third party claims, provided his or her opinion was honestly and reasonably held.

[10] J Harris, "Director Liability for Insolvent Trading: Is the Cure Worse than the Disease" (2009) 23 *AJCL* 266.

trading regime operates as a significant practical disincentive to informal workout arrangements, and encourages the appointment of an administrator at an earlier rather than a later point. The contrary view is that individual creditors, or creditors generally, may, possibly unknowingly, bear the risk that a restructuring proposal fails and they are left without recourse for debts incurred in the course of it.

I should also note the existence of the *Insolvency Law Reform Act* 2016 (Cth), although time will not permit me to discuss it at any length. This is a very substantial law reform exercise, both in the territory which is covered and in its bulk. There is, in principle, likely to be some benefit to insolvency practitioners and their advisers in seeking to achieve greater uniformity between the provisions which apply in individual bankruptcy and in corporate insolvency, as the *Insolvency Law Reform Act* seeks to do. Several provisions will likely raise new issues of law and practice, including new provisions for the provision of information by insolvency practitioners to creditors, for the removal of insolvency practitioners by resolution of creditors and for the assignment of rights to sue conferred on a liquidator by the *Corporations Act*. The reforms will also raise complex transitional issues for some time to come.

Managed investment schemes

This area plainly merits the description of unfinished business. There can be little doubt as to the substantial practical difficulties which presently arise in attempted reconstructions of managed investment schemes, by reason of the reluctance of a new responsible entity to assume liabilities of the former responsible entity under s 601FS of the *Corporations Ac*t, the absence of a regime corresponding to the voluntary administration regime in relation to companies, the difficulties of unraveling contractual relationships in common enterprise schemes, and (although perhaps least significant in practical terms) the absence of a detailed winding up regime for managed investment schemes in the *Corporations Act*.

In its review of managed investment schemes (July 2012), the Corporations and Markets Advisory Committee ("CAMAC") recommended, inter alia, that a registered scheme should be treated as a separate legal entity, which would hold assets of a managed investment scheme, and the responsible entity would act as its disclosed agent.[11] That proposal, combined with a power to appoint an administrator to a registered scheme that was insolvent or likely to become insolvent, may have simplified the position in the insolvency of a registered scheme. If that proposal was not adopted, CAMAC recommended the introduction of a voluntary administration regime and a winding up

[11] See CAMAC Report, *Managed Investment Schemes,* July 2012; and, for commentary, P Hoser, "Managed Investment Schemes – The next big thing" (2012) *Insolvency Law Bulletin* 26; N D'Angelo, "The CAMAC Report on Managed Investment Schemes: Another Opportunity Missed?" (2012) 23 *JBFLP* 253; L Zwier, J Vaastra and O Bigos, "Can Managed Investment Schemes be Restructured in the Context of Insolvency?" in S J Maiden (ed), *Insolvent Investments*, 2015, pp 101–121. For discussion of wider issues, see N D'Angelo, "The Trust: Evolution from Guardian to Risk-Taker, and How a Lagging Insolvency Law Framework Has Left Financiers and Other Stakeholders in Peril" (2009) 20 *JBFLP* 279; N D'Angelo, *Commercial Trusts*, 2014.

regime in respect of managed investment schemes[12] and the inclusion of voidable transaction provisions and a statutory order of priorities for the winding up of a scheme.

The Senate Economics Reference Committee has recently delivered its report in respect of agribusiness managed investment schemes on 11 March 2016, which has recognised the extent of financial loss and personal difficulty suffered by investors in such schemes. The Committee referred to "horrifying deficiencies" in the advice given to investors in respect of such schemes, including failure to have regard to clients' risk profiles or to disclose the speculative nature of investments or the risks attached to them. The Committee also expressed the view that, in the case of agribusiness managed investment schemes, reliance on disclosure is "woefully inadequate", by reason of investors' difficulty in understanding disclosure documents, the trust placed in advisers' recommendations, and the risk of adviser misconduct and that there is a "persuasive argument" that high risk agribusiness schemes "should not have been marketed to retail investors" (p xxv), and supported increased powers for ASIC in respect of intervention in the marketing of products (p xxvii). The Committee also recommended (Recommendation 8) that the Government consider expanding ASIC's powers to require additional content for product disclosure statements. The Committee also noted that its review highlighted the importance of ensuring that there are no loopholes in the Future of Financial Advice legislation that would "allow any form of incentive payments to creep back into the financial advice industry". I will return to that question below.

The Committee also recognised the practical difficulties involved in winding up agribusiness managed investments schemes; described CAMAC's work in respect of schemes in financial distress as an "ideal starting point for reform" (p xxvi); and recommended (Recommendation 20) that the Government use CAMAC's report on managed investment schemes for further discussion and consultation with industry "with a view to introducing legislative reforms that would remedy the identified shortcomings in managing an MIS in financial difficulties and the winding up of collapsed schemes". However, the Senate Committee did not undertake any detailed analysis of CAMAC's recommendations, and it is not clear that it was endorsing either CAMAC's primary recommendation that a scheme should be a separate legal entity, or the less ambitious proposal for the introduction of a voluntary administration regime in respect of managed investment schemes, or simply expressing a view that something ought to be done. It remains to be seen whether the Senate Committee's positive observations as to CAMAC's work will prompt further law reform activity in an area which is particularly complex but also a source of real practical difficulty.

Financial services regulation

I will also briefly touch upon financial services regulation, to identify three areas which seem to me to be of particular interest.

[12] Similar recommendations had also been made in the Australian Law Reform Commission's Report, *General Insolvency Inquiry Report No 45* (1988) and the Joint Report of the Australian Law Reform Commission and the Companies and Securities Advisory Committee, *Collective Investments: Other People's Money Report No 65* (1993).

First, ASIC is continuing to work through the implications of behavioral finance for disclosure and other financial services regulation. This issue has been recognised in the academic literature for a considerable period[13] and has received heightened attention from regulators since the global financial crisis. Following the global financial crisis, in its submission to the Ripoll Inquiry, ASIC recognised limitations to the efficacy of disclosure as a regulatory technique, and the Turner Committee in the United Kingdom had similar doubts. ASIC's submission to the Financial Services Inquiry (April 2014) also noted (at ([124]) the significance of disclosure as a regulatory tool, but also noted its limitations arising from behavioral biases, lack of resources of investors to read and understand disclosure documents and the complexity of financial products, and noted that disclosure was unlikely to correct market structures or conflicts that drove product development or distribution practices that result in poor investor outcomes. ASIC also noted (at [126]) that its experience is that:

> "Disclosure has proved relatively ineffective in enhancing consumer understanding of the level of risk involved in a product or service, or in addressing problems associated with conflicts of interest."

ASIC is now developing this territory in research and in its approach to regulation of more complex and higher risk financial products. ASIC's Strategic Outlook 2014 – 2015 notes ASIC's intention to continue to focus on the relationship between the design and disclosure of retail products and consumer decision-making and ASIC has sought to apply behavioral finance principles in respect of disclosure of hybrid securities and to financial calculators.[14] However, the application of behavioral finance principles to frame specific regulation is difficult. Disclosure-based regulatory regimes offer the promise of a wide regulatory solution, by bringing risks to the attention of investors who can then take them into account. Once confidence in that approach is shaken, as it has been, what is left are much more difficult exercises in shaping particular regulation in respect of particular products to seek to minimise adverse effects of investor biases. In parallel with the loss of confidence in disclosure, we are also seeing limited moves towards a form of merits regulation, both by the product intervention power proposed by the Murray Inquiry and in specific contexts, including the regulation of debentures issued by financial corporations.[15]

I should also touch on the Future of Financial Advice reforms, where we seem to have achieved an uneasy consensus, after a troubled exercise in law reform. These provisions provide an illustration of the practical impact of law reform, where it appears that these reforms may have accelerated an existing trend to industry consolidation and integration

[13] D Langevoort, "Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation" (2002) 97 *NWU L Rev* 135; L Stout, "The Mechanisms of Market Inefficiency: An Introduction to the New Finance" (2003) 28 *J Corp L* 635; R Shiller, *Irrational Exuberance*, Princeton University Press, 2nd ed, 2005; G Walker, "Securities Regulations, Efficient Markets and Behavioural Finance: Reclaiming the Legal Genealogy" (2006) 36 *Hong Kong LJ* 481.

[14] ASIC Report 427, *Investing in Hybrid Securities: Explanations Based on Behavioral Economics*, ASIC Consultation Paper 249, *Remaking ASIC Class Orders on Generic Financial Calculators*, [26]; ; L McCann & V Kumar, "Behavioral Economics: ASIC Puts Investors on the Couch" (2016) *BCLB* [152].

[15] E Brown, "From 'If not, why not' to 'if not, NOT' – Regulatory Reform of the Debenture Sector" (2014) 32 C&SLJ 159.

of product “manufacturers” and advisory businesses. It appears that, at least for the moment, the “best interests” duty will remain in its present form.[16] ASIC has also recently announced the commencement of its first proceedings for breach of the best interests duty.[17] It remains to be seen whether the provisions dealing with commission arrangements will be sufficient to neutralise the financial incentives for investment advisers to recommend inappropriate products. There may be a question whether the exceptions in this area, initially introduced in the Corporations Regulations 2001 (Cth) and now by the *Corporations Amendment (Financial Advice Measures) Act* 2016 may leave open some risk of incentives for inappropriate advice.[18]

Law reform relating to product disclosure and financial services also faces the need to achieve a difficult balance between promoting economic activity and investor protection, which is highlighted by the debate as to whether the *Corporations Amendment (Crowd-sourced Funding) Bill* 2015 will achieve its objectives.

[16] There has been substantial controversy as to the seventh step specified in s 961B(2)(g), which requires an adviser to take any other step that would reasonably be regarded as in the client’s best interests (as defined in s 961E), given the client’s relevant circumstances (as defined in s 961B(2)(b)). Those contending that s 961B(2)(g) should be removed rightly point out that the present form of s 961B(2) does not guarantee a “safe harbour” if the six previous steps are taken, but the adviser did not take another step that would reasonably be regarded as being in the client’s best interests as defined. That observation may beg the question whether a safe harbour should extend to that situation. If, in a particular case, the first six specified steps comprise all that should reasonably be done in the relevant circumstances, then s 961B(2)(g) has no additional content and the requirement for a safe harbour would be satisfied. If, on the other hand, those steps were not all that should have reasonably been done, then s 961B(2)(g) allows recourse for the client whose interests may have been prejudiced by the failure to take the additional steps that would reasonably have been taken by the adviser. It has also been contended that s 961B(1) establishes a best interests duty without the need for s 961B(2)(g). However, if s 961B(2)(g) were deleted and taking the six steps specified in s 961B(2)(a)-(f) was sufficient to comply with the duty specified in s 961B(1), that duty would not extend beyond the six steps necessary to establish compliance with it. I recognise this view is not universally shared.

[17] ASIC Media Release 16-187, 8 June 2016.

[18] ASIC Report 407, *Review of the financial advice industry’s implementation of the FOFA Reforms, S*eptember 2014; D Mendoza-Jones, “Reform of the Financial Advice Industries in Australia and the United States” (2013) 31 C&SLJ 261, 263–265.