**Criminal offences stagger into corporate law**

**Henry Holderness, the University of Canterbury, tries to get sense out of some recent and pending reforms**

The criminalisation of corporate wrongdoing seems to have become rather fashionable in New Zealand in recent times, some might say dangerously so. However, as is typical of much law reform carried out in this country, the introduction of criminal offences into the corporate sphere is being done in a largely *ad hoc*, piecemeal way. The result is a series of inconsistencies which give the law in this context a generally incoherent and disjointed feel. This article looks at three separate instances of criminalisation – false statements and other misconduct in public offers of securities, breaches of certain directors’ duties in company law, and cartel conduct under the Commerce Act 1986 – and provides a compare-and-contrast type discussion. The article concludes by suggesting that it might be time for the Law Commission to look at the issue generally and recommend some further changes to rationalise the reforms being made.

**Financial Markets Conduct Act 2013 (“FMCA”)**

The FMCA is now our primary piece of securities legislation, and criminalisation in this context is not new. However, certain changes to criminal offences that existed under previous securities law are notable, especially when compared to other examples of criminalisation.

The FMCA has its origins in a Ministry of Economic Development review of financial products and providers undertaken between 2005 and 2008, and a 2009 report of the government-appointed Capital Market Development Taskforce which was set up in 2008 to develop a blueprint for New Zealand’s capital markets. The Taskforce recommended a series of changes, including the establishment of a new market conduct regulator (what has become the Financial Markets Authority or “FMA”) to replace the Securities Commission and assume the regulatory functions of various other bodies.

The FMCA replaces and consolidates a number of pieces of legislation, including the Securities Act 1978 and the Securities Markets Act 1988. The Securities Act will continue to apply to some public offers of securities made during the first two years after commencement of the FMCA’s disclosure regime on 1 December 2014.

The Securities Act contains provisions creating criminal liability for certain conduct on the so-called primary market – ie, where offers of securities are made to the public by an issuer (the secondary market being where such securities, once in the hands of investors, are exchanged). The two most significant primary market offences in the Securities Act are:

* issuing a prospectus or advertisement containing “any untrue statement” (s 58); and
* “offering, distributing or allotting” a security “in contravention of” the Act (s 59).

These are both strict liability offences: see *R v Petricevic* [2012] NZHC 665 and *District Registrar of Companies v Heenan* (1997) 8 NZCLC 261,334. The s 58 offence may be committed by an individual issuer or a director of any corporate issuer. The s 59 offence may be committed by a wider range of persons, including an issuer, a principal officer of an issuer, a promoter of the relevant security or anyone consenting to be named in an advertisement of the security. However, relief from liability is potentially available. Under s 58 an accused person can raise defences of immateriality and/or reasonable belief in the truth of the statement, while under s 59 the accused can raise defences of immateriality and/or lack of knowledge or consent.

The FMCA replicates the primary market offences in ss 58 and 59 of the Securities Act to some extent (and also provides for criminal liability for certain conduct on the secondary market: see, eg, ss 244 and 264 which, respectively, relate to insider trading and the making of false or misleading statements). Under the FMCA there is criminal liability in relation to the primary market:

* For false and misleading statements by an issuer generally (s 512);
* For contravening s 82 of the FMCA, which prohibits the making of offers to the public where the required disclosure is “defective” (s 510);
* For contravening other provisions relating to defective disclosure (s 511).

These offences may be committed by a director of an issuer as well as by the issuer itself.

Significantly, under ss 510 and 511 criminal liability is confined to situations where it can be proved the accused knew, or was reckless as to whether, the relevant statement or omission was false or misleading or likely to mislead. Under s 512, the requirement is that the accused knowingly made or authorised the making of a false or misleading statement; no recklessness element is included here.

These sections represent a deliberate departure from the strict liability nature of the offences in ss 58 and 59 of the Securities Act. The secondary market offences in the FMCA also require *mens rea*. After the FMCA fully replaces the Securities Act on 1 December 2016, no longer will negligence be sufficient to ground criminal sanctions in the context of securities law. The framers of the FMCA thought that an increased emphasis on civil penalties would represent a better approach in respect of misstatements which do not involve an element of knowledge or recklessness, and accordingly Part 8 of the FMCA provides tiers of civil liability where differing penalties may be imposed depending on the nature of the misconduct involved.

One of the major developments in the FMCA is the introduction of a regime which purports to regulate the governance of financial products. This is provided in Part 4 of the Act – “Governance of financial products”. Among other things, Part 4 applies to debt securities (s 102). Those offering debt securities to the public will need to comply with certain requirements, for example the need to ensure that any regulated offer has a governing document (trust deed) and a supervisor (akin to a custodian trustee): s 103. Part 4 also imposes responsibilities on supervisors of debt securities, such as the duty to act honestly and in the best interests of the holders of the investments (s 112). There is no criminal liability for breaches of the regulatory regime imposed by Part 4; the only penalties for a breach of this Part are of a civil liability nature: see Subpart 5 of Part 4, s 228(2) and (4).

**Companies Amendment Act 2014 (“CAA”)**

Section 4 of the CAA inserted into the Companies Act 1993 a new section 138A. This criminalises serious breaches of the existing Companies Act directors’ duties to act in good faith and in the company’s best interests (s 131) and to refrain from reckless trading (s 135).

As with the FMCA, the CAA originated in the ongoing review of securities law undertaken by the government post-GFC. A Cabinet Paper of February 2011 from the Office of the Minister of Commerce dealing with securities law reform recorded a concern that there was a lack of any offence provision to deal with “certain types of conduct by directors covered by directors’ duties after the allotment of securities” (p 44) – an example of such conduct might be the kind of risky related-party lending which was so common in the finance company industry before it collapsed in 2007 and 2008.

The new s 138A provides (relevantly):

A [director](http://www.lexisnexis.com.ezproxy.canterbury.ac.nz/nz/legal/search/runRemoteLink.do?bct=A&risb=21_T21511730956&homeCsi=274497&A=0.5981817985815356&urlEnc=ISO-8859-1&&dpsi=0069&remotekey1=REFPTID&refpt=1993A105S2:DIRECTOR&service=DOC-ID&origdpsi=0069) of a [company](http://www.lexisnexis.com.ezproxy.canterbury.ac.nz/nz/legal/search/runRemoteLink.do?bct=A&risb=21_T21511730956&homeCsi=274497&A=0.5981817985815356&urlEnc=ISO-8859-1&&dpsi=0069&remotekey1=REFPTID&refpt=1993A105S2:COMPANY&service=DOC-ID&origdpsi=0069) commits an offence if the director exercises powers or performs duties as a director of the company—

(a)  in bad faith towards the company and believing that the conduct is not in the best interests of the company; and

(b)  knowing that the conduct will cause serious loss to the company.

Pursuant to s 7(2) CAA, there is also a new provision in s 380(4) of the Companies Act creating criminal liability for a director who allows the company to incur a debt when it is insolvent, or where the debt will render the company insolvent, knowing of the insolvency and acting dishonestly in not preventing the company incurring the debt. This offence is an addition to the existing suite of offences in Part 21 of the Companies Act (ss 377 – 380) aimed at preventing fraudulent conduct in the running of a company, and so does not represent criminalisation of a directors’ duty as such (although it may be questioned how much s 138A really adds to s 380).

The criminalisation of directors’ duties has been heavily criticised: see, eg, P Watts’ editorial at [2011] CSLB 51 (see also S Watson & R Hirsch (2011) 17 NZBLQ 302 offering an alternative perspective). Part of the problem is that the duties for which criminal sanctions will now be available can arguably be breached negligently, whereas s 138A requires *mens rea*: see P Watts [2012] CSLB 1. Professor Watts notes that the common law on which s 131 is based was capable of embracing negligence in some circumstances. He says ss 131 and 135 “…are complex provisions not amenable to criminalisation”. Indeed, what is the point of having a criminal offence provision under which only certain breaches of the relevant duties will attract a criminal sanction? Defendants in prosecutions under s 138A will be encouraged to assert that their misconduct was merely negligent, not knowing or deliberate: this is an unattractive direction for the law to take. Moreover, the need to categorise breaches before proceeding with a criminal prosecution (or not, as the case may be) will pose difficulties and likely increase costs for prosecuting agencies. There is also the problem that criminalising directors’ duties will in some cases discourage suitably qualified people from taking up directorships (see S Watson & R Hirsch, above). This could have a worse effect on the private sector generally than isolated cases of misconduct caught by s 138A.

**The Commerce (Cartels and Other Matters) Amendment Bill 2011 (“Cartel Bill”)**

The Cartel Bill has its origins in an Occasional Paper (2009) and a Discussion Document (2010) both released by the Ministry of Economic Development.

Clause 18 of the Cartel Bill introduces a new s 82B into the Commerce Act 1986 (this has not yet been enacted but looks likely to be). In essence, s 82B will make it an offence to enter into or give effect to an agreement or understanding with the intention of engaging in cartel conduct (which the section defines as price fixing, restricting output, market allocating or bid rigging). Under subs (2) of s 82B, a defence is available if the accused had an honest belief that the cartel conduct was reasonably necessary for the purposes of a permissible collaborative activity.

As with directors’ duties, the need to criminalise cartel conduct has been widely rejected. The proposed reform was promoted in terms of four supposed benefits: deterrence, moral condemnation, trans-Tasman harmonisation and international cooperation: see D Wilson [2012] NZLJ 173. Wilson argues that in relation to deterrence, there is a lack of evidence to support this claimed benefit (p 176), and further observes that moral condemnation has only been referred to once in the law reform process (in the Discussion Document); moral condemnation therefore remains a vague and unformulated concept in this context. The prime justification for cartel criminalisation is accordingly international cooperation and harmonisation, in particular with Australian competition law. Wilson suggests that this justification is also flawed: it appears to be harmonisation for its own sake, which is something that might be done with any law, and therefore the proposal reveals nothing special about cartels in New Zealand (p 176).

**Discussion**

Quite apart from the specific criticisms that have been levelled at the Cartel Bill and the amendments made in the CAA, it is difficult to perceive any coherent overall policy behind the various instances of criminalisation of corporate misbehaviour in New Zealand. The FMCA deliberately restricts the range of cases where criminal liability will be able to be established, and places greater emphasis on civil penalties. Yet this is the legislation which now deals specifically with participants in our financial markets, a context in which enormous losses have been suffered within the last decade. As one High Court Judge has acknowledged, losses suffered in the collapse of the finance company industry were in some cases “massive”: see Heath J in *R v Moses* [2011] NZHC 944 at [28]. While finance companies are supervised by the Reserve Bank under the Non-Bank Deposit Takers Act 2013, which does contain a limited range of criminal offences, it is clearly contemplated that entities other than finance companies will be offering debt securities to the public as time goes on. Any such offers will be governed by the FMCA with its reduced ambit of criminal sanctions.

In contrast, the CAA and the Cartel Bill introduce criminal liability in contexts where by and large the law appears to have worked quite adequately for more than two decades. There has been no general crisis of corporate governance in New Zealand. In the majority of cases the pre-CAA regime for enforcing directors’ duties, including personal and derivative actions by shareholders resulting in potential civil liability of directors, appears to have been more or less adequate (although see S Watson & R Hirsch, above, for a different view). Even if there were problems with enforcement pre-CAA, criminalisation of ss 131 and 135 was not necessarily the most rational response.

Further, on the question of cartels, it has been strongly argued that we do not have a problem in this area in New Zealand: see the editorial at [2010] NZLJ 41. The busting open of cartels occurs only sporadically in New Zealand, and there is little reason to believe that introducing criminal sanctions will further reduce this to any significant extent. There are many more examples (notably in the airline industry) of potential cartelists complying with the normal application process before entering into collaborative arrangements. Code-sharing on international air services is a good example collaborative conduct which may be permitted, and applications to engage in such conduct are frequently made (although admittedly the air travel industry has produced some of the cartels in New Zealand found to be unlawful).

It seems particularly incongruous that:

* The CAA now imposes potential criminal liability on those responsible for corporate governance generally, and the main driver behind this reform seems to have been a concern with the mismanagement of investments such as debt securities;

but

* The FMCA does not provide for potential criminal liability of those who commit serious breaches of the specific regime regulating governance of registered financial products, including debt securities, under Part 4 of the FMCA.

If mismanagement of primary market investments was the concern, as it seems to have been, one might have thought it more rational for the criminal law to intrude into the specific context of financial products governance under Part 4 of the FMCA before it strides into the much broader territory of directors’ duties under general company law. To illustrate, imagine Director A and Director B. Director A is in charge of a small closely-held company, and breaches s 131 knowing this will cause a loss to the company which given its size might seem “serious”. But A is also aware that in a broader context the loss is not going to damage the interests of creditors or shareholders very much. Indeed there may be no significant creditors and A may be the sole shareholder taking a calculated hit. By contrast, Director B is responsible for the governance of a much larger company and consciously breaches Part 4 of the FMCA, thereby triggering events causing truly catastrophic loss to investors in debt securities issued by the company. As a result, B will face civil liability only (for which he or she may well have indemnity insurance). Director A, by contrast, will be liable to be sent to jail. While these are just examples, they still suggest it is unlikely that a consistent overall approach to questions of comparative culpability and risk has been taken in respect of the various reforms introduced. An advantage of keeping criminal offences out of the corporate sphere is that it allows us largely to ignore these kinds of morally loaded question and keep the focus on how best to facilitate ordinary civil compensation for actual losses suffered at the hands of wrongdoers.

A further difficulty is that the Cartel Bill will impose criminal liability on the basis of intentional conduct, whereas the CAA will simply require knowing conduct. Although intention may be equated with knowledge that one’s action is virtually certain to produce a particular result, it would be preferable if Parliament took a consistent approach to the *mens rea* element in corporate offending (unless there is good reason to do otherwise). On that note, why is recklessness not included as a *mens rea* element in the CAA and Cartel Bill offences, when clearly it will be sufficient under the FMCA provisions? Surely, if one can make a false statement recklessly, then one can breach a director duty or engage in cartel conduct in the same state of mind. Perhaps Parliament was trying to make one small concession to the losses suffered by specific groups of investors in the finance company meltdowns by giving prosecutors a theoretically lower *mens rea* element to satisfy in respect of defective disclosure under the FMCA? But even if that were the case it hardly seems to be evidence of some rational overall policy based on real experience. The widespread losses suffered by unsuspecting consumers as a result of cartel conduct are potentially just as great as losses which may be suffered by investors on financial markets, if not greater. The Visy cartel exposed in Australia in the mid-2000’s was described by Heerey J as affecting every man, woman and child in Australia every day for as long as the cartel persisted.

The picture is arguably no clearer in relation to penalties. There may be some sense in that a breach of directors’ duties in terms of s 138A is punishable by imprisonment for a term not exceeding 5 years or a fine not exceeding $200,000, whereas a breach of s 510 of the FMCA by an individual is punishable in a much stiffer manner – by up to 10 years in prison, a fine not exceeding $1 million or both. Under the Cartel Bill, however, imprisonment is for a period of up to 7 years for individuals but fines can only be imposed (it appears) on bodies corporate. That virtually guarantees imprisonment for natural persons convicted under the proposed s 82B, whereas directors convicted under s 138A will in many cases receive a fine only by way of punishment.

**Conclusion**

To conclude this brief general survey, two questions seem apt. Has the New Zealand Law Commission ever been asked to look generally at the subject of criminalising corporate misbehaviour and report on how, if such criminalisation is truly necessary in particular areas, it might be achieved in a coherent way based on a single underlying policy foundation? The answer appears to be no (although the Law Commission has looked at the related topic of civil pecuniary penalties, where inconsistencies in legislative design were noted: see NZLC IP 33). Given the Law Commission is our primary law reform agency, why not?

Introducing the criminal law into the corporate sphere may well be justified in particular instances (although the justifications put forward in respect of the areas thus far targeted do seem doubtful). But if we are going to start criminalising a range of different corporate misconduct, we ought to do it in a consistent way. Consistency is desirable because it makes the law generally more comprehensible, but more so to avoid the law having a chilling effect on business generally, which may be one result of the increasing introduction of criminal offences without a coherent overall policy to guide such reforms.