

Submission to the Corporations and Markets Advisory Committee

Personal Liability for Corporate Fault

Discussion Paper

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Introduction

This submission addresses the release of the CAMAC Personal Liability for Corporate Fault Discussion Paper (May 2005). The University of Technology, Sydney's (UTS) has a corporate law group within the faculty of law as well as the independent Centre for Corporate Governance, a UTS key research centre, who have attempted to provide informed debate on these critical issues. Some of the suggestions that have been provided in this submission are of a policy nature and question the need for change without empirical data and support, through to technical suggestions as to the drafting of particular provisions.

If any of the responses require further explanations, please contact Professor Michael Adams at the UTS Faculty of Law at Michael.Adams@uts.edu.au

Staff involved in producing this response

The UTS Law Faculty has a variety of staff from many different areas of the law. In respect of this submission, the substantive legal submissions have been prepared by Professor Michael Adams, with help legal academic staff such as Dr

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Explanatory Notes

Two brief notes. First, references throughout the body of this submission to ‘the group’ are references to the corporate law group within the UTS Law Faculty. Second, for the sake of clarity and coherency in this submission, the group has considered it apposite to reproduce parts of the draft discussion paper where necessary. A second submission will be made by the same group in respect of the *Corporate Duties Beyond Board Level* Discussion Paper.

General Observations:

The discussion paper, *Personal liability for corporate fault*, May 2005 looks at circumstances in which a director or manager of the corporation may be personally liable for contravening conduct simply as a consequence of the position they hold, or the function they perform, within that corporation when a corporation contravenes a statutory requirement. The discussion paper, through proposing certain templates suggests alternative methods of assessing the compliance of directors/officers.

To date, CAMAC has found that the approach taken both within and between the Commonwealth, State and Territory jurisdiction for imposing individual derivative liability is inconsistent. Even in the circumstances where legislation implies the same method or concepts, different terminology is used to determine the procedure. These discrepancies may detract from the current methods of corporate governance as often it may be difficult for individuals to understand their legal responsibilities in such a diverse regulatory environment.

But is accessorial liability sufficient? Do we really need a derivative liability to be imposed on directors? CAMAC notes that one argument for going beyond accessorial liability to derivative liability is to ensure that people in key positions within a corporation inform themselves and assist in the prevention of any misconduct by the corporation.

This is a valid and poignant view. More commonly ASIC is requiring officers to give personal guarantees against company breaches the law. One explicit example of this can be identified in the majority of enforceable undertakings whereby ASIC requires the directors of the company to monitor the undertaking and it adds a clause that notes that in case the company breaches the undertaking, the directors will be held liable.

However, derivative liability will have the effect of imposing more liability on directors. Do we need to add more liability on directors? Directors are already liable for breaches of duty of care, duty to act in good faith and for proper purpose, duty to avoid conflict of interest and the duty to ensure that the company does not trade when it is insolvent. In addition, the director will be

liable for accessorial liability and cannot claim that they were not involved in the company as a defence. The director will be held liable anyway if he/she breaches the abovementioned duties.

Do we need to have a derivative liability in the *Corporations Act*? The group has come to the conclusion that the discussion paper issues, while valid, are already covered adequately by the provisions of s 79 of the *Corporations Act*.

Consideration Issue 2.6

Comment upon any aspect of the discussion in this section on the distinction between direct and derivative liability, including any aspect of the commonalities and differences between the application of direct and derivative liability to private sector corporations and government business enterprises.

If legislative changes are brought in, in the area of derivative liability for directors, this will require regulation- generally an area left to ASIC in the areas of regulating and overseeing corporate governance compliance. It is a worthy area to examine whether where public organisations are State based Government Business Enterprises, there will be issues with a Commonwealth Organisation such as ASIC regulating a State based organisation. The group does not address this issue with a ready answer, but leaves it as an issue for contemplation by the readers of this submission.

Consideration Issue 3.4

Comment on any aspect of the discussion in this section on the rationale for derivative liability, including in what circumstances, if any, it is necessary as a matter of public policy to go beyond accessorial liability and impose individual derivative liability.

- Currently, corporate liability without personal directorial liability for corporate fault is an insufficient deterrent for corporate offences. This is particularly of concern with larger corporations, for whom, it is often less expensive to pay monetary penalties for breaches of occupational safety, environmental and trade practices regulations than pay to make changes

- to established business practices which would bring them into line with corporate governance accepted practices.
- The practice of making directors/ officers personally liable for breaches would ensure that internal corporate compliance programs are put in place rather than simply avoided by corporations willing to pay for offences. Directors/officers are much more likely to ensure compliance when penalties are imposed directly upon the individual.

But are there cheaper/ less drastic alternatives?

- A sliding scale of penalties for corporations- depending upon the size/ assets of the corporation so that the costs of the breach will almost certainly outweigh the costs of the compliance.
- Clarification of and greater enforcement of the accessory provisions in s 79 of the *Corporations Act*, ensuring that they apply to environmental law and other relevant offences. Some rewording of s 79 along the lines proposed by the ALRC template (in 9.2 below) may achieve this objective more effectively than simply introducing a whole new provision.

Culture:

Ultimately this issue is a question of culture. Who is responsible for corporate culture? In large organisations, it may be difficult to determine which individuals are responsible for certain activities or areas/sub cultures within the organisation. A question to consider then, is would individual liability for directors and officers ultimately change the culture and the corporations' adherence to statutory requirements of the organisation?

Generally, it is the board of directors and the officers who are directly responsible for the establishment and conduct of procedure in the corporation. If these officers/directors were directly responsible for the outcomes of the company- would this change the culture and sub cultures i.e. the procedures and culture of protection or adherence to the law that the company has?

This is a fundamental question to consider in relation to this topic- would a culture of change and adherence evolve from these changes, or would it simply

mean that more officers/directors are prosecuted or disciplined? The *Commonwealth Criminal Code* requires a culture of compliance which could help enforce this concept within the corporate world.

Too often today, directors liabilities or any penalties that have been imposed upon the officers/ directors of a company are simply built into the costs of the corporation- thus, other parties, such as the shareholders have been paying for the irresponsible behaviour of directors and officers of the corporation. An illustration of this is the recent James Hardie investigation.

The question of corporate culture and a culture of compliance is well documented in the academic literature. Over the last two decades Australia has experienced massive shifts in business regulatory approaches. Policies have switched from a focus wholly on deregulation to selective re-regulation. Clarke *et al.* (2003)¹ argue these regulatory changes were, in part, carried by the economic reforms of the 1980s, which resulted in some "entrepreneurs" and "high flyers" profiting from speculative and unsustainable business ventures that ended, ultimately, in several high profile corporate collapses. Notwithstanding these factors, current trends indicate that the growth of business regulation will persist, as the nexus between norms of market pressure and norms of social accountability continue to spur further debate.

Julia Black (1997)² remarks that regulations are a framework of rules prescribed by authorities to coerce a target group of constituents towards certain desirable outcomes. Rules are generalised control mechanisms which provide a blunt instrument: they are abstract categories with which to group together particular instances or occurrences that are seen, somehow, to embody the definitional category forming the operative basis of the rule. Consequently the design of rules is based upon generalised calculations, both retrospective and prospective, which are vulnerable both to over and under-inclusiveness of phenomena that falls within their putative and actual ambit.

¹ Clarke, F., Dean G. and Oliver, K. (2003) *Corporate Collapse; Accounting, Regulatory and Ethical Failure*, Cambridge University Press, Melbourne

² Black, J. (1997) *Rules and Regulators*, Clarendon Press, Oxford

Critics such as Sally Simpson (2002)³ point out that ‘control and command’ type regulation have certain shortcomings because empirical evidence suggests that strict regulation does not improve compliance. Instead, it increases the amount of litigation – especially where defendants have deep pockets – as is the case with corporate organisations.

Baldwin *et al.* (1998)⁴ note regulating corporations is not a clear-cut task. First, there is no shortage of laws regulating corporations: there is any number of frameworks that attempt to restrict and apprehend undesirable behaviour by corporate organizations, as well as by their key decision-makers. Choosing which instrument to use is not always easy. Another added complexity is that many activities that may subsequently be represented as illegal are often viewed by both regulator and regulatee, at a given time, as normal behaviour or business – at least until it is established that some detriment to other parties has been caused. These complexities are not due to the shortcomings of the law but to the delicate nature of business judgements and the many competing interests that struggle to define the arenas in which they are engaged.

Given the nature and intricacies involved in regulating corporations, socio-legal theorists argue that enforced self-regulation would be a more efficient and effective alternative, rather than the traditional ‘command and control’ strategy. Ayres and Braithwaite (1992)⁵ characterize ‘enforced self-regulation’ as a negotiated instrument between the state and firms or industry groups. Firms and industry groups are required to propose their own regulatory standards so as to avoid harsher or direct state controls. If individual firms breach these ‘private’ or ‘negotiated’ regulatory standards, the state will then resort to legal action. The advantages from this approach are: (1) lower cost and less monitoring by the state; (2) more flexible and adaptive rules contingent on changing circumstances

³ Simpson, S. (2002) *Corporate Crime, Law, and Social Control*, Cambridge University Press, New York

⁴ Baldwin, R., Scott, C. and Hood, C. (ed) (1998) *A Reader on Regulation*, Oxford University Press, New York

⁵ Ayres, I. and Braithwaite, J. (1992) *Responsive Regulation; Transcending the Deregulation Debate*, Oxford University Press, New York

operationalised under the review of peer members in industry groups or the directors of a firm, and (3), since industry groups or individual firms share specific expertise and insights, effective monitoring will be better than if done by the state.

Managers' roles thus evolve beyond managing the affairs of a firm to including 'quasi-regulatory' obligations. These have to be institutionalised within the firm and thus a new breed of professionals, known as compliance officers, managers, and consultants, emerge in many business organizations, in new semi-professional roles that clearly go beyond the traditional bounds of general counsels and legal advisers. The effectiveness of their performance in this role will be measured by the design and implementation of the compliance programs for which they are responsible.

Many compliance systems are drafted along the lines of the 'Compliance Program: AS 3806-1988' developed by Standards Australia.⁶ Regulators such as the Australian Securities and Investment Commission, Australian Competition and Consumer Commission, Australian Taxation Office, and many state agencies, have adopted this framework as a measure to be used for assessing how well firms comply with various corporate regulations.

Even though compliance type regulatory strategy is a top down monitoring structure, nurturing a compliance culture is expected to foster a better enforcement ethos amongst executives and employees. Fiona Haines (1997)⁷ argues that compliance programs do not necessarily create a governmental culture at anything other than a superficial level, since it may be easier and cheaper to comply with the 'terms' stipulated in a selective manner, or use a 'blinker' approach, rather than reform culture at every level of the organization. For instance, corporations might not rigorously enforce and police regulatory obligations where they concentrate most of their resources on creating profits for their shareholders: regulatory compliance may be somewhat lower in the list of priorities and not effectively scrutinized or subject to controls.

⁶ Standard Australia International (1998) *Australian Standard; Compliance programs*, AS 3806-1998

⁷ Haines, F. (1997) *Corporate Regulation; Beyond 'Punish or Persuade'*, Clarendon Press, Oxford

The literature on this issue is largely confined to socio-legal perspectives. There appears to be a lack of research understanding and analysis from an organisation studies approach (see Clegg et al 2002)⁸. For example, the Australian Law Reform Commission depict compliance culture as a failure of corporate culture to endorse and encourage regulatory compliance, but stop short of explaining how compliance culture could be nurtured beyond mere processes and procedures.⁹

The definition and scope of corporate culture is hotly contested in the organisational literature. Edgar Schein (1997)¹⁰ defines culture as the deep, basic assumptions and beliefs that are shared by organizational members. Culture is not displayed on the surface but is rather hidden and often unconscious. It represents the taken for granted way an organization perceives its environment and itself.

⁸ Clegg, S. R. Pitsis, T., Rura-Polley T., and Marosszeky, M. (2002) 'Governmentality Matters: Designing an Alliance Culture of Inter-organizational Collaboration for Managing Projects', *Organization Studies*, 23:3, 317-337.

⁹ Australian Law Reform Commission , *Principled Regulation Report: Federal Civil & Administrative Penalties in Australia*, Report 95 (2002), pp 295-7

¹⁰ Schein, E. (2002) 'Organizational Culture', pp. 196-205 in S. R. Clegg (Ed.), *Central Currents in Organization Studies II: Contemporary Trends, Volume 7*, London: Sage; originally published in *American Psychologist* (1990) 45: 109-119.

To get a better understanding of the different components of culture in organisations, Schein differentiates between three levels of culture.

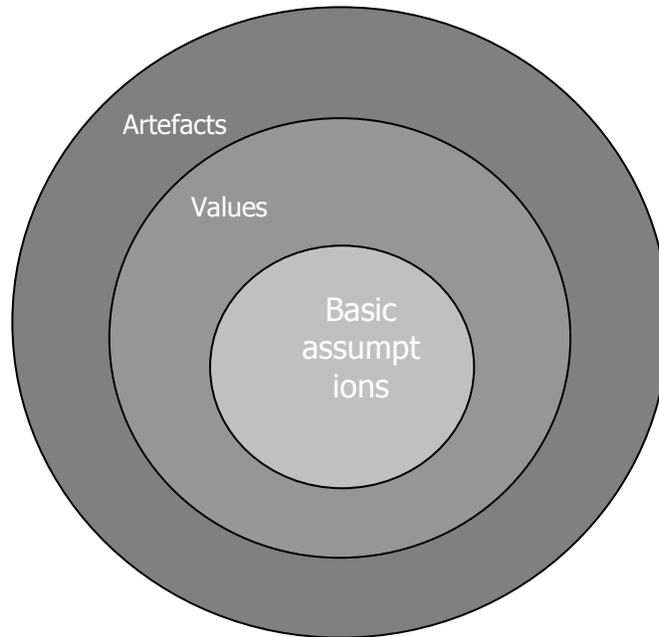


Figure 1 Schein's Three Levels of Culture; or, the Dartboard of Culture

The outer level of the figure represents the level of artefacts: this includes visible organisational features such as the physical structure of buildings, their architecture, uniforms, interior design and logos for instance. This level is easily observable, but does not reveal everything about an organisation's culture. Nonetheless, where the new semi-professions are physically located in relation to the corridors of power will be significant. The mid-level refers to values. They represent a non-visible facet of culture, as they express the norms and beliefs that employees express when they discuss organizational issues.

Mission statements or commitment to equal employment opportunities are part of this level. The deep culture is located at the inner level – where the

basic assumptions are hidden beneath artefacts and expressed values. This is the deepest and most important level, the bullseye in the dartboard of culture.

It includes the basic assumptions shaping the worldviews, beliefs and norms of organisational members, which guide their behaviour without being explicitly expressed. It is the most influential level, since it works surreptitiously and shapes decision-making processes almost invisibly. It is hard to observe, and even harder to change. Nonetheless it is the level that carries most potential for transformation. Hence, nurturing and promotion a culture of compliance requires more than a formal structure and process orientated system to be put in place.

Consideration Issue 7.2

Comment on any aspect of the discussion in this paper on the means by which statutes impose individual derivative liability including:

Have respondents encountered in practice any problems with disparate Commonwealth, State and Territory statutes that impose individual liability and provide for various defences?

If so, what have been the practical effects of these differences in approach, for instance, the impact on compliance programs?

These new proposals and methods of enforcing compliance of directors/officers underplay the effectiveness of s 79 of the *Corporations Act*. Section 79 has, to date, been very stable and has proven effective in pursuing directors and officers from wrongdoings in relation to corporations. The question to be considered here then, is, why change a provision that currently operates relatively effectively?

A further question that should be considered by CAMAC is whether the provisions should be changed before a demonstrated failure has occurred. Do the new provisions make the law clearer, or indeed more murky or confusing to enable both understanding and compliance? Would the current provisions provide a clearer path to understanding for officers and directors than the suggested provisions? What is clear in Australia today is that much time and money has been invested over the last decade to educate corporations and

directors and officers about their compliance responsibilities. To install new provisions would require further educatory programs, more disruption during the 'change over' period and indeed new confusions and stresses for those running corporations. Whether changes are necessary and the best course of action at the present time, is financially and based on corporate efficiencies a necessary and integral question to contemplate.

Is there any evidence to demonstrate that changes will protect shareholders any more effectively than in the existing law?

Consideration Issue 8.4

Comment upon any aspect of the discussion in this section on developing a derivative liability template including:

Are the criteria for assessing the alternate templates appropriate?

Should there be additional or different criteria?

The group proposes that a general template be included in the *Corporations Act*. The underlying purpose of the model is to make adherence to laws uniform between States and different forms of business enterprise. If a different model were to be introduced into each jurisdiction, the action of doing so will defeat the initial purpose of introducing the model.

If a model is proposed and chosen, this must be implemented into the *Corporations Act*, having the effect of making the model a uniformity across all jurisdictions. Without uniform implementation, the use of a model will be of limited use in order to encourage compliance as, states will continue to use their own methods to regulate.

Consideration Issue 9.8

Comment upon any aspect of the discussion in this section on developing a general derivative liability template, including:

Should the ALRC template be adopted, either as proposed by the Commission or with any of the following modifications, namely:

- *modify the categories of individuals liable by adding a specific reference to directors*
- *require the prosecution to prove that the individual knew that, or was reckless or negligent as to whether, the contravening conduct might (rather than 'would') occur*
- *impose an evidential onus on a defendant to provide admissible prima facie evidence of having taken one or more reasonable steps, which the prosecution would then have to negate beyond reasonable doubt*

Should the State and Territory representative template be adopted either:

- *as set out, or*
- *modified to impose only an evidential rather than a legal burden on the defence in relation to the defences?*

Should the alternative State template be adopted?

Should some other general derivative liability template be adopted

Should there be a business judgment rule defence?

If a new legislative template is introduced – whatever final form it takes – it should definitely be included in the *Corporations Act*, so that it applies in a uniform manner throughout Australia. If the template is merely “promoted as a model for each jurisdiction,” and not included in the *Corporations Act*, then the

whole purpose of the reform will be nullified. The states will simply continue to adopt their own inconsistent frameworks.

Thus, with respect to the proposed templates, the Faculty proposes that the definition of those who will be liable should be consistent with the recommendations of extending the duty of care in the CAMAC discussion paper '*Corporate Duties Below Board Level*' (May 2005), i.e. those liable should include "directors, officers, or any other person who takes part, or is concerned, in the management of the corporation".

While we believe that the ALRC template is more practicable than the other proposed templates, the ALRC template would require some modifications. These would include:

(a) defining those who will face liability consistently with any revisions to s.180(1) of the *Corporations Act* (as noted above);

(b) making the test for knowledge, recklessness or negligence with respect to the breaching activity consistent with part 2.2 of the *Criminal Code*, in other words, more detailed and defined more carefully. In fact, there needs to be more consideration overall of the differing burdens of proof for civil and criminal liability;

(c) using "might occur" rather than "would occur"; and

(d) imposing an evidential burden on the defendant with respect to taking reasonable steps to prevent the contravening conduct (as it would be very difficult to prove that someone has not taken any steps)

The representative template goes too far in creating an absolute liability that infringes on the presumption of innocence. Since the typical offences being prosecuted will be at least quasi-criminal, one should not tilt the balance too far in favour of ASIC and against individual rights.

The alternative template creates a test that is extremely difficult for the prosecution to satisfy, for example, proving "knowledge" of the officer. It is also unclear what it means to "have regard to" the enumerated factors: are they

defences or not? Again, the quasi-criminal nature of a prosecution by ASIC makes it essential that the rights of defendants are set out very clearly in the statute.

Burdens of Proof:

The burden of proof used in these templates are a very important consideration. The ALRA template implements the element of '*mens rea*' into all offences of directors and officers. This in turn, places the evidentiary burden on the prosecution to prove that the director/ officer had the necessary mind set to commit the crime and additionally, protects the concept of the presumption of innocence. These factors are important for a variety of reasons:

- upholds the basic underlying principle of the Australian legal system of innocence until guilt is proven
- Avoids the introduction of 'strict liability' offences being implemented into the *Corporations Act*.

Consideration Issue 10.4

Comment upon any aspect of the discussion in this section on developing a responsible officer derivative liability template, including:

- *who should have what burden of proof in relation to reasonable steps ?*
- *should some other responsible officer derivative liability template be adopted?*

The responsible officer derivative liability template would lead to a highly undesirable situation where only one officer becomes liable for the wrongful behaviour of many corporate actors.

The responsible officer may also lack the power or authority to put in place compliance measures. If he or she raises a successful defence that all his/her attempts to put measures in place were rebuffed by the Board, does that mean

the Board cannot be held liable for obstruction? If other members of the Board can be held liable, then why have a responsible officer at all? If other members cannot be held liable, then wrongful behaviour could easily go unpunished. Finally, what are the “designated purposes” for which the responsible officer will be held liable? The template leaves this open

The template also leaves undefined the concept of what the “designated purposes” are for which a responsible officer will be held liable.

This directly relates back to the whole purpose of the reform proposal: is it just to unify the existing disparate state legislation, or is it meant to extend personal liability to directors/officers for *all* corporate fault? The scope of the legislation needs to be addressed more clearly before a clear idea of its potential benefits can be formed.

The Canadian Position

In Canada, there is no general personal liability provision for corporate breaches of statute. In his monograph *Canadian Criminal Law* (Carswell 1995), Don Stuart (at p.590) refers to automatic personal liability imposed on corporate officers as “bypassing fundamental principles of justice to scapegoat company executives. ... The normal fault required for accessory liability is an intent to aid the commission of an offence. This should also be the standard for persons working in corporations. Apart from arguments of law enforcement expediency, it is difficult to justify special accessory rules for company executives and directors. In the case of directors, there would often be a vast difference between the culpability of a hands-on inside director and that of an outside director. A corporate executive should be punished on the basis of his or her own act and fault. Working for a company should not forfeit rights to be protected against unjust punishment.”

However, Stuart also notes (with disapproval) that some individual Canadian federal and provincial statutes do in fact impose personal liability on officers and directors for offences by the corporation. One example is the Ontario Environmental Protection Act, R.S.O. 1990, c. E-19, s.194, which reads in part as follows [emphasis added]:

194. (1) **Every director or officer of a corporation has a duty to take all reasonable care to prevent the corporation from,**

(a) discharging or causing or permitting the discharge of a contaminant, in contravention of,

(i) this Act or the regulations, or

(ii) a certificate of approval, provisional certificate of approval, certificate of property use, licence or permit under this Act;

(b) failing to notify the Ministry of a discharge of a contaminant, in contravention of,

(i) this Act or the regulations, or

(ii) a certificate of approval, provisional certificate of approval, certificate of property use, licence or permit under this Act;

....

Offence

(2) **Every person who has a duty under subsection (1) and who fails to carry out that duty is guilty of an offence.** R.S.O. 1990, c. E.19, s. 194 (2).

The Canadian approach suggests that imposing a general personal liability on officers/directors for corporate fault would be too draconian, especially if it included criminal and quasi-criminal offences, due to the lack of proof of individual fault. However, restricting personal liability to a handful of offences in the area of environment, occupational safety and so on begs the question as to why there are double standards for different kinds of breaches. The group believes that these issues need to be discussed by CAMAC in more detail.

The American Position:

CAMAC has noted that the USA has developed a Responsible Corporate Officer doctrine (RCO). The discussion paper however, failed to note the criticism that surrounds this doctrine in the USA.

The RCO was first introduced in the USA in the Public Welfare Statutes in the 1940's in the case of *United States v Dotterweich* (1948) 320 US 277. In that case, Dorweich, the President and General Manager of a small pharmaceutical packaging company, had been convicted, along with his company, for misdemeanour violations of the *Federal Food, Drug and Cosmetic Act of 1938*. Dotterweich was held personally liable for violations of the Act even though there was no showing that he knew of or participated in the illegal activity. His mere position in the company made him liable.

Today the RCO in the USA is also applied in environment laws. This doctrine is being criticized by both academia and the legal profession. It was possible to apply the RCO in the Public and Welfare Statutes because the Acts are ones of strict liability. Accordingly there is no need to prove mens rea- just holding a board position is sufficient to attract liability. The principle when applied to the environment laws is more complex because the liability is not one of strict liability. As a result, there is an ongoing debate about the efficiency and the application of the RCO in the USA. Should a person be liable because of the position they hold or because they knew that the contravention was taking place. So do we require a present element of mens rea or not? Most of the cases in the USA that deal with RCO in relation to environment laws require that the prosecution proves that the person knew of the contravention. Accordingly the burden of proof is on the prosecution.

Conclusion:

CAMAC should be commended for commencing an important discussion on this topic of corporate fault liability and the supplementary discussion on liability below board level. However, as our submission indicates, there is a lot more to these issues than which is raised in the Discussion Paper. The existing law is not “failing” in a demonstrable way and these potential changes could cause greater uncertainty in this complex area. The work that is being conducted on corporate governance and corporate social responsibility also goes to the heart of the civil and criminal liabilities of corporations. CAMAC needs to take into careful consideration these many threads and not produce a “knee-jerk” reaction to some current corporate failures. The Corporate Law Group at the faculty of Law and the UTS Centre for Corporate Governance, both support the refinement and development of the concept of a culture of compliance, as found in the Commonwealth *Criminal Code* and as has been developed by the Australian Competition and Consumer Commission.

UTS Corporate Law Group, Faculty of Law.

10th August, 2005

Please email any comments/questions to Michael.Adams@uts.edu.au