Should companies be allowed to recover competition law fines from their directors?

(based on: Kelvin Kwok and Ernest Lim, 'Optimal Deterrence, Corporate Attribution and the Illegality Defence' European Business Organization Law Review (accepted and forthcoming))

Kelvin Hiu Fai Kwok
Assistant Professor, Faculty of Law, University of Hong Kong

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Companies are subject to different regulatory requirements under different statutes

- Many of these statutes impose liability on the company itself, as opposed to its directors or employees (i.e. no personal liability for insiders)
- E.g.: Gas Act 1986, s.30A; Electricity Act 1989, s.27A; Financial Services and Markets Act 2000, s.206; Communications Act 2003, s. 96
- A company as an artificial entity can only act through its agents (insiders)
- The acts or state of mind of the insiders must be attributed to the company to to render it liable under the relevant regulatory provisions
- If a company are fined for violating a regulatory provision, should it be allowed to recovery the fine (and relevant expenses) from the relevant insiders, by suing the insiders for breach of duty?

Competition law as a case study

- Competition Act 1998 – Chapter I prohibition, Chapter II prohibition – imposes civil liability on undertakings (i.e. companies, partnerships and sole proprietors)
- s. 36(3): OFT/CMA may impose a penalty on an undertaking only if it is satisfied that the infringement has been committed intentionally or negligently by the undertaking
- As a company can only act through its agents, anti-competitive activities of insiders have to be attributed to the company to render it personally liable
- As a matter of practice, the acts of employees are always attributed to the company

NB. Compliance programme does not prevent attribution – only mitigation in penalty

- "the Act attributes liability to the undertaking and it is for the undertaking to organise its affairs in such way as can prevent infringements" (*Safeway v Twigger*, per Longmore LJ)
- The statute itself does not prohibit the company's recovery against its insiders

Safeway Stores v Twigger (CA decision)

- Company fined for violating the Competition Act because of the information-sharing activities of its directors or employees
- Safeway brought suit against the directors and employees (D&O insurers), for breach of contract, breach of fiduciary duty, and/or negligence
- Unusual in that D&O insurance usually excludes coverage for intentional breaches
- Nothing under statute or insurance policy prevents the suit, but …
- CA held: company is **prohibited** from suing for breach of duties because of the illegality defence
- Two policy reasons in favour of applying the illegality defence: 1) consistency 2) deterrence
- **NB.** case was decided prior to Supreme Court decision in ***Patel v Mirza*** **[2016] UKSC 42**
  - New, 'range of factors' approach to the illegality defence.

Does attribution matter?

CA in *Safeway* – NO. Does not affect the application of the illegality defence ([29]).

Attribution only matters for the regulatory liability stage.

Acts of the employees and directors have to be attributed to the company to render it liable.

Once attributed → company liable under CA 1998 → company has acted illegally → illegality defence is engaged

Attribution is irrelevant at the stage of applying the illegality defence (*Hampshire Land* exception, i.e. no attribution where company is victim of insiders' fraud/breach of duties, is irrelevant)

But policy considerations remain relevant – ie. the reasons in favour of (and against) barring the private law claim under the illegality defence

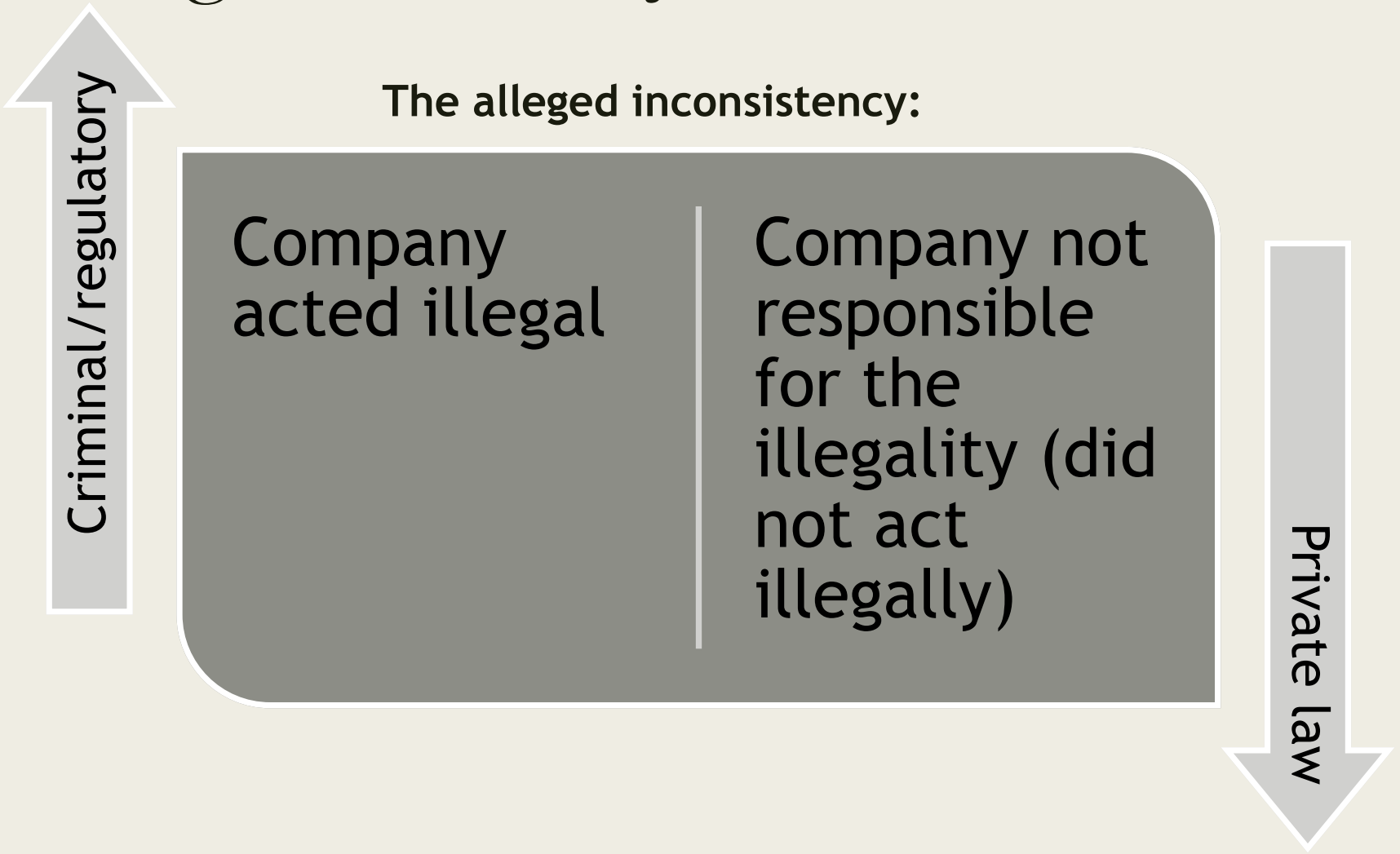
Reasoning of *Safeway*

First ground: consistency

'… the need for the criminal courts and the civil courts to speak with a consistent voice. It would be inconsistent for a claimant to be criminally and personally liable (or liable to pay penalties to a regulator ...) but for the same claimant to say to a civil court that he is not personally answerable for that conduct. … [The claimant companies] are personally liable to pay those penalties and it would be inconsistent with that liability for them to be able to recover those penalties in the civil courts from the defendants. '

- Per Longmore LJ

Reasoning of ***Safeway***



Reasoning of ***Safeway***

- Is there really an inconsistency?
  - Public law (regulatory) stage – the subject matter is the company's illegality
  - Private law issue – the subject matter is the insiders' breach of duties
  - Company is <u>not</u> seeking to deny the fact that it has acted illegally and is responsible for the illegality, but it is simply seeking to recover, pursuant to a separate set of laws (i.e. contract, tort, company law), damages for the insiders' breach of duties
  - To deprive the company of the right to pursue the well-established private law remedies would be to ignore or bypass separate legal personalities

Reasoning of ***Safeway***

Second ground: deterrence

'The policy of the statute would be undermined if undertakings were able to pass on the liability to their employees or the employees' D & O (directors and officers) insurers. Only if the undertaking itself bears the responsibilities, and meets the consequences of their non-observance, are the public protected. A deterrent effect is contemplated and the obligation to provide effective preventative measures is upon the undertaking itself.'

- Per Pill LJ

Deterrence –the 'range of factors' approach to the illegality defence

Stage 1: consider the purpose of the regulatory prohibition

➔ *To deter anti-competitive activities*

➔ *Deterrence objective undermined?*

Stage 2: consider the impact of denying the claim on other public policies

➔ *Company's right to seek redress for breach of duties by insiders / employees under the Companies Act and common law*

Stage 3: consider whether it would be disproportionate to refuse relief to the company

➔ *If there is a conflict between Stages 1 and 2, need to conduct a 'balancing' / proportionality analysis.*

Criticism #1: Allowing recovery may actually enhance *deterrent* effect

- First, it's more realistic to assume *partial* recovery as opposed to full recovery (e.g. coverage limit, legal expenses, reputational damage may prevent full recovery)
- Company still bears some of the loss → has incentive to company with Act → has incentive to invest in compliance measures to control the actions of directors and employees, through:
  - *ex ante measures:*
    - providing regular legal training to its insiders
    - establishing mechanisms for monitoring and detection of violations
  - *ex post sanctions:*
    - dismissing the delinquent insiders
    - **suing them for breach of duties (no longer available!)**

    → Barring the company from suing will remove an **effective mechanism** through which the company seeks to punish, and hence deter, insiders' engagement in illegal activities

Criticism #1: Allowing recovery may actually enhance *deterrent* effect

- *ex post* sanctions are still effective even if insiders are insured as:
  - *may still have to pay out of their own pockets if insurance policy is subject to a coverage limit*
  - *reputational damage as their identities may be publicly disclosed in the course of legal proceedings*
  - *dissuade future employers from hiring them (also higher insurance premium that future employers may have to pay for any D&O insurance)*

Criticism#2: Optimal Deterrence

Rethinking deterrence

- Undoubtedly an important objective of competition law enforcement
- But should 'deterrence' be understood as the pursuit of deterrence at all costs? Or only deterrence at an 'optimal' level, considering the social costs involved in promoting deterrence?
- What are the social costs involved? Compliance costs incurred by companies, to set up the *ex ante* and *ex post* measures.
- Implications:
  - Undermining deterrence is only a valid concern in favour of applying the illegality defence if it means a suboptimal level of deterrence
  - At Stage 1 of the 'range of factors' approach, we should be asking whether allowing the company's recovery would undermine optimal deterrence, as opposed deterrence without limitation/qualification

Optimal Deterrence

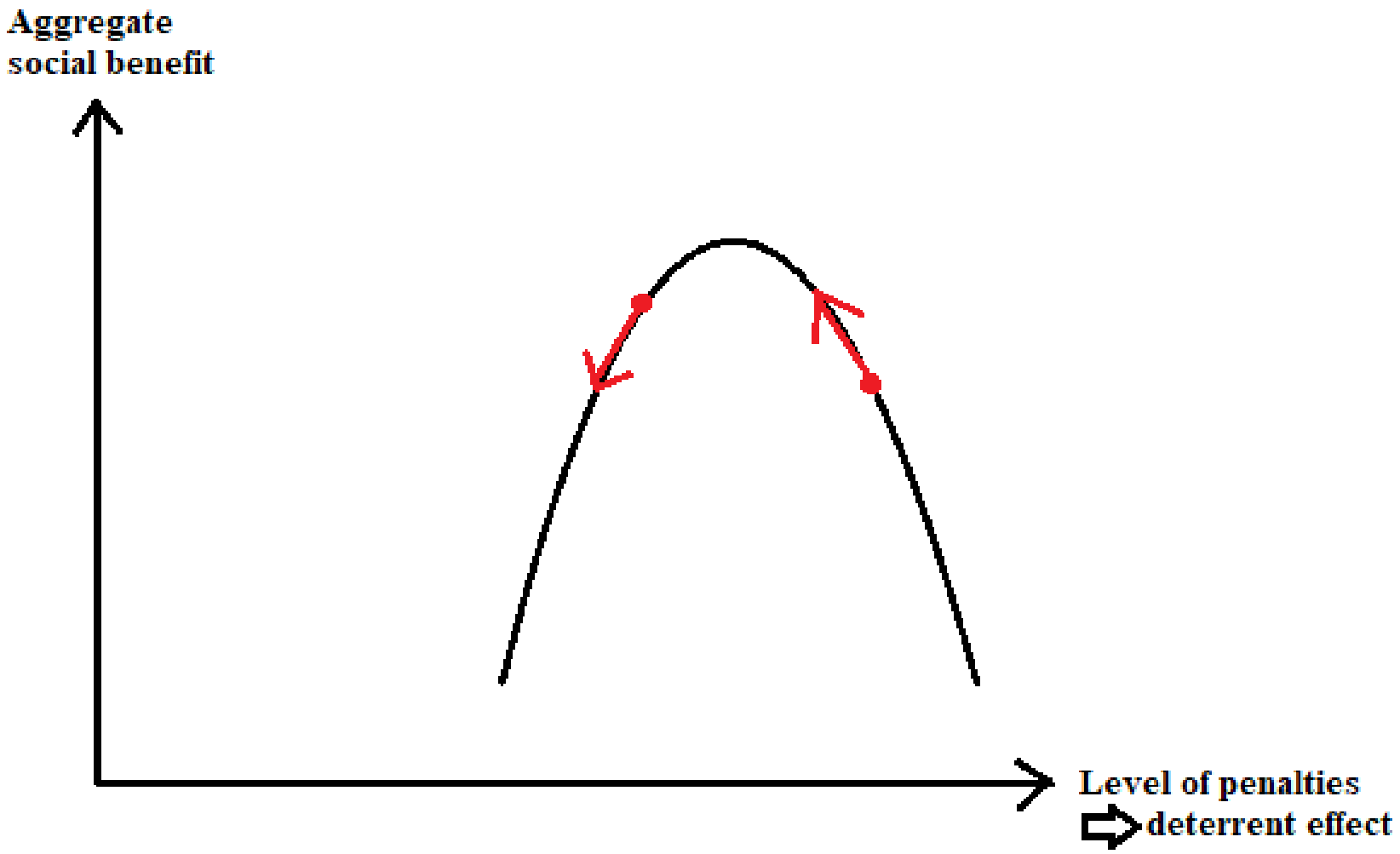
- Involves a careful trade-off between the benefits and costs of promoting deterrence
- The law should only promote deterrence to the extent that the incremental benefits > incremental costs
- Should no longer step up deterrence if incremental costs > incremental benefits
- Should not increase the de facto penalty (by barring the companies' claim) if incremental costs > incremental benefits

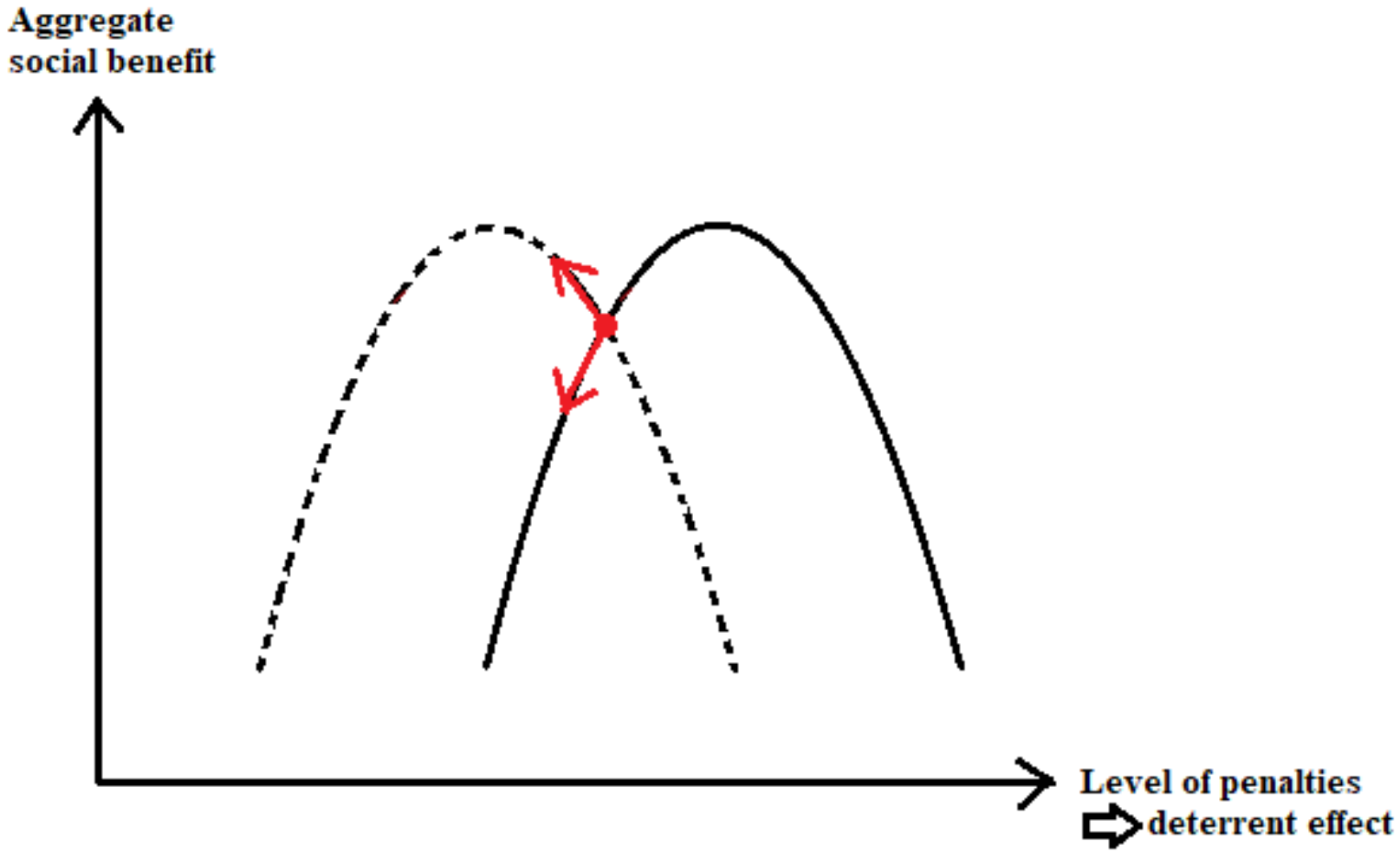
Benefit:

an increase in consumer or social welfare resulting from fewer competition law violations

Cost:

the increase in corporate expenditure on compliance, and any consequential reduction in output due to passing-on effects (companies increasing their prices)


Aggregate
social benefit
Level of penalties
deterrent effect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Optimal Deterrence

- So courts, in determining whether allowing the companies' recovery would undermine deterrence in the sense of moving the law further away from optimal deterrence, must have some idea of whether the current fines are set an optimal level (assuming no recovery)
- But courts are not in a good position to do so because:

(1) Complexity of determining optimal deterrence

(2) Beyond the institutional competence of courts

Benefit:	**Cost:**
an increase in consumer or social welfare resulting from fewer competition law violations	**the increase in corporate expenditure on compliance, and any consequential reduction in output due to passing-on effects (companies increasing their prices)**

(1) Difficult to determine the point of optimal deterrence

- Cannot assume that the OFT/CMA (or the CAT) sets penalties at an optimal level

- Also, it would be unrealistic to expect a court deciding the ***Safeway*** issue to determine whether the penalty set by the regulator or appeal tribunal is in fact optimal

  → Must not only consider the trade-off between consumer/social welfare loss v compliance costs, but also <u>how an increase in the de facto penalty affects other enforcement mechanisms</u>

Difficult to determine the point of optimal deterrence

- Other mechanisms that alter the point of optimal deterrence:
  - Private enforcement
  - Director disqualification orders made under the Company Directors Disqualification Act 1986
  - Criminal prosecution of directors or employees under the cartel offence

Difficult to determine the point of optimal deterrence

- Other mechanisms that alter the point of optimal deterrence:

- permitting a company's recovery may undermine the leniency policy → depends crucially on assistance from directors or employees involved in the unlawful activities
  - *They may be discouraged from offering incriminating evidence*
    - increase their chance of being sued by the company ex post
  - *Even where the company benefits from a full immunity*
    - company may wish to recover legal expenses incurred during the investigation
    - the company may also be exposed to the risk of follow-on private actions for damages

(2) Limits of judicial law-making

- Issues of optimal deterrence are beyond the institutional competence of the courts
- Lacks relevant information and lacks policy expertise
- 'Traidic structure' of the court
  - *Function merely as a platform for resolving legal disputes*
  - *ill-suited to make decisions on issues of a 'polycentric' nature, as in legal issues which are intertwined with broader policy questions and impact upon many third parties other than the litigants themselves*

(2) Limits of judicial law-making

- Polycentric issues arising from optimal deterrence are best handled by policy-makers ie **the government through Parliament**
  - *Capable of conducting a comprehensive empirical study on whether optimal deterrence could be enhanced by systematically barring companies' recovery against insiders*
  - *If so, can impose a blanket ban by legislative amendment*

Conclusion

- In the absence of such legislative intervention, the judiciary should not bar a company's recovery by the illegality defence
  - NB no conflict between the first 2 stages of the illegality defence
- Intervention to bar company's recovery should come from legislature
- The normative proposal can be generalised beyond competition law to other regulatory contexts