

# MISSING THE MARK?

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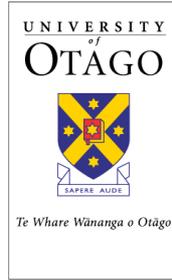
## **Economic theory and optimal penalties for competition offences under New Zealand's Commerce Act**

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**A dissertation submitted in partial fulfillments of the degree of Bachelor  
of Laws (Honours) at the University of Otago, Dunedin.**

**October 2007**



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## **ACKNOWLEDGMENTS**

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## CHAPTER ONE: INTRODUCTION

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Over twenty years have now passed since the introduction of the Commerce Act 1986 ("the Act"). The Act has the purpose of "promoting competition in markets for the long-term benefit of consumers within New Zealand."<sup>1</sup> It does this by prohibiting a range of anti-competitive business practices including the formation of contracts, arrangements or understandings which substantially lessen competition;<sup>2</sup> price fixing;<sup>3</sup> resale price maintenance;<sup>4</sup> and prohibitions on the actions of firms that possess a substantial degree of market power.<sup>5</sup> Anti-competitive behaviour leads to inefficiency which makes it harder for New Zealand to compete on the international stage.

Since the Act's genesis, 27 cases have resulted in a pecuniary penalty being imposed by the court.<sup>6</sup> Penalties have ranged in scope from nominal<sup>7</sup> to millions of dollars.<sup>8</sup> They have been imposed on everyone from horticulturalists,<sup>9</sup> to professionals and professional bodies,<sup>10</sup> to our biggest companies.<sup>11</sup>

The courts have noted that the main consideration in setting a penalty is the need for that penalty to deter.<sup>12</sup> The individual must be deterred from performing the same act again and there must be general deterrence for the commercial community. However, on the whole the penalties awarded by the courts have been modest. This dissertation will assess whether the courts' reasoning and the subsequent penalties imposed have been adequate to deter competition offences. Adequacy implies a comparison with a standard. Due to the inherent economic nature of competition law, it is appropriate to compare the statutory regime and judicial application to see if they are consistent with

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<sup>1</sup> Commerce Act 1986, s1A.

<sup>2</sup> *Ibid.*, at s27.

<sup>3</sup> *Ibid.*, at s30.

<sup>4</sup> *Ibid.*, at s37.

<sup>5</sup> *Ibid.*, at s36: where a firm with a substantial degree of market power is prohibited from taking advantage of that power for the purpose of restricting the entry of a person into a market; eliminating a person from a market; or preventing or deterring a person from engaging in competitive conduct.

<sup>6</sup> See Appendix Two for details of these cases.

<sup>7</sup> *Otago and Southland*: where 14 awards of \$5 were made.

<sup>8</sup> *Koppers*: where a penalty totaling \$3.6 million was imposed for price fixing (\$2.85 million) and exclusionary conduct (\$750,000).

<sup>9</sup> *Otago and Southland*.

<sup>10</sup> *Ophthalmological; Ellingham*.

<sup>11</sup> *Carter Holt* (HC, CA).

<sup>12</sup> See Chapter Four for further discussion on deterrence.

the economic ideal of 'optimal deterrence'.

Chapter Two contains an introduction of the idea of economic deterrence through the construction of the model of optimal deterrence. The basic principle of optimal deterrence is that the expected gain from commission of an offence must be less than the expected losses. From this starting point other factors can be included, such as risk aversion, costs to the firm arising from detection and the probability that the fine will deter illegal behaviour.

Chapter Three analyses the current statutory regime and discusses the extensive changes made to penalties by the Commerce Act Amendment 2001 ("the 2001 Amendment"). Presently there are discrete sections with different mandatory considerations and maximum penalties for breaches of Part 2 (restrictive trade practices) and Part 3 (business acquisitions).

Applying the principles of economic deterrence I will critique the statutory framework. I will examine the problems identified as the impetus for the 2001 change and discuss whether they have been rectified. I will also focus on the statutory maxima which were substantially increased in 2001.

Chapter Four undertakes an analysis of how the courts have interpreted and applied the statutory law, including a discussion of the mitigating and aggravating factors considered when setting penalties. I will then examine each of these factors in turn to consider whether these factors are consistent with optimal deterrence and whether the courts are placing sufficient weight on them.

In Chapter Five I will focus on what is touted as the most important issue in competition law worldwide: the existence of powerful international cartels. No large-scale international cartels have been uncovered in New Zealand so far. However, this does not mean they have not existed; cartel behaviour is inherently hard to uncover. Several national cartels have been discovered and penalised.<sup>13</sup>

Many of our closest trading partners allow for the criminalisation of those caught engaging in cartel behaviour and Australia is soon to follow. While the debate remains undeveloped in New Zealand, it is inevitable that calls for criminalisation

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<sup>13</sup> See Appendix Two for a list of price fixing cases between 1986 and 2007.

will grow louder when Australia introduces criminal penalties, or when the first large scale 'hard-core' international cartel is discovered. New Zealand has already followed Australia's lead with the introduction of criminal penalties for insider trading offences.<sup>14</sup>

There are strong arguments on both sides of the criminalisation debate. 'Hard-core' cartels have drastic effects on efficiency, causing losses of billions of dollars every year. They are hard to detect and successful prosecution is rare. The risk of a criminal conviction for an individual could provide a deterrent which the risk of a civil penalty simply cannot match. I will conclude that criminal sanctions can be justified in New Zealand for individuals, but not corporations.

In Chapter Six I discuss another way of deterring cartel behaviour; by increasing the likelihood of detection. I will outline and evaluate the Commerce Commission's ("the Commission's") leniency policy, under which the Commission will not prosecute the first person to inform it about the existence of a cartel.

In Chapter Seven I will conclude and make recommendations. I take a Harvardian view of competition law, because it is more consistent with the principles of the legal system. This Harvardian view allows me to argue that criminal penalties can be justified for individuals in New Zealand. I also make recommendations as to how the statutory framework needs to be changed to promote deterrence.

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<sup>14</sup> Securities Markets Amendment Act 2006, s5 would allow imprisonment of up to 5 years for insider trading. Note that this section only comes into force from a date yet to be appointed by an Order of Council.

## CHAPTER TWO: THE ECONOMIC STANDARD

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### ***Introduction***

Economics is inescapably intertwined with competition law. Many of the key competition law concepts have their origins in economic discourse, for example 'markets', 'market power', 'competition', and 'efficiency'.<sup>15</sup> Economic considerations are valuable to the courts in assessing liability and can give a coherent framework for calculating a pecuniary penalty. Both competition law and economics have the common purpose of creating an environment which promotes efficiency.<sup>16</sup>

### ***Efficiency as a common goal***

Broadly defined, the efficient allocation of scarce resources is the primary concern of economics. The classic conception of efficiency in economics is that of Pareto efficiency. Pareto efficiency is attained when there is no outcome which will leave someone better off without leaving someone else worse off. This was modified into the Kaldor-Hicks conception of efficiency: an efficient situation is one where the gains of those who are made better off *could* more than fully compensate for the losses of those who are made worse off. The Kaldor-Hicks criterion does not actually require this compensation to be paid.

The Chicago school of law and economics grew from this economic background. The primary belief of Chicagoans is that the market system is the most efficient way of organising economic activity and the government should have only a minimal involvement.<sup>17</sup> This view is hostile to market regulation. The Chicago school offers an "elegant, pro-market and largely anti-government vision of antitrust policy".<sup>18</sup>

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<sup>15</sup> New Zealand Law Society, "Economics and Competition Law" (Seminar presented by James Mellsop and James Palmer, September 2004), at 3; Similarly, Richardson J commented in *Tru Tone*, at 358, that the input of economists in competition law cases was beneficial.

<sup>16</sup> New Zealand Law Society, "Economics and Competition Law", at 3.

<sup>17</sup> Stephen Martin, "Remembrance of Things Past: Antitrust, Ideology, and the Development of Industrial Economics" in Vivek Ghosal and Johan Stennek (eds), *The Political Economy of Antitrust* (Amsterdam: Elsevier, 2007) 25, at 32.

<sup>18</sup> Herbert Hovenkamp, "The Reckoning of Post-Chicago Antitrust" in Antonio Cucinotta et al (eds), *Post-Chicago Developments in Antitrust Law* (Massachusetts: Edward Elgar Publishing, 2002) 1, at 3.

The Chicago school considers efficiency to be the sole goal, and is “not concerned with issues such as equity, fairness or redistribution of wealth”.<sup>19</sup> Government interference can only be justified if interference would increase efficiency. William Landes has stated that the justification for making cartel behaviour illegal is not that it redistributes welfare<sup>20</sup> from consumers to producers, but that it creates a ‘deadweight loss’ - an overall loss of efficiency.<sup>21</sup> The Chicago school, encapsulating the fundamental neo-classical view,<sup>22</sup> rose to prominence in the 1980s concurrently with the monetarist revolution and policies of market liberalisation.<sup>23</sup>

Pre-dating the Chicago school, economic thought in competition law was dominated by the Harvard school. The Harvard school recognises efficiency as important, but not as the *sole* purpose for competition law. The Harvard view stresses the importance of the distribution of wealth between consumers and producers, in contrast to the Chicagoan focus on overall welfare gain. The Harvard school is wary of concentrated power and asymmetries of information existing between consumers and producers. Its members perceive the market to be less robust than do the Chicagoans. Harvardians see a valuable role for the government in regulating to correct market failure and promoting competition.<sup>24</sup>

It could be argued that the pendulum has swung back the other way, and that competition economics are now in a ‘post-Chicago era’ in which many of the Harvard School’s concerns are being reconsidered and the robustness of the market criticised. The major international developments in competition law since the Chicago school gained ascendancy in the 1980s have been in Europe with the integration of markets within the European Community (EC). Roger Van den Berg argues that the emphasis put on consumer welfare, as opposed to net economic welfare, shows distributive goals are being pursued, and is evidence

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<sup>19</sup> Stephen Corones, *Competition Law in Australia* (Sydney: 3<sup>rd</sup> ed, Lawbrook, 2004), at 21.

<sup>20</sup> Welfare is an economic term meaning the overall enjoyment received by a consumer purchasing a good or by a producer selling a good.

<sup>21</sup> William Landes, “Optimal Sanctions for Antitrust Violations” (1983) 50 *Chicago Law Review* 652, at 653.

<sup>22</sup> A neo-classical view is an economic approach which considers that the market is the most efficient way to allocate resources, and impediments (such as subsidies and minimum wages) detrimentally effect this efficient allocation.

<sup>23</sup> Such as Reaganomics in the United States of America; Thatcherism in the United Kingdom; Rogernomics in New Zealand.

<sup>24</sup> Corones, *Competition Law in Australia*, at 20.

that the EC has adopted a post-Chicago approach.<sup>25</sup>

Globally, the impetus for a movement away from the Chicago school is related to the global justice movement.<sup>26</sup> In a globalising world the question is posed: "Can we contain private power without crossing the bound into too much public power?"<sup>27</sup> This wariness about private power and a general disenchantment with neo-liberalism fits into a post-Chicago framework. Post-Chicagoans contend efficiency should no longer be the sole goal of competition - "the world of post-Seattle does not revolve around Chicago".<sup>28</sup>

### ***New Zealand's position***

Prior to 2001, the long title of the Act was to "promote competition in markets". This is Harvardian in nature because it suggests that competition is an end in itself, and does not mention the paramount Chicagoan concern of 'efficiency'.

Despite this, the courts took an interpretation of the Act which was Chicagoan in nature. In *Tru Tone*, Richardson J stated that the Act "is based on the premise that society's resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources".<sup>29</sup>

The long title was reclassified as a 'purpose' section in 2001 and amended to read: "An Act to promote competition for the long-term benefit of consumers in New Zealand".<sup>30</sup> According to the Commerce Committee ("the Committee") this was meant to confirm the interpretation taken by the courts that competition is a means to the end of efficiency, and not a goal in itself.<sup>31</sup> However, section 1A is ambiguous and capable of both a Chicagoan and a Harvardian interpretation.

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<sup>25</sup> Roger Van den Berg, "The Difficult Reception of Economic Analysis in European Competition Law", in Cucinotta et al (eds), *Post-Chicago Developments in Antitrust Law* (Massachusetts: Edward Elgar Publishing, 2002) 34, at 42.

<sup>26</sup> Global justice is a political theory concerned with notions of distributional fairness. It is widely regarded that the Seattle protests against the World Trade Organisation in 1999 were the first overt, large-scale expression of this movement.

<sup>27</sup> Eleanor Fox, "Post-Chicago, Post-Seattle and the Dilemma of Globalisation", in Antonio Cucinotta et al (eds), *Post-Chicago Developments in Antitrust Law* (Massachusetts: Edward Elgar Publishing, 2002) 76, at 84.

<sup>28</sup> *Ibid.*

<sup>29</sup> *Tru Tone*, at 358.

<sup>30</sup> Commerce Act 1986, s1A.

<sup>31</sup> Commerce Amendment Bill 1999, No. 296-2, at 7.

A Harvardian interpretation could be taken because of the explicit reference to 'consumers' which arguably suggests distributional concerns.<sup>32</sup> This is buttressed by the Chairperson of the Committee, David Cunliffe, saying in Parliament that in competition law, consumers' interests are more important than businesses' interests.<sup>33</sup> Furthermore, the Committee removed a reference to the 'efficient operation of markets' which was included in SOP No. 37.<sup>34</sup>

Despite removing any reference to efficiency, the Committee did intend a Chicagoan interpretation. The Committee stated that an efficiency analysis, which considers productive, allocative and dynamic efficiency, is consistent with 'long-term consumer welfare',<sup>35</sup> and that 'long-term consumer welfare', is the overarching goal of competition law.<sup>36</sup> Furthermore the Committee stated that efficiency was a satisfactory reason to rebut the presumption that competition was beneficial for consumers.<sup>37</sup> This conclusively demonstrates the Committee's Chicagoan interpretation.

The courts have maintained the Chicagoan interpretation by explicitly not changing their interpretation of the Act despite the change in the wording of section 1A.<sup>38</sup> The Committee's statement that the new purpose section will not fundamentally change the (Chicagoan) interpretation of the Act was correct, despite the fundamental change that a plain reading of section 1A suggests and contrary to the intention of Parliament.

### ***The goals of sentencing***

In general law there is no single coherent purpose of sentencing.<sup>39</sup> Ascribing a purpose is of instrumental importance to ascertain the pecuniary amount which will fulfil the objective of the sentence. The comprehensive Australian Law

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<sup>32</sup> Distribution concerns (the distribution of welfare between consumers and producers) is important in a Harvardian view, but not a Chicagoan view which focuses on *total* welfare.

<sup>33</sup> David Cunliffe (2001) 592 NZPD 9070, at 9077.

<sup>34</sup> Supplementary Order Paper, 1 August 2000, No. 37.

<sup>35</sup> Commerce Amendment Bill 1999, at 7.

<sup>36</sup> *Ibid.*

<sup>37</sup> *Ibid.*, at 6. This indicates that efficiency is the primary goal, and competition should only be pursued where it is consistent with efficiency.

<sup>38</sup> In *Qantas*, at [241] Hansen J noted that "the introduction of s1A should not disturb the Commission's established practice of treating as neutral the wealth transfers between New Zealand consumers and producers". This view takes a holistic efficiency interpretation of the Act.

<sup>39</sup> Geoff Hall, *Butterworth's Sentencing Guide* (Wellington: Butterworths, 1994), at 61; Arthur Campbell, *A Law of Sentencing* (New York: Rochester, 1978), at 21.

Review Committee report outlines the following aims of sentencing:<sup>40</sup>

- Retribution ('just deserts')
- Social condemnation
- Specific deterrence (to deter the individual from offending again)
- General deterrence (to deter others for engaging in the prohibited activity)
- Protection of third parties or the public at large
- Payment of reparation or compensation.

"The form and level of penalty applied will depend on its purpose as well as on the area of activity, the type of wrongdoer and the nature of the wrongdoing".<sup>41</sup> However, the aims of sentencing often conflict with each other, making considerations of the level of penalty problematic. The law also has other overriding principles, such as 'proportionality', which can also conflict with sentencing objectives. For example the death penalty for parking violators would fulfil the aim of deterrence but fail dismally on proportionality.

### ***Applying economics to the sentencing of competition law offenders***

Chicagoans and Harvardians agree that an important purpose of economic regulation is specific and general deterrence. However, the schools disagree over whether social condemnation should also be a goal. A Chicagoan would say that sentences should 'internalise' the harm caused by the offence, giving the offender a choice whether or not to commit the action. If the harm caused (which is imposed on the defendant through the fine) exceeds a firm's private gain, it is irrational in economic terms to commit the offence. Therefore, by imposing this cost, the offence will be deterred. However, if the gain to the offender exceeds the harm caused to society, it is profitable for the offender to commit this act because using an internalisation approach they will still profit. These are known as 'efficient offences' and the Chicagoan would argue that

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<sup>40</sup> Australian Law Reform Commission, "Principled Regulation: Federal Civil & Administrative Penalties in Australia" (ALRC 95), (Australian Law Reform Commission, Sydney, 2003), at 104.

<sup>41</sup> Ibid.

these should not be deterred

This 'internalisation approach' leaves no room for additional penalties to include moral condemnation, as doing so could deter otherwise efficient crimes. The moral effect of fining under the internalisation approach is "weakened, or even eliminated ... because the antitrust fine is not presented as 'a sanction for doing what is forbidden', but rather as the 'price for doing what is permitted'".<sup>42</sup>

The Harvard school rejects the notion of an 'efficient offence'. It contends breaking antitrust laws should always be penalised, and showing that an offence was efficient should not be a defence. This approach is more deontological<sup>43</sup> compared to the largely utilitarian<sup>44</sup> approach of Chicagoans. The Harvard or post-Chicagoan schools would deter all offences "irrespective of whether the offenders' gain exceeded the harm caused to consumers".<sup>45</sup> This recognises the importance of distributional notions of justice as opposed to holistic notions of efficiency,<sup>46</sup> and as a result provides greater protection to consumers. The Harvard school would impose harsher penalties than the Chicago school by pursuing both deterrence *and* moral condemnation.

### ***The key assumption***

That the offender is a rational decision-maker is an assumption required by both economic schools. The importance of the validity of such assumptions is downplayed by some who emphasise that the sole litmus test for a theory is its ability to predict, not the accuracy of its assumptions.<sup>47</sup> This is far from compelling, as to have relevance surely this fundamental assumption needs to be satisfied.

Economists need not resort to the questionable argument above, since the assumption is justifiable on other grounds. Posner refers to an empirical literature that notes that criminals with little education respond to chances in

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<sup>42</sup> Wouter Wils, "Optimal Antitrust Fines: Theory and Practice" (2006) 29 *World Competition* 183, at 198.

<sup>43</sup> Deontology is an ethical belief in an absolute set of laws, which everyone should follow regardless of any potential beneficial consequences by not following them.

<sup>44</sup> Utilitarianism, in its simplified form, is an ethical belief that only consequences matter, so if more good consequences will come of a breach of a rule than bad consequences, it is ethical to breach the rule.

<sup>45</sup> Wils, "Optimal Antitrust Fines: Theory and Practice", at 13.

<sup>46</sup> As used by the Chicago school.

<sup>47</sup> Martin, "Remembrance of Things Past: Antitrust, Ideology, and the Development of Industrial Economics", at 36; Richard Posner, *Antitrust Law, An Economic Perspective* (Chicago: The University of Chicago Press, 1976), at 165.

opportunity costs.<sup>48</sup> Conversely, competition offences are often committed by well-educated business people who would be more likely to act rationally.<sup>49</sup> Furthermore, the nature of competition offences is that they are not carried out in the 'heat of the moment'. Overall, there is enough realism to this assumption to validate the use of economics in sentencing.

### **The formula**

A proxy for the moral condemnation necessary for the Harvard model cannot be included in the formula; therefore a discussion on the formula must be Chicagoan in nature. Nevertheless, the model can be used as a starting point for the Harvard calculation, with a penalty to represent moral condemnation added subsequently.

*Figure One: Optimal deterrence penalty formula:<sup>50</sup>*

$$P_{OPT} = \frac{(H-S)p}rq - C' \quad (6)$$

where:

$P_{OPT}$	=	$f$	=	optimal penalty
$H$	=			harm caused through the contravention
$C$	=			costs to the firm arising from contravention
$r$	=			risk aversion
$q$	=			factor based on probability that punishment will deter illegal conduct
$p$	=			probability of detection and penalty imposed.
$S$	=			stigma arising out of detection

<sup>48</sup> Posner, *Antitrust Law, An Economic Perspective*, at 165.

<sup>49</sup> A counter-argument can be raised that business people often infringe laws because of greed and not necessity (like those forced into 'common' crime). Therefore, persons engaging in competition law offences may be less economically rational than an ordinary criminal stealing a loaf of bread.

<sup>50</sup> This is adopted but slightly altered from Ministry of Commerce, "Penalties, Remedies and Court Processes Under the Commerce Act: A Discussion Paper" (Ministry of Commerce, Wellington, 1998), at 8.

## 1. The starting point for sentencing

The modern economic analysis of sentencing has grown out of the seminal work of Gary Becker.<sup>51</sup> Becker wrote about crimes such as murder, robbery and assault, but he intended the analysis to be equally applicable to white-collar offences<sup>52</sup> such as antitrust offences. Becker maintains the Chicagoan dichotomy of 'efficient' and 'inefficient' offences. In a discussion of inefficient crimes he states:

*"[I]f the costs of apprehending, convicting, and punishing offenders were nil, and if each offense caused more external harm than private gain, the social loss from offenses would be minimised by setting punishments high enough to eliminate all offenses".<sup>53</sup>*

Becker contends that the penalty which would eliminate all inefficient contraventions is a fine equivalent to the 'illegal gain' of the contravener. This was the genesis of the 'internalisation approach', whereby the offender is made to bear the external costs of their violations - costs which are otherwise borne by society. Inefficient crime would therefore be rendered economically pointless.

The novelty of Becker's work was the related argument that efficient crimes (where the loss caused through the contravention was smaller than the gain to the contravener) should *not* be deterred, because they are wealth-creating. Applying Coase's theorem,<sup>54</sup> in the absence of transaction costs, the contravener could compensate the victim for their loss and there would still exist a net benefit.

This work has subsequently been developed and applied specifically to competition offences.<sup>55</sup> Working from a competition perspective, William Landes developed Becker's observation that an optimal fine for inefficient offences was the 'illegal gain' and concluded that the fine should be equivalent to 'total harm' (the amount of 'illegal gain' *plus* any 'deadweight losses'). The difference

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<sup>51</sup> Gary Becker, "Crime and Punishment: An Economic Approach" (1968) 76 *Journal of Political Economics* 169.

<sup>52</sup> *Ibid.*, at 170.

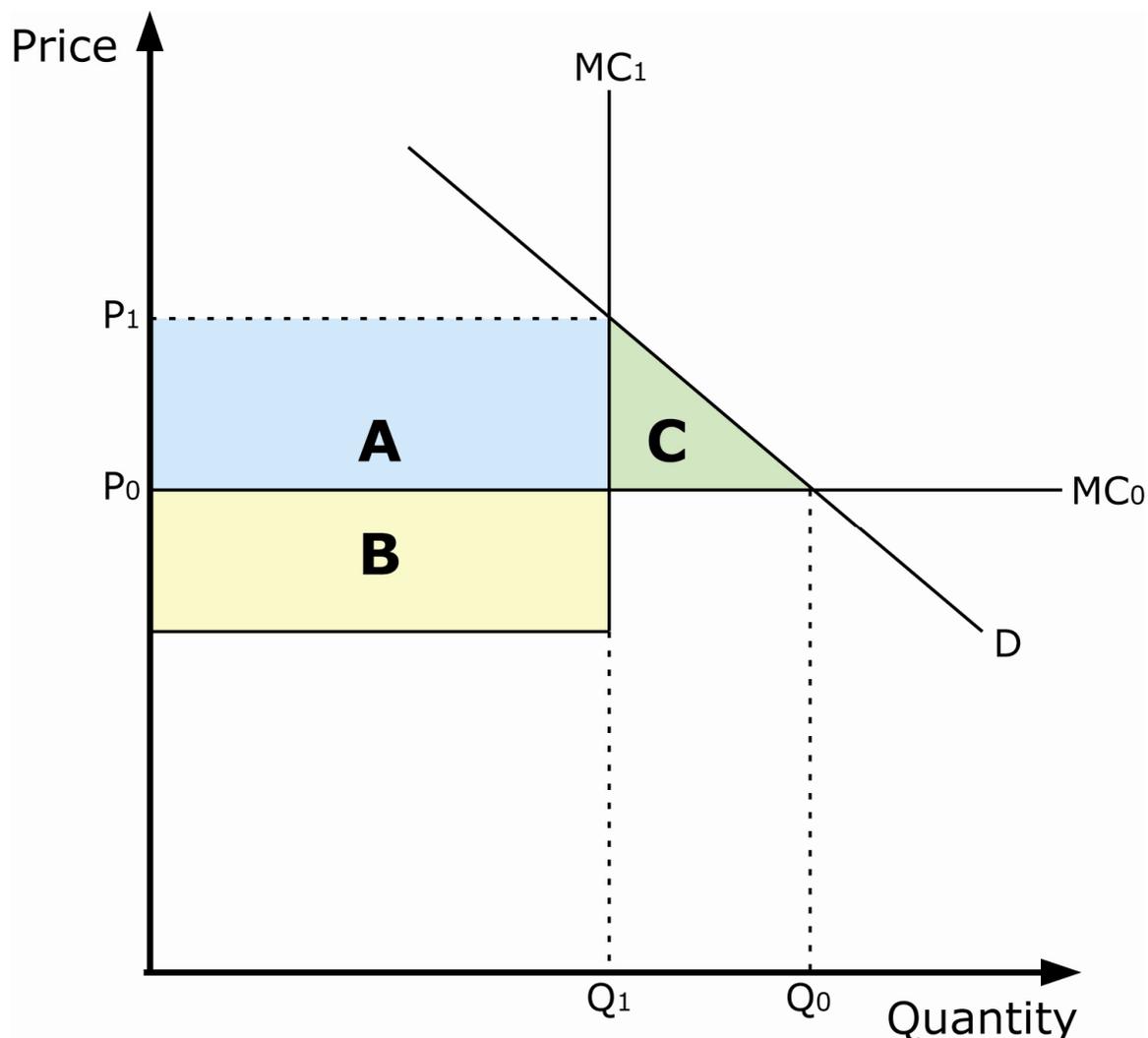
<sup>53</sup> *Ibid.*, at 191.

<sup>54</sup> Ronald Coase proposed this theorem in a paper in 1959.

<sup>55</sup> Landes, "Optimal Sanctions for Antitrust Violations".

between these formulae is demonstrable by the following diagram:<sup>56</sup>

*Figure Two: Efficient cartel model*



This is a monopoly diagram for an efficient cartel. In the diagram,  $MC_0$  is the marginal cost curve with competition, rendering a quantity of  $Q_0$  and a price of  $P_0$ . The MC curve for a cartel is represented by  $MC_1$ .  $MC_1$  is below the  $MC_0$  curve until the quantity of  $Q_1$ . This represents the cost saving of an efficient cartel. Cost saving could occur through (illegal) agreements securing an efficient allocation of resources. At the point  $Q_1$  the MC curve becomes perfectly inelastic, representing a restriction in output.

Three areas of the diagram are important for analysis. Area A represents the increase in producer surplus, achieved at the expense of consumer surplus

<sup>56</sup> Ibid.

subsequent to the price increase (from  $P_0$  to  $P_1$ ). This is the 'illegal gain' which Becker referred to. Area B is the 'cost saving' caused by the cartel agreement. Area C represents the 'deadweight loss'. This is the loss to society, representing the decrease in quantity of goods bought because consumers who would have purchased at a price between  $P_0$  and  $P_1$  now cannot.

The Beckerian conception of illegal gain (Area A) does not encapsulate the total inefficiency of the offence, so fining at an amount equivalent to the illegal gain would fail to deter inefficient crimes. For example, if Area A was \$100, Area B was \$125, and area C was \$50, the offence would be efficient (according to Becker) because the cost savings (\$125) would outweigh the monopoly profit or illegal gain (\$100). Therefore, in economic theory the offence should not be deterred. However, the total harm to society comprises the value of the illegal gain plus the deadweight loss (\$100 + \$50 = \$150). To deter this inefficient behaviour a fine of over \$150 would be required - more than just fining at the level of the illegal gain (\$100). Therefore, when applying Becker's model to competition law, it is appropriate to use Landes' 'net harm rule'.<sup>57</sup> "The rule for determining the optimal fine or damage award is easy to state: the fine should equal the net harm to persons other than the offender"<sup>58</sup>.

This gives us a starting point to a formula which could be used to calculate optimal fines.

$$P_{OPT} = H \quad (1)$$

where  $P_{OPT}$  is the optimal penalty and  $H$  is the total harm caused by the offence. It is now appropriate to increase the complexity of the model to construct a realistic and functioning model.

## **2. Probability of detection**

The assumption that all offences are detected and successfully prosecuted ( $p=1$ ) is clearly unrealistic. There is an incentive for offenders to conceal their crimes. The contravener will consider the expected cost of the violation, that is the cost if they are caught ( $f$ ) discounted by the probability of being caught and

<sup>57</sup> Landes, "Optimal Sanctions for Antitrust Violations", at 656.

<sup>58</sup> Ibid. This is the Chicago viewpoint. Harvardians or Post-Chicagoans would view the existence of a transfer of wealth from consumers to producers (the existence of area A) as justification for government intervention.

prosecuted ( $p$ ). Therefore the fine should be increased above the measure of total harm because the prospective violator will discount the expected punishment cost by the probability of detection.<sup>59</sup> Therefore:

$$P_{OPT} = \frac{H}{p} \quad (2)$$

### **3. Enforcement Costs**

The marginal cost of enforcement (the extra resources which need to be dedicated to the detection, apprehension and sentencing of the offender) are incurred because of the offender's decision to offend. Therefore the cost should be imposed directly on the offender.<sup>60</sup> Including these charges gives us:

$$P_{OPT} = \frac{H + C'}{p} \quad (3)$$

where  $C'$  is the marginal cost of enforcement.

### **4. Costs to the firm arising from detection**

According to optimal penalty theory, the firm should receive some discount for the penalties imposed through the market, for instance stigma.<sup>61</sup> Therefore, it is appropriate to subtract this amount from the total harm caused. Because this is only incurred if the offence is detected, it should be multiplied by the possibility of detection. Therefore:

$$P_{OPT} = \frac{(H - Sp) - C'}{p} \quad (4)$$

where  $S$  are the costs to the firm arising out of detection.

### **5. Tradeoffs between probability and fines: the optimal approach**

This model sets the expected penalty cost for a violation. However, it does not furnish the most efficient combination of probability of detection ( $p$ ) and magnitude of fine ( $f$ ). For example, if the harm caused by a price fixer was \$10,000, the government could in theory set the probability of detection at  $p=1$

<sup>59</sup> Posner, *Antitrust Law, An Economic Perspective*, at 223. Posner gives the example of an offence with a \$1 million social cost, but only 25% chance of detection. The optimal fine in this case would be \$4 million to give an expected punishment cost ( $p \times f$ ) of \$1 million.

<sup>60</sup> Michael Block, "Optimal Penalties, Criminal Law and the Control of Corporate Behavior" (1991) 71 *Boston University Law Review* 394, at 397.

<sup>61</sup> Whether a stigma in fact attaches to corporate breaches of competition law is questionable. See Chapter Five for a discussion.

by investing in many enforcement officials. If detection was certain ( $p=1$ ), a \$10,000 fine would be optimal (since  $1 \times \$10,000 = \$10,000$ ). If the government set the probability of detection to 0.5 (that is, they expected one out of every two violations would be caught) the optimal deterrent would be a \$20,000 fine ( $0.5 \times \$20,000 = \$10,000$ ). Taken to the extreme, the government could reduce  $p$  to 0.0001 with only one in ten thousand offences detected. To ensure optimal deterrence a fine of \$100,000,000 would be needed ( $0.0001 \times \$100,000,000 = \$10,000$ ).

Deterring more people (raising  $p$  close to unity) costs money. Becker observed that the loss to society of resources devoted to apprehension and conviction of offenders would be minimised by “lowering  $p$  arbitrarily close to zero and raising  $f$  sufficiently high so that the product  $p \times f$  would induce the optimum level of offenses”.<sup>62</sup> Put poetically, the solution to the question of enforcement was to occasionally hang a price-fixer – lumber for gallows is cheap and very few would be hanged.<sup>63</sup> However Becker noted that there was an upper limit to what an individual could pay – an individual’s wealth is finite. Therefore the optimal penalty required setting  $f$  to equal total wealth, and then adjusting  $p$  so that the product was equivalent to the total harm.

This provides a valuable starting point for devising an optimal level of penalty. However, there are three main economic problems which, when included, will have a downwards effect on the magnitude of the fine:

- a. The assumption of risk neutrality is unrealistic.
- b. The assumption of an errorless legal system is unrealistic.
- c. Marginal deterrence will lead to ‘offence escalation’.

a. The unrealistic assumption of risk neutrality

Risk neutrality means that a person does not have a preference or aversion to risk but is merely concerned about long term expected probability ( $r=1$ ).

Polinsky and Shavell note that “the assumption of risk neutrality seems implausible in situations in which individuals would face the risk of losing all their

<sup>62</sup> Becker, “Crime and Punishment: An Economic Approach”, at 183.

<sup>63</sup> Michael Block and Joseph Sidak, “The Cost of Antitrust Deterrence: Why not Hang a Price Fixer Now and Then?” (1980) 68 *Georgetown Law Review* 1131, at 1132.

wealth".<sup>64</sup> Because of the severe sanction, people will have a risk aversion ( $r < 1$ ). A risk-averse person would only commit an offence if the private benefits outweighed the harm to others *plus a risk premium*. Therefore it is economically rational to reduce the fine ( $f$ ) by the risk premium to avoid over-deterrence. We can include this in the diagram by multiplying the total harm (plus marginal enforcement cost) by a risk premium ( $r$ ).

$$P_{OPT} = \frac{(H-Sp)r - C'}{p} \quad (5)$$

*b. The unrealistic assumption of an errorless legal system*

Judicial error increases the cost of enforcement and these errors cannot be eliminated by a low probability and high magnitude of fine.<sup>65</sup> Errors include, for example, mistakenly classifying conscious parallelism as price fixing<sup>66</sup> and erroneously concluding that a contract, arrangement or understanding substantially lessened competition under s27.

Holding the proportion of mistaken convictions constant, the error cost is higher using a high magnitude, low probability approach.<sup>67</sup> Furthermore, as fines increase ( $f$ ), so will the degree of risk aversion. Intuitively we can assume that people are less likely to engage in borderline (efficient) behaviour if there is a chance the courts could erroneously impose an extremely high fine than a smaller fine. Therefore, because of the existence of errors in the legal system, fines ( $f$ ) should be less than total wealth.

The extent of this risk depends on how close to the 'borderline' an action is. What is important is the difference between the chance of punishing illegal behaviour and punishing legal behaviour. Erroneously classifying a borderline offence as illegal will significantly deter others from operating at the legal side of the border. Therefore to guard against these cases, the magnitude of the fine should be reduced to compensate for the possibility of legal error. "The optimal

<sup>64</sup> Michael Polinsky and Steven Shavell, "The Optimal Tradeoff between the Probability and Magnitude of Fines" (1979) 69 *American Economic Review* 880, at 881.

<sup>65</sup> Block and Sidak, "The Cost of Antitrust Deterrence: Why not Hang a Price Fixer Now and Then?", at 1136.

<sup>66</sup> Commerce Act 1986, s30 deems price fixing to substantially lessen competition in s27. Section 30 was not designed to catch situation of 'conscious parallelism' which does not have centrality of agreement: *Giltrap*, at [67], and *Ophthalmological*, at [139].

<sup>67</sup> For example prosecuting one in nine with nine-fold damages ( $p=0.11$ ,  $f=9$ -fold) than prosecuting one in three with three-fold damages ( $p=.33$ ,  $f=3$ -fold). This was the example in Block and Sidak, "The Cost of Antitrust Deterrence: Why not Hang a Price Fixer Now and Then?", at 1137.

penalty should be reduced to the point that the marginal benefit from the increase in socially desirable conduct is equal to the marginal cost from reduced deterrence of the illegal activity".<sup>68</sup> In borderline cases, optimal penalties should be reduced. In clear-cut cases, penalties should not be reduced. This can be represented by introducing to the model  $q$ , a factor based on the probability that punishment will deter legal conduct. In a perfectly clear-cut breach of the Act, there is no chance that legal behaviour will be deterred, so  $q=1$ . At a borderline case,  $q$  will be considerably smaller than unity, which will decrease the magnitude of the fine:

$$P_{OPT} = \frac{(H-Sp)rq - C'}{p} \quad (6)$$

### c. Marginal deterrence leading to offence escalation

Offence escalation can occur if  $f$  is set at the amount of a person's wealth: there is a perverse incentive for offenders to commit the more serious crime<sup>69</sup> because both crimes are fined at the amount of the defendant's wealth and more severe crimes will have greater potential rewards.<sup>70</sup> This may encourage 'hard-core' cartel behaviour which causes more societal harm than 'soft-core'.

It must be conceded that there may be a higher chance of detection with hard-core cartel arrangements because of their greater harm. Society may invest more resources in their detection (thereby raising  $p$ , which will in turn raise the expected punishment cost). However it may not be practical for society to distinguish between 'hard-core' and 'soft-core' collusion, so the probabilities of detection of these two offences may in effect be very similar despite the greater harm caused by 'hard-core' offences.

Marginal deterrence encapsulates the legal principle of proportionality. Marginal deterrence is an economic explanation for our justice system's heavier punishment of more serious offences (*ceteris paribus*) and is a compelling argument in favour of fines less than total wealth.

<sup>68</sup> Ministry of Commerce, *Penalties, Remedies and Court Processes Under the Commerce Act: A Discussion Paper*, at 10, paraphrasing Richard Posner, "An Economic Theory of the Criminal Law" (1985) 85 *Columbia Law Review* 1193, at 1206.

<sup>69</sup> Landes, "Optimal Sanctions for Antitrust Violations", at 655.

<sup>70</sup> An example that Block and Sidak use is that if murder and robbery had the same penalty, for example the death penalty, the criminal is not marginally deterred from murdering the person he or she has just robbed. Block and Sidak, "The Cost of Antitrust Deterrence: Why not Hang a Price Fixer Now and Then?", at 1134.

## ***6. Conclusions and implications of an economic approach***

The Chicago method of calculating fines is not a simple mathematical reduction of sentencing factors to be applied with rigid uniformity. Rather, its value is that it identifies relevant considerations and demonstrates how they should affect the level of the fine. Although a Chicagoan construct, the model can provide a valuable starting point if additional penalties for moral condemnation are considered appropriate (Harvard and Post-Chicago model). Both schools would concur that a methodical approach to assessing penalties is required. This is not to say that the components of the formula are easily calculated, but the model provides useful general guidance on setting fine. The beauty and utility of this model is its simplicity.

## CHAPTER THREE: THE STATUTORY REGIME

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### ***The present regime***

The penalties in the Act are contained in two separate sections, sections 80 and 83.<sup>71</sup> Section 80 provides for penalties for breaches of Part 2 of the Act (restrictive trade practices). Section 83 provides for breaches of Part 3 of the Act (business acquisitions).

### ***Maximum penalties***

Section 80(2B) stipulates that the maximum penalty for a body corporate is the greater of \$10,000,000; or three times the value of the commercial gain if this can be readily obtained; or if this cannot be readily obtained, 10% of the turnover of the body corporate or interconnected bodies corporate. Section 80(2B) also provides a maximum penalty for individuals of \$500,000.

By contrast, s83 allows for lesser penalties: a maximum penalty of \$5,000,000 for a body corporate and \$500,000 for an individual. There are no alternate maxima as in s80.

### ***Statutory framework***

A key difference between the sections is the mandatory considerations the court must take into account when determining the appropriate fine. Section 80(2A) requires the court to consider all relevant matters, in particular any exemplary damages awarded and the nature and extent of any commercial gain (for a body corporate). Section 83(2) lists four matters that the court must consider. These are the nature and extent of the act of omission; nature and extent of any damage to any person as a result of the act or omission; circumstances in which the act or omission took place; and prior involvement in similar behaviour.

### ***The 2001 Amendment***

Prior to the Amendment, section 80 had maximum penalties and mandatory considerations identical to those of section 83. The 2001 Amendment extensively changed section 80, but did not alter section 83 at all. No reason was given for

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<sup>71</sup> The sections are reproduced in their entirety in Appendix One.

not also amending section 83. One potential reason is that at the time of the Amendment, the courts had never applied section 83.<sup>72</sup> However, this is hardly a compelling reason for creating the inconsistency.

It could be argued the justifications for changing section 80 did not apply to section 83 because much of the harm of section 47 offences could be undone with divestiture proceedings. However, divestiture is exceedingly difficult to implement, does not account for the lost chances of competitors to enter the market, and as a result is very rare. There is no justifiable basis for amending section 80 without concurrently amending section 83.

### ***The impetus for change***

The impetus for changing section 80 was the perception that the current regime was not deterring anti-competitive behaviour to a great enough extent.<sup>73</sup> A Ministry of Commerce (“the Ministry”) discussion document concluded that while the High Court had identified deterrence as the key consideration in setting penalties, the penalties were consistently set at levels which were unlikely to achieve this.<sup>74</sup>

The Commerce Committee (“the Committee”) reported back to the New Zealand Parliament on the 1<sup>st</sup> February 2001. The Committee advised that the courts were not ordering pecuniary awards of the magnitude envisaged by Parliament, noting that only three firms had been ordered to pay more than \$1 million.<sup>75</sup> The Government and the ACT Party wanted to raise the maximum penalty to send an ‘unequivocal’ message to the courts that anti-competitive behaviour should be severely punished as a deterrent as well as to make the offence profitless.<sup>76</sup> The National Party opposed the increase to \$10 million, saying that there was scope for larger orders to be made within the existing parameters,<sup>77</sup> and that it was ridiculous to have maxima that were vastly above what judges

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<sup>72</sup> And currently has only ever been used once. By contrast, section 80 had been used 25 times for conduct prior to 2001 Amendment and has been used 2 times since.

<sup>73</sup> The “forward looking aim of promoting general deterrence” was accepted by the Commerce Committee to be the dominant objective of penalties: Commerce Amendment Bill 1999, at 3.

<sup>74</sup> Ministry of Commerce, *Penalties, Remedies and Court Processes under the Commerce Act: A Discussion Paper*, at 31.

<sup>75</sup> Referring to three firms in *Taylor Preston*.

<sup>76</sup> Commerce Amendment Bill 1999, at 25.

<sup>77</sup> *Ibid.*

would ever impose.<sup>78</sup> Surprisingly, the Committee was not convinced that increasing the maxima would increase the size of the orders.<sup>79</sup>

This was despite the earlier report by the Ministry which the Committee would have seen.<sup>80</sup> This report considered judicial comments made after the 1990 Amendment.<sup>81</sup> The report highlighted that these judicial comments “demonstrate that the court specifically looked to follow Parliament’s intentions”.<sup>82</sup> Therefore the argument can be made that the increase of the maximum penalty in the 2001 Amendment sends a strong signal that the courts should increase the level of their penalties. The view of the National Party, and subsequently the Committee, on this issue seems untenable.

Neither of the alternative maximum penalties - the most striking change to s80 - have yet been considered by the courts. ‘Three times the commercial gain’ has its origins in the longstanding (but much criticised) formula for recovery of private damages in the United States where treble damages are available. This formula is based on the presumption that one in three offences will be detected and prosecuted. The Committee noted that calculating commercial gain was a ‘broad brush affair’ rather than one of ‘pedantic specification’.<sup>83</sup> The ‘three times commercial gain’ formula had been used in six other New Zealand statutes previous to the 2001 Amendment,<sup>84</sup> has since been used once,<sup>85</sup> and a similar term ‘3 times the gain’ used once.<sup>86</sup>

The second alternative maximum fine of 10% of a firm’s turnover is available when the amount of the commercial gain is not readily ascertainable.<sup>87</sup> The Committee considered it appropriate to use 10% of turnover despite submissions

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<sup>78</sup> Alec Neill (2001) 592 NZPD 9070, at 9083.

<sup>79</sup> Commerce Amendment Bill 1999, at 25.

<sup>80</sup> Ministry of Commerce, *Penalties, Remedies and Court Processes under the Commerce Act: A Discussion Paper*.

<sup>81</sup> This amendment drastically increased awards for an individual from \$100,000 to \$500,000 and a body corporate from \$300,000 to \$5million.

<sup>82</sup> Commerce Amendment Bill 1999, at 20.

<sup>83</sup> *Ibid.*, at 24.

<sup>84</sup> Civil Aviation Act 1990, s47(1); Electricity Industry Reform Act 1998, s55(1); Resource Management Act 1991, s339B; United Nations Convention on the Law of the Sea Act 1996, s8; Hazardous Substances and New Organisms Act 1996, ss52, 124C; Maritime Transport Act 1994, s409.

<sup>85</sup> Meat Board Act 2004, s70(2)(b)(ii)(A).

<sup>86</sup> Securities Markets Amendment Act 2006, s42W.

<sup>87</sup> Commerce Act 1986, s80(2B)(b)(ii)(B).

that it would unduly punish high turnover, low margin producers.<sup>88</sup> This was because the Committee felt that the courts would use their discretion where this penalty would be disproportionate. The Committee recommended that turnover should only relate to New Zealand turnover.

There were changes regarding penalties imposed on individuals. Prior to 2001, the court *may* impose a penalty on an individual. Presently there is a presumption that there *should* be a penalty on an individual *unless* there is a good reason not to impose one.<sup>89</sup> Furthermore an agent, director or servant cannot be indemnified over price fixing.<sup>90</sup>

There is also a significant change in the framework for assessing penalty, discarding the old considerations for 'any exemplary damages awarded' and the amount of 'illegal gain'.<sup>91</sup> The considerations are mandatory but non-exclusive.

### ***Economic appraisal of the statutory regime***

#### Framework

The current framework to section 83 (the repealed framework to section 80) provides little assistance to the courts, and includes a factor which is at odds with an economic approach. The framework consists of four mandatory criteria:

- a. The nature and extent of the act or omission.<sup>92</sup>
- b. The nature and extent of any loss or damage suffered by any person as a result of the act or omission.<sup>93</sup>
- c. The circumstances in which the act or omission took place.<sup>94</sup>
- d. Whether or not the person has a previous record of similar conduct.<sup>95</sup>

We can infer that criterion 'a' is instructing the court to treat contraventions that are more serious in their 'nature and extent' more seriously by imposing a

<sup>88</sup> Commerce Amendment Bill 1999, at 24. The submission was from Federated Farmers.

<sup>89</sup> Commerce Act 1986, s80(2).

<sup>90</sup> Ibid., s80A.

<sup>91</sup> Ibid., s80(2A).

<sup>92</sup> The now repealed s80(1)(a) or current s83(2)(a) Commerce Act.

<sup>93</sup> The now repealed s80(1)(b) or current s83(2)(b) Commerce Act.

<sup>94</sup> The now repealed s80(1)(c) or current s83(2)(c) Commerce Act.

<sup>95</sup> The now repealed s80(1)(d) or current s83(2)(d) Commerce Act.

higher fine. This takes a post-Becker approach, rejecting the suggestion that the fine should be equivalent to total wealth while minimising the probability of detection so that the expected punishment cost ( $p \times f$ ) is equal to the illegal gain. Economists from both schools would recognise that Becker's fine of total wealth is not practical and criterion 'a' recognises this. Allowing for gradation of fines according to a contravention's seriousness is consistent with the economic ideal of marginal deterrence as well as the legal principle of proportionality.

The Ministry noted that criterion 'b' was inconsistent with the economic framework for determining optimal deterrence.<sup>96</sup> This is because while harm suffered by consumers is relevant to considerations of penalty, loss suffered by competitors is exogenous to the model. Loss suffered by competitors can be recovered by private actions in damages. This criterion implies that an absence of harm suffered by competitors could be a mitigating factor, which is completely at odds with the economic theory.

Criterion 'c' is not particularly helpful to the court. There is no elaboration of what is meant by 'circumstances'. I will critique the circumstances that the courts have chosen to take into account in Chapter Four.

Contrary to criterion 'd', optimal deterrence theory does not make any provision for repeat offenders. This is because, theoretically, all inefficient offences are deterred by setting the optimal fine. If a firm is repeatedly engaging in the same conduct it could mean that previous fines have not been at the optimal level so the firm has found it worthwhile to continue engaging in anti-competitive behaviour. Or it could mean that the firm, unlike most, is not risk averse ( $r < 1$ ) but a risk preferrer<sup>97</sup> ( $r > 1$ ). This means that the firm might still commit a prohibited act even if the expected punishment costs were greater than the expected gain. In these circumstances it would make sense to increase the magnitude of the fine for subsequent offences.

The key problem with this section lies in the fact that the primary economic considerations, the amount of total harm and the probability of detection are not mentioned, suggesting that these considerations may be less important than the

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<sup>96</sup> Ministry of Commerce, *Penalties, Remedies and Court Processes Under the Commerce Act: A Discussion Paper*, at 16.

<sup>97</sup> When a firm recognises that the expected cost exceeds expected benefits but takes the risk regardless.

listed factors. For this reason, section 83 is inadequate.

The new considerations in section 80 encapsulate one of these key considerations and reduce confusion by removing the old considerations. The key starting point after the Amendment is the 'nature and extent of any commercial gain'. This is essentially the transfer in welfare from consumers to the producer. The Ministry recommended an 'illegal gain' over a 'total harm' approach because the size of the deadweight loss is usually small (total harm = illegal gain + deadweight loss) and because it chose not to adopt the "contentious" Chicagoan idea of efficient offences.<sup>98</sup>

The second criterion expressed in s80<sup>99</sup> is simply a guard against double jeopardy. There is no reason why it would be inconsistent with optimal deterrence.

The new criteria provides more assistance to the courts because they explicitly mention a starting point based on economic theory. However, the criteria do not mention the probability of detection – the other key determinant in setting a penalty. The guidelines could provide even further clarity by stating that the illegal gain was a starting point and not just a factor. Furthermore, important mitigating and aggravating factors should be expressly stated.

### Maximum penalties

In optimal penalty theory, optimal penalties should be not have a maximum, but be unlimited (for practical reasons the only limit should be the defendant's wealth). Optimal deterrence would not be achieved if a maximum prevented the penalty from exceeding the expected benefit. It is entirely feasible that serious breaches of Part 3 of the Act would not be deterred by fines of \$5,000,000 and serious breaches of Part 2 of the Act would not be deterred of fines of \$10,000,000.<sup>100</sup>

Presumably, this is the reason for the alternative maxima in section 80.<sup>101</sup> The

<sup>98</sup> Ministry of Commerce, *Penalties, Remedies and Court Processes Under the Commerce Act: A Discussion Paper*, at 9.

<sup>99</sup> Commerce Act 1986, s80(2A)(a).

<sup>100</sup> \$5,000,000 and \$10,000,000 being the current maxima in section 80 and 83 Commerce Act 1986, respectively.

<sup>101</sup> There are no alternative maxima in section 83. Section 83 was not changed by the 2001 Amendment.

'10% turnover' maximum is used as a proxy of the illegal gain. This would increase the maximum fine for firms with over \$100 million turnover. Importantly the section states 10% of the turnover of interconnected companies. Interconnected companies include a parent company and its subsidiary and two subsidiaries of the same parent.<sup>102</sup> This maximum has the potential to set an incredibly high fine for our largest companies. If Fonterra or one of its interconnected companies breached the Act they could face a penalty up to \$1.3 billion.<sup>103</sup>

Three times the value of the commercial gain will generally be ineffective as an alternative maximum. This is because it will be less than the penalties suggested by optimal deterrence if  $p=0.33$  or less. It has been suggested in a recent work that the probability of detection is between 13% to 17%, which would require a multiplier of six or seven.<sup>104</sup>

Criticisms of treble damages can be applied to the New Zealand context.<sup>105</sup> Having a 'multiplier' set at 3 does not allow the courts to adopt a "high-multiple-low-prosecution rate approach which conserves enforcement costs".<sup>106</sup> Rather than having the multiplier set at a discrete figure, it makes more sense for it to depend on the difficulty of detection of each offence. This is because this multiple does not distinguish between overt and covert offences.

## **Conclusion**

The 2001 Amendment was introduced to encourage the courts to increase the magnitude of the penalty to better achieve the goal of deterrence. However, the Amendment fails to do this, ignoring the root of the problem: the failure of the Act to encourage the court to employ an economically rational framework.

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<sup>102</sup> Commerce Act 1986, S2(7).

<sup>103</sup> Fonterra's turnover is \$13 billion according to its website <[www.fonterra.com/wps/wcm/connect/fonterra.com/fonterra.com/Home/Frequently+Asked+Questions/Frequently+Asked+Questions](http://www.fonterra.com/wps/wcm/connect/fonterra.com/fonterra.com/Home/Frequently+Asked+Questions/Frequently+Asked+Questions)> accessed 17 September 28, 2007.

<sup>104</sup> Alan Fels, "The Trade Practices Act and World's Best Practice: Proposals for Criminal Penalties for Hard-Core Collusion" (2002) (Paper presented by the Chairman of the Australian Competition and Consumer Commission at the Current Issues In Regulation Conference, Melbourne), at 12 quoting Wils Wouter, "Does Effective Enforcement of Articles 81 and 82 EC Require not only Fines or Undertakings, but also Potential Penalties, in Particular Imprisonment?". A probability of  $p=0.33$  implied a multiplier of three.

<sup>105</sup> Bearing in mind that many of the criticisms originate from the United States, where 'treble damages' refers to the extent of damages a defendant can be awarded, not a maximum penalty payable to the courts.

<sup>106</sup> Frank Easterbrook, "Detrebling Antitrust Damages" (1985) 28 *Journal of Law and Economics* 455, at 455.

Increasing statutory maxima is an unsophisticated way of suggesting that the penalties be increased. Furthermore, the effect of the alternative maxima may be counter-productive, by encouraging the court to shirk from the complex, but necessary task, of estimating the illegal gain and evaluating the probability of detection.

A better way of achieving deterrence would have been by explicitly stipulating the key economic factors which the court should consider when setting a penalty. Section 80, by contrast, mentions only one out of the two key factors. Furthermore, the Act would benefit from the inclusion of economically rational mitigating and aggravating factors.

The Act, in its current form, does not encourage the court to use economic considerations. As a result, the Act is unlikely to achieve its goal of deterrence.

## CHAPTER FOUR: APPLICATION BY THE COURTS

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The courts have been given much latitude to develop and apply sentencing considerations as they see fit. This section will describe the purpose, starting point and mitigating and aggravating factors the courts have considered when deciding upon a pecuniary penalty. Particular emphasis will be placed on considerations after the 2001 Amendment, which significantly changed the mandatory factors. I will consider the ways in which the courts' approach is consistent with an economic approach.<sup>107</sup> I will conclude by assessing whether the penalties set are adequate to achieve the aims set by the courts and the legislature, and whether these correspond to economic theory.

### ***The objective of penalties: deterrence***

Deterrence is the overwhelming objective of penalties under the Commerce Act.<sup>108</sup> Penalties should be set at a level which would deter not only the particular defendant but the entire commercial community,<sup>109</sup> by sending a clear message to others who could be tempted to engage in anti-competitive behaviour.<sup>110</sup> In coming to a pecuniary penalty, the court must choose an amount which is more than a "laughable tap on the wrist"<sup>111</sup> and which cannot be seen as an "acceptable license fee".<sup>112</sup>

While deterrence is widely acknowledged to be the primary objective of sentencing, there is yet to be a meaningful discussion of what deterrence is or how it might be achieved.<sup>113</sup> However, a general lack of support for the proposition that condemnation is a major goal in antitrust sentencing suggests a Chicago approach: that deterrence can be achieved by multiplying the illegal gain, by the less than certain probability of detection, without an additional penalty to reflect moral condemnation. However, the courts have not stated this, nor have they suggested what level of penalty might achieve this.

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<sup>107</sup> Frequent reference will be made to variables included in the economic model depicted in Chapter Two.

<sup>108</sup> *Herberts*, at 729; *Wrightson*, at 672; *Christchurch*, at 7; *Eli Lilly*, at 3; *Koppers*, at [18] and [30]; *Ellingham*, at [7]; *Ophthalmological*, at [18].

<sup>109</sup> *Koppers*, at [30].

<sup>110</sup> *Christchurch*, at 7.

<sup>111</sup> *Herberts*, at 731.

<sup>112</sup> *BP Oil*, at 15.

<sup>113</sup> Ministry of Commerce, *Penalties, Remedies and Court Processes Under the Commerce Act: A Discussion Paper*, at 19. This was as of 1998. This is still in the case in 2007.

### ***The starting point***

Prior to the 2001 Amendment, the courts' starting points for sentencing were a multitude of factors including the four requirements of the old section 80(1) (current section 83(1)) and a list of factors in the Australian case of *Annand*.<sup>114</sup> While indicative of whether a penalty should be increased or decreased, these do not actually indicate what the paramount considerations are and how the penalty should achieve the goal of deterrence.

The first case after the 2001 Amendment was *Koppers*, which was an application for approval of an agreed settlement. The starting point was the Commission's initial calculation of penalties of \$5.7 million: the Commission calculated the fine by considering what would have been imposed if the case was successful. The Commission looked at the seriousness of the conduct, the number of breaches and doubling of the maximum penalties. The judgment included no mention of illegal gain which was the only relevant mandatory factor. Despite approving of Weinberg J's strong rhetoric in *Colgate*, that 'rubber stamping' agreed settlements "involves an abrogation of responsibility by the court",<sup>115</sup> the Court proceeded to do just that, considering that the amount was appropriate; otherwise the defendant's solicitors would not have agreed to it.<sup>116</sup>

There is no justifiable reason why the court should accept this without independent calculation. Crucially, there is no acknowledgment or attempt to calculate the illegal gain or total harm, despite *Koppers* having "a significant effect on the prices for wood preservative chemicals during the period".<sup>117</sup>

*NZ Bus* was a section 47 case, so section 83 contained the relevant penalty regime. However, the Court considered as its starting point the estimate of *NZ Bus*' unlawful gain. This is a mandatory factor under section 80, but *not* section

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<sup>114</sup> *Annand*, at [48,394] The factors included:

- Whether the conduct was deliberate;
- The size of the corporation's activity;
- The degree to which the conduct was initiated by senior management;
- What steps were taken by the employer to educate the employees prior to the contravention;
- The existence or otherwise of a policy by the corporation against breaches of the provisions of the Act;
- Whether the conduct was a result of a mistake by the employee;
- Whether there has been similar conduct in the past;
- Whether, since the occurrence, controls over employees, particularly sales personal has been increased or improved to prevent repetition of the conduct;
- Whether the corporation has made full and frank disclosure and cooperated with the commission.

<sup>115</sup> *Koppers*, at [35] quoting *Colgate*, at [35].

<sup>116</sup> *Ibid.*

<sup>117</sup> *Koppers*, at [20].

83. This is the adherence to an economic framework that the legislature had been searching for and that was so blatantly ignored in *Koppers*. To calculate the gain, the Commission used the SSNIP test (Small yet Significant Non-Transitory Increase in Price) which the Commission defines as 5 to 10%. Discounting this to get the net present value, it estimated the gain to be between \$1.27 and \$2.54 million.

Admittedly this approach owes more to judgment than calculation,<sup>118</sup> but it represents a principled and logical way in which to begin to assess penalty.

### ***Difficulty of detection***

In most cases, breaches of the Act are not easy to detect and prosecute because they normally occur between close business associates or because the harm is diffuse, so it is not economic for any one party to pursue damages. For example, the resale price maintenance was only detected in *Herberts* because the complainant brought the action to the attention of the Commission when “many lesser mortals would have folded their tents and slunk away into the night never to be heard from again”.<sup>119</sup> The penalty should therefore be sufficient to deter those otherwise comforted by this low level of detection.<sup>120</sup> Price fixing is hard to detect and should be dealt with firmly when it is detected.<sup>121</sup>

This is consistent with economic theory. The magnitude of the fine ( $f$ ) increases when the probability ( $p$ ) is smaller to keep the expected fine ( $p \times f$ ) equal to the total harm. Difficulty of detection is therefore a key starting point. The court has not tried to quantify  $p$ , but simply worked from the principle that when  $p$  is smaller the fine should be greater. Unfortunately, a key problem with the courts’ approach is that cases in which consider the probability of detection are few and far between.

### **Co-operation**

Co-operation means admission of liability and co-operation against co-defendants, not just co-operating when it serves one’s own interests to do

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<sup>118</sup> *NZ Bus*, at [66].

<sup>119</sup> *Herberts*, at 731.

<sup>120</sup> *Ibid.*

<sup>121</sup> *Giltrap*, at [59].

so.<sup>122</sup> Defending proceedings is not an aggravating factor, but it constitutes the absence of a mitigating factor.<sup>123</sup> Similarly, absence of remorse or acknowledgment is not to result in a higher penalty but constitutes the absence of a mitigating factor.<sup>124</sup>

In *Ellingham* the Court considered that a prompt acknowledgment of liability might lead to a significant discount, perhaps between a quarter and a third.<sup>125</sup> In *Giltrap* the Court considered that it would be wrong for Giltrap to pay more than \$50,000 (which was 50% of the total fine, although this percentage was not expressly mentioned) to reflect the admission discount available to the other defendants.<sup>126</sup>

*Koppers* noted that an 'echo' of the rationales for discounting in criminal law must apply to Commerce Act violations.<sup>127</sup> These include the community interest in miscreants acknowledging responsibility, reduced stress to witnesses, and a more efficient court system.<sup>128</sup> After stating this, the Court endorsed a discount of 50% which amounted to \$2.85 million.

Co-operation can result in agreed settlements, where the Commission and the defendant come to an agreement over the level of penalty which should be imposed and then submit it to the court for approval. To date 14 agreed settlements have been submitted to the court.<sup>129</sup> In every case the court has endorsed the agreed settlement.

*NZ Milk* was the first New Zealand with a negotiated settlement. The court held that it was allowable for the defendant to consent to a set of facts or the presentation of a joint submission as to penalty. However, no discount in relation to the penalty would be given to reflect problems the Commission might have faced in proving its case. This is because in general the court separates

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<sup>122</sup> *NZ Bus*, at [65].

<sup>123</sup> *Ophthalmological*, at [48]. By this the judge meant that the fine should not be increased if someone chooses to defend proceedings as this is contrary to the notion that everyone deserves to defend charges against them under the law. However, if a firm did cooperate the judge observed that it would be appropriate to decrease the penalty to reflect this.

<sup>124</sup> *Ophthalmological*, at [48].

<sup>125</sup> *Ellingham*, at [14].

<sup>126</sup> *Giltrap*, at [58] – [62].

<sup>127</sup> *Koppers*, at [47].

<sup>128</sup> *Ibid.*

<sup>129</sup> *NZ Milk; Country Fare; Toyota; Roadmarkers; Taylor Preston; Christchurch; Acer; Ellingham; Koppers; Motor Bodies; North Albany; DB Breweries; Eli Lilly; Aquanaut.*

questions of liability and sentence.<sup>130</sup> Nevertheless a discount is routinely given because of the benefit to the public. Public interest is promoted through having litigation concluded as early as possible.<sup>131</sup> This avoids the “clogging [of] the court lists with potentially complex and lengthy litigation with the attendant expense”.<sup>132</sup>

The courts have expressly noted that the court would not ‘rubber stamp’<sup>133</sup> a negotiated settlement, but would consider whether it was within a range the court would impose.<sup>134</sup> This view has evolved from the early case of *Motor Body* where the court reneged on its opportunity to consider in detail the level of penalty imposed but rather trusted that the Commission would have assessed it adequately.<sup>135</sup> Recently the High Court outlined a new approach for the Commission to take in submitting joint submissions. The joint submission must now recommend a range of penalties the parties believe to be appropriate, with reasons for these recommendations.<sup>136</sup> These comments by the court suggest that a more methodical approach should be used. It also suggests that in future the courts may decline the suggested penalty unless a rational and well reasoned approach is employed by the Commission.

The economic approach would condone co-operation being rewarded with a reduced penalty. Co-operation can decrease the considerable cost of investigation and free up resources for the Commission to detect and prosecute other firms. Offering no discount for this would be a disincentive for firms to co-operate as, by withholding information, they would have a lower probability of being successfully prosecuted.

However, if too large a discount was offered firms would be encouraged to commit the offence because they knew the fine for the offence would be less than optimal. “Lowering the fine because of co-operation is of course only justified if and to the extent that the co-operation has ... beneficial effects ...”<sup>137</sup>

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<sup>130</sup> *NZ Milk*, at 6.

<sup>131</sup> *Ibid* at 5; endorsed in *Roadmarkers*, at 4; *Christchurch*, at 8; *Ellingham*, at [5]; *Motor Body*, at 2.

<sup>132</sup> *NZ Milk*, at 5.

<sup>133</sup> *Country Fare*, at 2, *Aquanaut*, at [17], *Koppers*, at [35].

<sup>134</sup> *Toyota*, at 3.

<sup>135</sup> *Motor Body*, at 4. Even though there was “less than clear guidance as to [the Commission’s] final assessment” the Commission’s recommendations were approved on the assumption that there was no suggestion was “other than an informed and conscientious assessment of [the Commission’s] obligations.

<sup>136</sup> *Koppers*, at [37].

<sup>137</sup> Wils, “Optimal Antitrust Fines: Theory and Practice”, at 23.

The courts should estimate the amount which the Commission would have spent without co-operation. This will be affected by many things including the amount of information which the Commission had before co-operation. If the Commission already had a compelling case, no discount should be given. The court should estimate this figure as was done in *Giltrap* and not rely on percentage discounts which can lead to ridiculous reductions in penalty as occurred in *Koppers*.

### **Novelty**

The first penalty decision under the Act was *Otago and Southland*. The “relatively new legislation”<sup>138</sup> was a key mitigating factor in the awarding of nominal damages of \$5. The judge went to great lengths to stress that this award was “peculiar to the facts of the case” and that awards would be lenient until there was full knowledge of the Act<sup>139</sup> and its application was “appreciated by all engaged in commerce”.<sup>140</sup> Changing circumstances, such as a recent statutory increase in penalties, have had a mitigating effect.<sup>141</sup>

Ignorance of the law has also been regarded as a mitigating factor.<sup>142</sup> The judge in *Taylor Preston*, heard in 1998, gave some allowance for relative novelty in that it was the first large-scale challenge by the Commerce Commission to violations of the Act.<sup>143</sup> However, the judge stressed that this was a ‘one-off’ mitigating factor, and that players in this or any other market were now ‘on notice’.<sup>144</sup> The problem with this is that statements pleading ignorance are easy to make and impossible to refute. Little significance should be attached to this pleading.<sup>145</sup>

Even though *NZ Bus* was the first penalty case under s83, the risk that the Commission might take action was obvious and well understood.<sup>146</sup> Not every new set of facts can be treated as novel for penalty purposes.<sup>147</sup> Presently,

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<sup>138</sup> *Otago Southland*, at 9.

<sup>139</sup> *Ibid.*

<sup>140</sup> *Ibid.*

<sup>141</sup> *BP Oil*, at 10.

<sup>142</sup> *Ophthalmological*, at [49], *Ellingham*, at [10].

<sup>143</sup> *Taylor Preston*, at 7.

<sup>144</sup> *Ibid.*

<sup>145</sup> *Eli Lilly*, at 4.

<sup>146</sup> *NZ Bus*, at [64].

<sup>147</sup> *Ibid.*

judicial statements indicate that novelty is no longer a mitigating factor: that ignorance of the law is no longer an excuse.

Novelty can be included in the economic model as  $q$  - a factor representing the probability that the punishment will deter illegal conduct. New legislation is not as clear as legislation with a solid base of case law. Therefore punishing a party heavily before the law is clear is likely to deter some legal behaviour. This is because managers are risk averse; even though they judge certain conduct probably legal, the possibility of a high fine deters them from engaging in that behaviour. The courts are correct to note that the effect of this is currently negligible. The legislation has been around for over 20 years. The commercial community is or should be aware that penalties can be imposed for anti-competitive behaviour.

### ***Previous good record***

This has been briefly mentioned as mitigating the seriousness of the offence.<sup>148</sup> Breaches of the Fair Trading Act 1986 were immaterial when assessing previous good record under the Commerce Act.<sup>149</sup>

The economic theory gives no explicit allowance for previous good record. It could be included in the formula as a proxy for risk aversion. Theoretically, repeated offending by a firm (not that there has been any previously) would indicate that the firm was not risk averse and accordingly the fine should be increased.

Economically, having a good record is an absence of an aggravating factor and should *not* be used to mitigate the penalty. The way previous good record is currently considered is inconsistent with an economic approach.

### ***Financial circumstances***

Judges have been sympathetic to those with limited means. The court has mitigated penalties in the case of retired persons on whom penalties would bear more heavily than on commercial companies.<sup>150</sup> Also professional societies,

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<sup>148</sup> *NZ Bus*, at [61]; *Herberts*, at 730; *Wrightson*, at 673; *Eli Lilly*, at 4; *Acer*, at [14]; *Koppers*, at [31].

<sup>149</sup> *NZ Bus*, at [61].

<sup>150</sup> *Ellingham*, at [10].

which may need to set a high levy on members to pay a fine,<sup>151</sup> companies vulnerable to market fluctuations with a weak overseas market,<sup>152</sup> and small companies in general<sup>153</sup> have had their penalties mitigated for those reasons.

There are conflicting statements regarding the increase of penalties for wealthy firms. In *Koppers*, the “financial circumstances of a defendant engaging in anti-competitive behaviour, including their resources, is a factor to be taken into account in setting penalty levels”,<sup>154</sup> while the Court took the opposite view in *Carter Holt (HC)* and *Caltex*.<sup>155</sup> In *Carter Holt (HC)*, the penalty represented a diminutive 0.02% of Carter Holt’s turnover, or 3.2% of its consolidated net profit.<sup>156</sup> It is arguable how much of a deterrent that a penalty of this size actually sends.

Financial circumstances are relevant to the question of penalty. A firm with a lot of wealth and resources will not be deterred by a negligible fine. The basic (although oversimplified) economic approach to sentencing was to fine at an amount equivalent to wealth and adjust probability of detection to equate to expected probability cost. Therefore, companies with more resources should be fined more than those with less.

Financial circumstances are important in economic theory. In order to gauge the deterrent effects of a penalty, the courts should assess financial circumstances, a task which they have consistently neglected to do. The courts have used meager financial circumstances into account as a mitigating factor, but have deficiently neglected to use large financial resources as an aggravating factor for wealthier entities.

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<sup>151</sup> *Ophthalmological*, at [42].

<sup>152</sup> *Taylor Preston*, at 7.

<sup>153</sup> *Acer*, at [14]; *Aquanaut*, at [15].

<sup>154</sup> *Koppers*, at [34].

<sup>155</sup> In *Carter Holt (HC)*, at [22], the Court took the view that it is “difficult to see why the same actions of a large and affluent company should give rise to a greater penalty”. Likewise, *Caltex*, at [31], where the fact that the defendants were “large, wealthy, international corporations” was not relevant to penalty considerations.

<sup>156</sup> This is calculated by using figures from the 1991 Annual Report, because this is the year in which the offending occurred. The turnover was \$2,360,713,000, consolidated net profit of \$162,731,000. “Carter Holt Harvey Annual Report 1991” <<http://companyresearch.nz.com.ezproxy.otago.ac.nz/archive/>>, accessed September 17 2007, at 3.

### **Compliance training**

It was noted in *Caltex* that two of the three oil companies involved had instigated extensive training programmes, and Caltex's own procedures had improved since the breach.<sup>157</sup> All three companies had done everything practicable to avoid a recurrence of the anti-competitive behaviour. The "commendable" actions of BP Oil in providing advice and instruction to its subordinates about the Commerce Act and its "substantial efforts" to educate its employees after the breach were both mitigating factors.<sup>158</sup> Likewise compliance training after the anti-competitive behaviour had occurred was in itself a mitigating factor.<sup>159</sup>

Effective compliance programmes can decrease the harm caused by anti-competitive behaviour by preventing further infringements. However, a compliance programme is merely a firm's reaction to the penalties set by a court, done for the firm's own benefit and not the community as a whole.

Wouter Wils argues that having a compliance programme should not earn a reduced fine.<sup>160</sup> He notes that as long as the optimal penalty is imposed, no other incentives are needed to secure compliance. This is the economic view and one which is undertaken by the EC.<sup>161</sup> Therefore, the courts should not discount because of compliance programmes.

### **Seniority of persons involved and policy or spontaneous action**

That senior persons were involved in the breach was a "significant" aggravating factor in *Caltex*.<sup>162</sup> In *Herberts*, the senior manager engaging in the conduct added to the seriousness of the breach.<sup>163</sup>

The courts have also drawn a distinction between policy and spontaneous action. A penalty "much closer to the maximum" would have been awarded in *BP Oil* had the price fixing been part of company policy or a predetermined plan or

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<sup>157</sup> *Caltex*, at [19]. Mobil and Shell had taken "extensive steps [to] educate employees in the provisions of the Act".

<sup>158</sup> *BP Oil*, at 12.

<sup>159</sup> *Acer*, at [14]; *Taylor Preston*, at 8.

<sup>160</sup> Wils, "Optimal Antitrust Fines: Theory and Practice", at 24.

<sup>161</sup> *Ibid.*

<sup>162</sup> *Caltex*, at [25].

<sup>163</sup> *Herberts*, at 730.

design.<sup>164</sup>

The courts should not use spontaneity or the fact that the act was carried out by a junior member as a mitigating factor. Reducing the fine for spontaneous actions and for actions of junior employees reduces the incentives for the company to invest in effective compliance programmes.

### **Public stigma**

The fine required to achieve the optimal penalty will be less if a stigma attaches.<sup>165</sup> Even though stigma is imposed by the market, the courts should in theory take it into account and reduce the fine accordingly. As discussed in Chapter Five, whether such a stigma attaches to corporations is debatable.

### **Legal advice**

Mistaken legal advice was not a mitigating factor in *NZ Bus*. This was because there was no evidence that the lawyers were fully informed of all information that Mana was privy to, and because the advice was equivocal.<sup>166</sup>

There is no provision for mistaken legal advice in the economic model. It could be argued that legal advice should be included as a part of  $q$ ; being unable to trust the advice of your lawyer would be likely to deter borderline (legal) behaviour. But if this were a mitigating factor it would remove incentives for people to use the best lawyers and would do nothing to deter them from misinforming or neglecting to inform the lawyers of vital information.

### **Communication with the Commission**

In *NZ Bus*, the court held that the Commission had led NZ Bus to believe that it would not need to apply for clearance, and this led to NZ Bus retracting a clearance application. This mitigated NZ Bus's culpability very substantially.<sup>167</sup>

The requirement to consider communication with the Commission is exogenous to the economic model. It is justifiable on legal grounds such as fairness and consistency. If the Commission indicated a transaction was not in breach of the

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<sup>164</sup> *BP Oil*, at 15.

<sup>165</sup> *NZ Bus*, at [62].

<sup>166</sup> *Ibid.*, at [58].

<sup>167</sup> *Ibid.*, at [59].

Commerce Act, but subsequently prosecuted, this could also result in deterring borderline legal behaviour 'q' because of lack of trust in the Commission.

### **Penalties awarded**

Bearing in mind aggravating and mitigating factors, the courts have been conservative in the 27 cases where pecuniary penalties have been imposed.<sup>168</sup> It is useful to consider two categories of awards: those of per se offences and those which are not. The difference being with per se offences there is lesser risk of over-deterrence as  $q$  will be close to unity, and therefore penalties should be higher. The exact amounts are perhaps not comparable; penalties will vary according to setting, and due to the difficulties of estimation the exact amount owes more to judgment than calculation.<sup>169</sup> However, it is still interesting to get a flavour of the amount the courts are willing to impose for breaches of the Act.

As far as per se offences are concerned, the highest award to date is \$2.85 million against *Koppers* for price fixing.<sup>170</sup> On top of this the Court awarded a substantial \$750,000 penalty for exclusionary conduct.<sup>171</sup> There have been seven other awards for price fixing, ranging in penalty from \$15,000<sup>172</sup> to \$500,000.<sup>173</sup> There have been two awards for boycotts,<sup>174</sup> of \$15,000<sup>175</sup> and \$5000.<sup>176</sup> The highest award for resale price maintenance<sup>177</sup> was \$250,000,<sup>178</sup> with seven other awards between \$5,000<sup>179</sup> and \$110,000.<sup>180</sup>

There have been seven cases where a penalty was imposed for an agreement substantially lessening competition. The highest was *Taylor Preston* with three awards of \$1.5 million, with the others ranging from \$30,000<sup>181</sup> to \$750,000.<sup>182</sup> Under the monopolisation provision the highest award has been \$525,000.<sup>183</sup>

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<sup>168</sup> See appendix for a table setting out the pecuniary penalties imposed 1986-2007.

<sup>169</sup> *NZ Bus*, at [67].

<sup>170</sup> Commerce Act 1986, s30.

<sup>171</sup> *Ibid.*, S27.

<sup>172</sup> *Roadmarkers*.

<sup>173</sup> *Eli Lilly*.

<sup>174</sup> Commerce Act 1986, s29.

<sup>175</sup> *Motor Body*.

<sup>176</sup> *Wrightson*.

<sup>177</sup> Commerce Act 1986, s37.

<sup>178</sup> *Toyota*.

<sup>179</sup> *Herberts*.

<sup>180</sup> *DB Breweries*.

<sup>181</sup> *NZ Milk*.

<sup>182</sup> *Koppers*.

<sup>183</sup> *Carter Holt (CA)*.

The only decision under the business acquisitions category was a fine of \$500,000.

It is not surprising that a maximum award has not been made. There has been no case where a long-term, international cartel has operated. The question is one of degree: should larger awards have been made?

### ***Individual penalties***

Individual penalties are available under the Act<sup>184</sup> and have been imposed in seven cases.<sup>185</sup> There is a presumption that individual penalties should be imposed unless there is a good reason not to.

In *Ophthalmological* the penalty was against an individual who was a “business entity in his own right” as opposed to a “responsible officer of a corporation”.<sup>186</sup> The ophthalmologist himself would benefit from his actions and not the professional society to which he belonged. Similarly, it was ophthalmologists as individuals who were liable in *Ellingham*.<sup>187</sup> This situation is unusual as generally the corporation is the business entity to be prosecuted.<sup>188</sup> The more orthodox case occurred in *Christchurch Transport* where individual penalties were imposed to reflect senior management’s central involvement in bid rigging.

The courts are conscious of the suggestion of double penalties.<sup>189</sup> This is the concept that an excessive amount will be recovered because of penalties imposed on a company as well as its director/servant/agent. To avoid this, the judge in one case took the approach that a penalty which reflected the culpability of anti-competitive behaviour should be made and then blame apportioned between the individual and the company.<sup>190</sup>

Optimal penalty theory is concerned with companies and not individuals. Making an individual liable for the entire gain to the company which employs them

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<sup>184</sup> Commerce Act 1986, s80(2) stipulates that individual penalties should be imposed unless there is a good reason for them not being imposed. Section 83(1) allows for individual penalties for breaches of Part 3 of the Act.

<sup>185</sup> *Christchurch* \$10,000; *Ophthalmological* \$25,000, \$5000; *Ellingham* \$15,000 x3, \$10,000; BP Oil \$8,000; North Albany \$50,000; Wrightson \$10,000 x5; Otago Southland \$5 x 14.

<sup>186</sup> *Ophthalmological*, at [25].

<sup>187</sup> The company only being added as fifth defendant to enable the Court to decide questions involved, and no orders were sought against it: *Ellingham*, at [3].

<sup>188</sup> *Ophthalmological*, at [47].

<sup>189</sup> *Ophthalmological*, at [44].

<sup>190</sup> *Christchurch*, at 8 to 9.

would certainly have negative impacts because this large threat would deter behaviour which is legal. However imposing a penalty on individuals is a valuable means of achieving deterrence.

### ***Is it realistic for the court to attempt to calculate the optimal penalty?***

Economic models by their very nature make assumptions and include figures which cannot accurately be specified in practice. While assessment of variables, for example the probability of a successful detection ( $p$ ) and risk aversion ( $r$ ), can not be accurately calculated, they are still factors which the courts should consider when assessing an optimal penalty.

### ***Conclusion***

The penalties made by the court have been too low. This is because the courts have seldom recognised economic principles in its calculation of penalty, and have taken a very confused approach as to the applicability of criminal mitigating factors.

The judge in *Otago and Southland*, the first case in which a penalty was imposed under the Act, noted that while it was “not a criminal charge...it was so close to it that the same principles apply”.<sup>191</sup> *Wrightson* took the other approach: that ‘criminal morality’ was out of place and that “[o]ne should not slip automatically into applications of orthodox criminal law sentencing concepts simply because they are familiar”.<sup>192</sup> The prevailing view steers a middle course between these extremes: that Commerce Act penalties are a “hybrid” between criminal and civil,<sup>193</sup> have a “quasi-criminal element”,<sup>194</sup> or while substantially differing to criminal proceedings have a “rough hewn comparability”.<sup>195</sup>

There is divergence between the economic schools as to whether a criminal penalty should be imposed additionally to the economically optimal penalty.<sup>196</sup> However, both schools agree that criminal *mitigating* factors should never be used.

<sup>191</sup> *Otago and Southland*, at 9.

<sup>192</sup> *Wrightson*, at 673.

<sup>193</sup> *NZ Milk*, at 3; *North Albany*, at 5; *Ellingham*, at [2].

<sup>194</sup> *Country Fare*, at 1; *North Albany*, at 14.

<sup>195</sup> *Koppers*, at [44].

<sup>196</sup> Chicagoans argue that criminal morality is out of place, and that the penalty imposed should be equivalent to that calculated using the optimal deterrence model. Harvardians, on the other hand, argue that criminal morality should attach, and a penalty representing moral condemnation should be added to the optimal deterrence model.

The ad-hoc introduction of criminal mitigating factors have produced penalties which, on the whole, have been too low. The courts need to focus on the importance of economics in competition law, and ignore exogenous criminal considerations. Until they do, penalties are unlikely to pose an adequate deterrent to anti-competitive behaviour.

## CHAPTER FIVE: IS CRIMINALISATION JUSTIFIABLE?

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The current penalty regime consists of 'civil penalties'. These steer a middle course between 'criminal' and 'civil' penalties. A civil penalty imposes a punitive sanction but not through the usual criminal process.<sup>197</sup> Pecuniary penalties under the Act need only be proven to a civil standard.<sup>198</sup> Civil penalties theoretically impose less moral condemnation than criminal penalties.<sup>199</sup>

The question can be posed: should competition offences be reclassified as 'criminal offences'. This could represent greater moral condemnation of companies as well as allowing for the additional threat of imprisonment against individuals.

### ***The economic approach to criminalisation***

Chicagoans on the whole take a hostile view towards the concept of criminalisation. Chicagoans believe competition law should revolve around promoting efficiency and jail sentences do not achieve this. Furthermore, fines should be equivalent to the total harm, and no extra sanction should be introduced to reflect moral blame because this may deter efficient crimes.

A Chicago conception would see imprisonment as an alternative to a fine. Rather than increasing the fine above the optimal level to demonstrate social condemnation, Chicagoans would calculate days in jail using a "rate of exchange ... that equates, for any individual, a number of dollars with a number of days in jail".<sup>200</sup>

Even if the rate of exchange could be determined, which is problematic in itself, Chicagoans note that jail is less efficient than an equivalent penalty, because a penalty represents a transfer payment. Less the cost of convicting, sentencing and collecting, society is no worse off if a fine is imposed. The payment by the offender becomes a gain for the government, which can then spend it as it sees

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<sup>197</sup> Australian Law Reform Commission, "Principled Regulation: Federal Civil & Administrative Penalties in Australia", at [2.45].

<sup>198</sup> Commerce Act 1986, s80(3).

<sup>199</sup> Ministerial Council on Consumer Affairs, "Civil penalties for Australia's consumer protection provisions: A discussion paper", (Ministerial Council on Consumer Affairs, 2005), at 13.

<sup>200</sup> Richard Posner, *Economic Analysis of Law* (Boston: 2<sup>nd</sup> ed, Little Brown and Company, 1977), at 168.

fit. There are no equivalent transfers for imprisonment. The “costs incurred by the imprisoned criminal in foregone lawful income, misery etc., are not transferred, and yield no benefits to anyone else; they represent a deadweight social loss”.<sup>201</sup>

One argument is that this rate of exchange is necessary when the criminal can not afford to pay the fine. Posner notes that jail can be justified if the criminal cannot pay, but “inability to pay judgments is not a problem in the antitrust field”.<sup>202</sup> He bases this contention on the argument that involvement with a company which has been subject to an antitrust case will hamper an individual’s efforts to get further employment. This, Posner says, has a deterrent effect equivalent to short prison sentences.<sup>203</sup>

The key difference between these approaches is that Harvardians consider efficiency to be a goal of competition law, but not the sole goal. Furthermore, Harvardians consider that a moral blameworthiness attaches to competition offences. This allows them scope for arguing that jail should be used because of its greater punitive and condemning effect despite it being a less efficient punishment than fines.

Therefore, the justification of criminal sanctions in antitrust law will depend on which school one adheres to. I will now evaluate the debate and highlight, where appropriate, each school’s main contentions.

### ***Overseas experience***

Overseas jurisdictions impose heavy jail sentences for cartel activity. The United States have a maximum penalty of 10 years<sup>204</sup> and the United Kingdom have a maximum penalty of five years.<sup>205</sup> Australia does not currently have criminal penalties, although their introduction is expected very shortly to both individuals and companies for cartel conduct. Following the Dawson Report, the Australian

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<sup>201</sup> Ibid., at 169.

<sup>202</sup> Ibid., at 225.

<sup>203</sup> Ibid., at 226.

<sup>204</sup> Antitrust Criminal Penalty Enhancement and Reform Act 2004 (US). The United States’ provision criminalises any attempt to restrain trade, so is very wide. However, the Department of Justice only prosecutes ‘hard-core cartel behaviour’. It penalises both individual and corporate offenders: Julie Clarke and Mirko Baganic, “The Desirability of Criminal Penalties for Breaches of Part IV of the Trade Practices Act” (2003) 31 *Australian Business Law Review* 192, at 198.

<sup>205</sup> Enterprise Act 2002 (UK), ss 188 and 190. This act is specific to cartel behaviour and only applies to individuals.

Treasurer announced that he accepted 'in principle' that criminal penalties should be introduced.<sup>206</sup> The long-awaited Trade Practices (Cartel Conduct) Amendment Bill is publicly listed for introduction in the spring of 2007,<sup>207</sup> although it has consistently been publicly listed without being introduced. This bill would introduce criminal penalties.

Both sides of the Tasman argue for harmonisation of business laws. In relation to Australia adopting alternative maximum penalties, the Dawson Report stressed the desirability of consistency in the interests of closer economic relations between Australia and New Zealand.<sup>208</sup> There is explicit recognition of this in trans-Tasman memoranda.<sup>209</sup>

As far as penalties go, New Zealand has led Australia. In 1990 New Zealand increased the penalty of a corporation from \$300,000 to \$5,000,000 and for an individual from \$100,000 to \$500,000.<sup>210</sup> Australia followed a year later, raising maximum fines from \$250,000 for a corporation and \$50,000 for an individual to \$10,000,000 for a corporation,<sup>211</sup> and \$500,000 for an individual.<sup>212</sup> New Zealand introduced alternative maximum penalties in 2001,<sup>213</sup> Australia did so in 2006.<sup>214</sup> It seems likely that Australia will now forge ahead of New Zealand with the introduction of criminal penalties.

However, the fact that other countries have implemented criminal sanctions does not mean they would be appropriate for New Zealand. There must be some justification independent of a desire to follow others. As Clarke and Baganic said, "reform (as opposed to simply change, which quite often is regressive) is hardly likely to arise from reflexively copying standards and laws operating in other

<sup>206</sup> "Commonwealth Government Response to the Review of the Competition Provisions of the Trade Practices Act 1974" <[www.treasurer.gov.au/tsr/content/publications/TPAResponse.asp](http://www.treasurer.gov.au/tsr/content/publications/TPAResponse.asp)> accessed 17 September 2007.

<sup>207</sup> "Legislation Proposed for Introduction in the 2007 Spring Sittings" <[http://www.pmc.gov.au/parliamentary/docs/proposed\\_legislation.doc](http://www.pmc.gov.au/parliamentary/docs/proposed_legislation.doc)> accessed 17 September 2007

<sup>208</sup> Trade Practices Act Review Committee, "Review of the Trade Practices Act", <<http://tpareview.treasury.gov.au/content/report.asp>> accessed 17 September 2007 ("*Dawson Report*"), at 161.

<sup>209</sup> The Memorandum of Understanding Between the Government of New Zealand and the Government of Australia on Coordination of Business Law <[http://www.treasury.gov.au/documents/1073/PDF/Business\\_law\\_MOU.pdf](http://www.treasury.gov.au/documents/1073/PDF/Business_law_MOU.pdf)> accessed 17 September 2007

<sup>210</sup> Commerce Amendment Act 1990.

<sup>211</sup> Trade Practices Amendment Act 1992, s10(1A)(b).

<sup>212</sup> *Ibid.*, s10(1B).

<sup>213</sup> Commerce Act Amendment 2001.

<sup>214</sup> Trade Practices Legislation Amendment Act (No 1) 2006, Schedule 9 Part 1, s4.

jurisdictions".<sup>215</sup>

But the availability of criminal sanctions by other countries does have the very real problem of making New Zealand comparatively vulnerable to cartel activity. One of the arguments for the introduction of criminal sanctions put forward by the chairman of the Australian Competition and Consumers Commission<sup>216</sup> (ACCC) was that Australia had to 'remain in step' with the law of its major trading partners to avoid becoming a 'soft target', expressly noting the availability of criminal sanctions in the United States, Canada, Japan, Korea and now Britain.

This argument would have great relevance to New Zealand when Australia do introduce criminal sanctions. A vast majority of New Zealand's trading partners would then be able to punish cartel offences more severely than New Zealand could. By extension, if Australia implemented criminal sanctions to prevent it being a soft target, New Zealand would become a sitting duck.

### ***What behaviour should criminal sanctions apply to?***

Criminalisation could only be justified for very serious anti-competitive behaviour. Cartels' actions have been labelled the most "egregious violations of competition law".<sup>217</sup> Cartel conduct refers to price-fixing, bid-rigging, market sharing and output restrictions.<sup>218</sup> Cartels cause huge harm by increasing prices and reducing quantity, and in essence they destroy competition nationally and transnationally. For these reasons the Organisation of Economic Co-operation and Development (OECD) have made 'hard-core cartelization' a focus of its attention since the late 1990s.<sup>219</sup> The harm is hard to estimate accurately, but 16 large cartel cases reported to the OECD between 1996 and 2000 caused more than \$US55 billion in harm worldwide.<sup>220</sup> There were 119 cases in this time

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<sup>215</sup> Clarke and Baganic, "The Desirability of Criminal Penalties for Breaches of Part IV of the Trade Practices Act", at 192.

<sup>216</sup> Fels, "The Trade Practices Act and World's Best Practice: Proposals for Criminal Penalties for Hard-Core Collusion", at 2.

<sup>217</sup> OECD, "Recommendation of the Council Concerning Effective Action against Hard Core Cartels" (OECD, Paris, 1998).

<sup>218</sup> Ibid. This behaviour is covered by the Commerce Act 1986 by section 30.

<sup>219</sup> As evidenced by the adoption by the OECD of the "Recommendation of the Council Concerning Effective Action Against Hard Core Cartels".

<sup>220</sup> OECD, "Report on Nature and Impact of Hard Core Cartels and Sanctions against Cartels under National Competition Laws" (OECD, Paris, 2002).

period,<sup>221</sup> so while the exact harm cannot be accurately assessed, it can be accepted that it is huge.

Closer to home, the ACCC gave the example of the TNT/Mayne Nickless/Ansett express freight cartel, which colluded to fix prices in the express freight market. This “particularly pernicious” conduct which lasted 20 years was estimated to control and distort commerce in excess of \$1 billion annually.<sup>222</sup>

### ***Are criminal sanctions necessary?***

Opponents have argued that the current penalty regime is adequate. Fines were not close to the maximum before the Amendment in 2001 and maximums have increased further since. However, I do not think that this is dispositive of the issue. That no real ‘hard-core’ international cartels have been detected does not prove they do not exist, or will not exist in the future. Currently, the Commission is investigating four international cartels (through leniency applications).<sup>223</sup>

It is a flawed argument to use the fact that New Zealand has had no case where criminal sanctions were appropriate as a justification for not introducing them. Furthermore, there is an argument that while they might not be used if introduced, their very existence could alter potential abusers’ behaviour because of the threat of criminal sanctions. This is the rationale behind Braithwaite’s enforcement pyramid.

### ***The enforcement pyramid***

Professor John Braithwaite has developed the influential<sup>224</sup> ‘enforcement pyramid’.<sup>225</sup> This model is based on the contention that regulators should have at their disposal a range of escalating penalties and sanctions. Braithwaite’s thesis is that having a hierarchy from very low penalties and sanctions through to ‘cataclysmic’ penalties and sanctions is more likely to secure compliance than having more limited options. In the context of financial regulation, Vivian

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<sup>221</sup> Ibid.

<sup>222</sup> Fels, “The Trade Practices Act and World’s Best Practice: Proposals for Criminal Penalties for Hard-Core Collusion”, at 3.

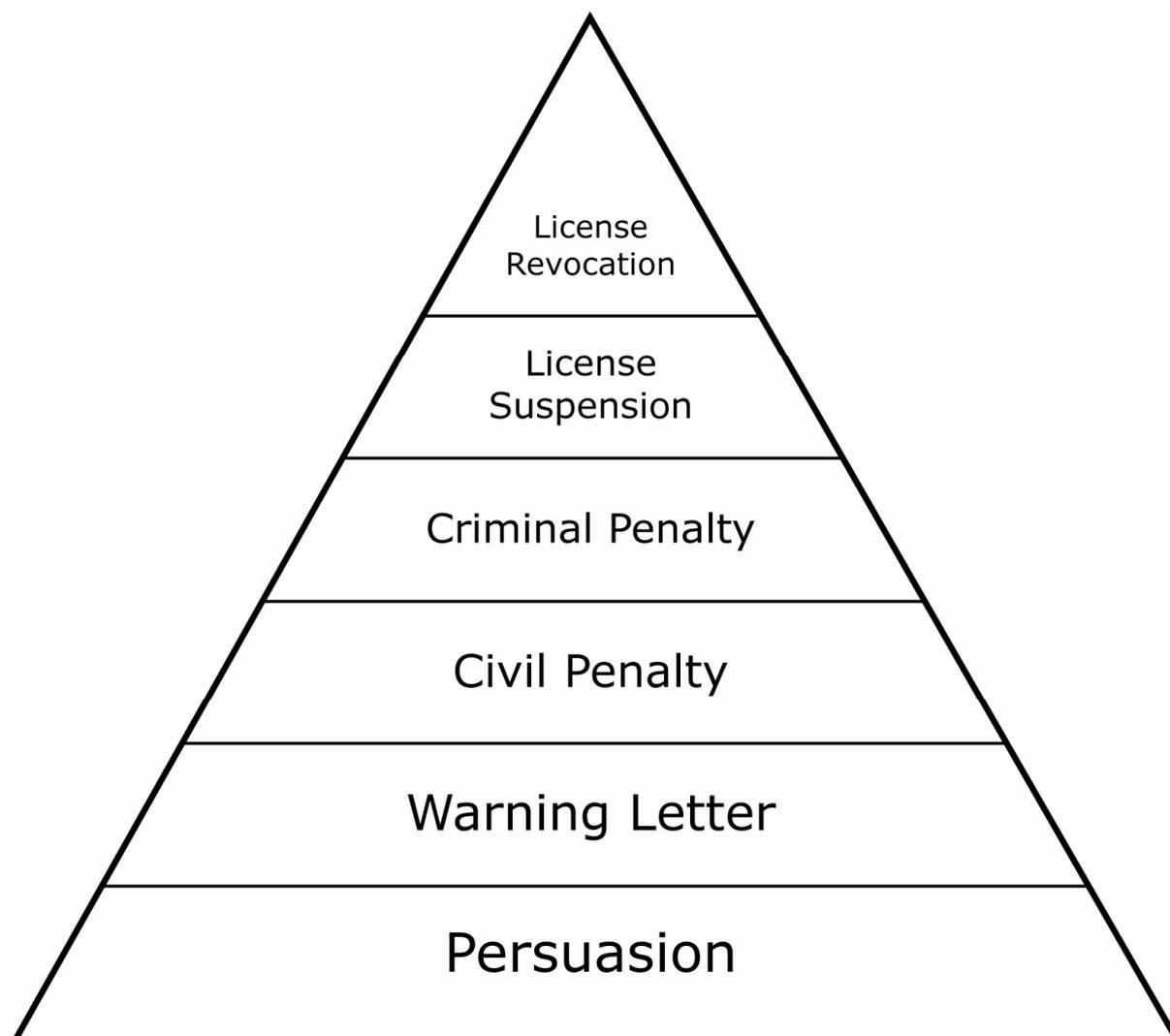
<sup>223</sup> Peter Taylor, “Commerce Commission Leniency Policy” (2005) (Paper to the Competition Law and Policy Institute of New Zealand Conference), at 4.

<sup>224</sup> Australian Law Reform Commission, “Principled Regulation: Federal Civil & Administrative Penalties in Australia”, at 11.

<sup>225</sup> Brent Fisse and John Braithwaite, *Corporations, Crime and Accountability* (Hong Kong: Cambridge University Press, 1993), at 142-8; Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (New York: Oxford University Press, 1992), at 35.

Goldwasser states the same point: "The argument for a cogent structure of cumulative sanctions incorporating civil remedies at the base and criminal sanctions at the apex and civil penalties filling the middle ground is compelling".<sup>226</sup> The basic model envisaged by Braithwaite is depicted below:<sup>227</sup>

*Figure Three: Braithwaite's enforcement pyramid*

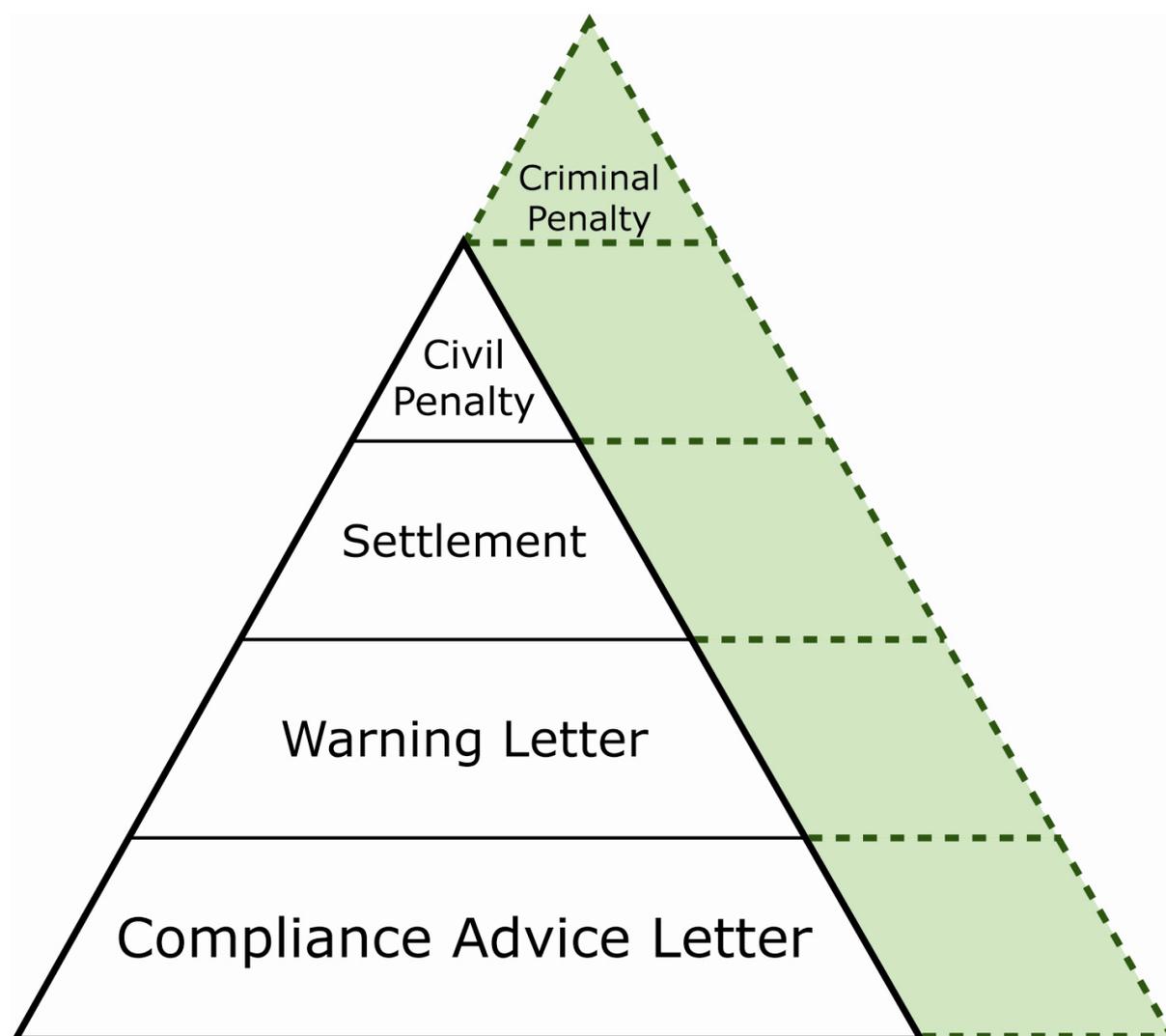


This model can be applied to competition law in New Zealand:

<sup>226</sup>Vivian Goldwassier "CLERP 6 - Implications and Ramifications for the Regulation of Australian Financial Markets" (1997) 17 Companies and Securities Law Journal 210, Quoted in Ministry of Economic Development, Reform of Securities Trading Law <[http://www.med.govt.nz/templates/MultipageDocumentTOC\\_\\_\\_6281.aspx](http://www.med.govt.nz/templates/MultipageDocumentTOC___6281.aspx)> accessed 17 September 2007, at [165].

<sup>227</sup> Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, at 35; Fisse and Braithwaite, *Corporations, Crime and Accountability*, at 142.

*Figure Four: Commerce Commission enforcement pyramid*



The white triangle represents the current hierarchy of enforcement responses currently available to the Commission.<sup>228</sup> The green area to the right of the white triangle depicts the enforcement pyramid if criminal sanctions are introduced. According to Braithwaite, the criminal sanctions are desirable because “the taller the enforcement pyramid, the more levels of possible escalation, the greater the pressure that can be exerted to motivate ‘voluntary’ compliance at the base of the pyramid”.<sup>229</sup>

Braithwaite claims that it is better to have severe punishments available, even if they will not be used. Braithwaite calls this having ‘benign big guns’:

<sup>228</sup> These are compiled from “Enforcement Responses – Options”, <<http://www.comcom.govt.nz/BusinessCompetition/Anti-competitivePractices/ContentFiles/Documents/Enforcement%20Responses.doc>>, accessed 17 September 2007

<sup>229</sup> Fisse and Braithwaite, *Corporations, Crime and Accountability*, at 148.

*"[R]egulators will be able to speak more softly when they carry big sticks (and crucially a hierarchy of lesser sanctions). Paradoxically, the bigger and more various the sticks, the greater the success regulators will achieve by speaking softly".<sup>230</sup>*

If there were only greater penalties available, the rational company might continue to offend, calculating that there was a slim chance of a large penalty being imposed. Braithwaite uses the analogy: "A country with a nuclear deterrent but no conventional forces may be more vulnerable than one that can bargain with a limited range of conventional escalations".

Therefore, Braithwaite's argument can be used to support the introduction of criminal sanctions even if there have been no cases where criminal sanctions would have been justified had they been available. The role of criminal sanctions using Braithwaite's jurisprudence is to act as a threat to people who may contemplate illegal acts: having a benign big gun.

### ***Should criminal morality attach?***

This is an aspect in which divergence between Chicago and Harvard school economists is obvious. As alluded to earlier, Chicagoans view penalties as the price of engaging in activity and not as a sanction. Applying criminal morality is only compatible with the Harvard or post-Chicago paradigm of antitrust law.

Cartel behaviour is the worst form of anti-competitive behaviour.<sup>231</sup> The ACCC, a firm supporter of the introduction of criminal penalties, asserts that cartel behaviour is so "morally reprehensible" that criminal sanctions should attach.<sup>232</sup>

The harm caused is great and a common thief would be sent to jail for much less. Judge Finkelstein has noted "[i]t is not unusual for antitrust violators to involve far greater sums than those that may be taken by thieves and fraudsters, and the violators can have a far greater impact on the welfare of

<sup>230</sup> Ayres and Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, at 19.

<sup>231</sup> Paula Rebstock, "Speech to the New Zealand Institute of Management" (2007) <[www.comcom.govt.nz/mediaCentre/Speeches/speechtothenewzealandinstituteofma.aspx](http://www.comcom.govt.nz/mediaCentre/Speeches/speechtothenewzealandinstituteofma.aspx)> accessed 17 September 2007, at [20].

<sup>232</sup> Fels, "The Trade Practices Act and World's Best Practice: Proposals for Criminal Penalties for Hard-Core Collusion", at 3.

society".<sup>233</sup> The ACCC contends that "[t] law must be blind to the colour of your collar".<sup>234</sup>

Clarke and Baganic call this type of argument the 'extension-analogy' argument: that "[o]ther less harmful conduct is criminalised so for consistency and for fairness, anti-competitive conduct should not be exempt from such classification".<sup>235</sup>

Recently, in New Zealand, criminal sanctions were introduced for insider trading.<sup>236</sup> There are certain parallels between these two offences. Both are regulatory in nature, both deal with economic regulation, and offenders will typically be 'white-collar'.

However, while persuasive, the extension-analogy argument is not definitive. Clarke and Baganic note that "the criminal law is a set of disparate rules which are devoid of a unifying thread".<sup>237</sup> Therefore, to use existing criminal law standards could well perpetuate existing errors.<sup>238</sup> So while it is useful to note that an action which is broadly similar to cartel behaviour attracts criminal conviction, this alone is not enough to warrant the introduction of such penalties to competition law.

### ***Are criminal penalties a greater deterrent than civil penalties?***

#### *A greater deterrent for individuals?*

For individuals, the threat of jail would deter more effectively than a fine. The US Director of Criminal Enforcement of the Antitrust Division of the Department of Justice has observed that there is "no greater deterrent to the commission of cartel activity than the risk of imprisonment to corporate officials".<sup>239</sup> The loss of liberty is a sanction that would strike fear in the heart of any price fixer. Intuitively, one can agree with the sentiment that people would pay more to

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<sup>233</sup> *ABB Transmission*.

<sup>234</sup> Fels, "The Trade Practices Act and World's Best Practice: Proposals for Criminal Penalties for Hard-Core Collusion", at 3.

<sup>235</sup> Clarke and Baganic, "The Desirability of Criminal Penalties for Breaches of Part IV of the Trade Practices Act", at 2.

<sup>236</sup> Securities Markets Amendment Act 2006, Section 5 allows for imprisonment of up to 5 years for insider trading. Note that this section only comes into force from a date yet to be appointed by an Order of Council.

<sup>237</sup> Clarke and Baganic, "The Desirability of Criminal Penalties for Breaches of Part IV of the Trade Practices Act", at 15.

<sup>238</sup> *Ibid.*

<sup>239</sup> Fels, "The Trade Practices Act and World's Best Practice: Proposals for Criminal Penalties for Hard-Core Collusion", at 8.

avoid jail, but not spend more time in jail to avoid paying.<sup>240</sup>

This view is not without its critics, who include Posner. Posner claimed that the threat of imprisonment was a deterrent no greater than the threat that market forces would make it harder for a person convicted of an antitrust offence to get a job. The Law Council of Australia suggests that the presence of cartels in the United States despite the threat of criminal sanctions shows that the risk of imprisonment does not necessarily deter individuals.<sup>241</sup> However, Posner's position seems untenable and the Law Council offers no estimate of the amount of offending that would exist in the United States were these sanctions not available.

Criminal liability may also be a superior deterrent because despite the existence of anti-indemnity provision in both the Act and the Trade Practices Act,<sup>242</sup> there is little which can be done to prevent a company in subsequent years from offsetting the amount of fines to individuals with bonuses.<sup>243</sup> This option does not apply to jail time.<sup>244</sup>

#### *A greater deterrent for companies?*

A corporation is a legal entity, and as such cannot be imprisoned. This major rationale for individual criminal penalties is therefore not available. However, the Dawson Report noted that this "does not mean [a corporation] cannot suffer the opprobrium of a criminal conviction and be fined".<sup>245</sup> The Dawson Report notes that a criminal sanction represents the "condemnation of society in a way that civil penalties cannot".<sup>246</sup> Put succinctly, "a civil fine is a financial penalty without additional penalty of stigma, while a criminal fine is a financial penalty with the additional penalty of stigma".<sup>247</sup>

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<sup>240</sup> The statement was by James Griffin, the Deputy Assistant Attorney General of the US Department of Justice, Antitrust Division, as quoted in Fels, "The Trade Practices Act and World's Best Practice: Proposals for Criminal Penalties for Hard-Core Collusion", at 9.

<sup>241</sup> Law Council of Australia, "Submission on the Trade Practices Act Review", <<http://tpareview.treasury.gov.au/submissions.asp>> accessed on 17 September 2007, at 85.

<sup>242</sup> Trade Practices Act, S77A.

<sup>243</sup> Fels, "The Trade Practices Act and World's Best Practice: Proposals for Criminal Penalties for Hard-Core Collusion", at 7

<sup>244</sup> Nor does it with banning orders, available under the present regime.

<sup>245</sup> The Dawson Report, at 157.

<sup>246</sup> *Ibid.*, at 158.

<sup>247</sup> Edwin Sutherland, "Is 'White Collar Crime' Crime?" (1945) 10 *American Sociological Review* 132, at 136-137.

The notion that a 'stigma' attaches to companies for breaches of economic regulation is contentious. Some regulatory offences, such as breaches of occupational health and safety and environmental regulations, are acts harmful in themselves (*mala in se*).<sup>248</sup> Regulation of economic interests involves conduct that society chooses to attach sanctions to (*mala prohibita*)<sup>249</sup> including antitrust offences.<sup>250</sup> Block conducted research into the stigma involved in regulatory offences by studying share prices before and after the conduct became known.<sup>251</sup> Block concluded that stigma does attach to *mala in se* regulatory offences, but not to *mala prohibita* offences where the effect on the contracting parties was small.<sup>252</sup>

### **Problems with corporate criminalisation**

The burden of proof from criminal conviction is 'beyond reasonable doubt', which is more onerous than the civil standard of the 'balance of probabilities'. Because, as argued earlier, there is negligible 'stigma' involved with the criminalising competition offences for companies, the only effect criminalising companies' actions would have would be to make the offence a lot harder for the prosecution to prove.<sup>253</sup>

A criminal offence would also be harder to prove because of the additional element of mens rea. Mens Rea is the "state of mind, or mental element, required for criminal liability".<sup>254</sup> Most criminal offences require mens rea,<sup>255</sup> and there is a presumption that mens rea is part of the offence if the statute is silent.

Two standards of mens rea have been used internationally. The English provision, and the soon to be introduced Australian provision use the mens rea

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<sup>248</sup> Australian Law Reform Commission, "Principled Regulation: Federal Civil & Administrative Penalties in Australia", at 113.

<sup>249</sup> Ibid.

<sup>250</sup> Bruce Kobayashi, "Agency, Amnesty, & Antitrust: An Economic Analysis of the Criminal Enforcement of the Antitrust Laws Against Corporations" (2001) 69 *George Washington Law Review* 715, at 742.

<sup>251</sup> Block, "Optimal Penalties, Criminal Law and the Control of Corporate Behavior".

<sup>252</sup> Ibid., at 414.

<sup>253</sup> Because the additional criminal sanction of imprisonment is clearly not available against companies.

<sup>254</sup> Bruce Robertson et al, *Adams on Criminal Law* (Wellington: 4<sup>th</sup> ed, Brookers Ltd, 2005), at 41.

<sup>255</sup> The exceptions are 'strict liability' offences which allow the defendant to prove absence of fault; and 'absolute liability' offences which have no defence of absence of fault.

of dishonesty;<sup>256</sup> whether people dishonestly enter into cartel arrangements. The United States uses a standard of 'specific intent'; whether a person has acted with the specific intent to restrict trade.

Regardless of which approach is adopted, or even if a third approach was introduced, there is the same problem in relation to companies as with the increased standard of proof: the offence is harder to prove, with little or no additional gains.

A criminal offence for individuals would be harder to prove as well, but there is the additional penalty of imprisonment available if the tougher criminal standard is met.

### **Conclusion**

There is not a strong enough case to justify the introduction of criminal penalties for corporations. I base this argument on pragmatic over ideological concerns because of the difficulty in proving the offence to a higher standard, and - given that the extra deterrent effect of a criminal conviction would be negligible - there is no offsetting gain.

There is, however, a convincing case for criminal penalties for individuals. For individuals contemplating competition offences, unlike corporations, the possibility of jail is the most effective deterrent. Although there has not been a case in New Zealand that would have warranted criminal sanctions, this is not dispositive. Legislation should be prospective, not reactive.

I have come to this conclusion by adopting a key argument inconsistent with the Chicagoan approach: that moral condemnation should apply, and that efficiency should not be the sole goal of competition law. Criminal morality should attach to those who deliberately and systemically distort competition and take advantage of consumers. This view is inconsistent with the notion of 'efficient offences'. Penalties should have a morally condemning effect. The Chicagoan approach is useful in theory but when applied to the law it is deficient. While competition law is a form of economic regulation, the law should uphold not only

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<sup>256</sup> This adoption of 'dishonesty' for the Australian provision was highly criticised by Brent Fisse, "The Cartel Offence: Dishonesty?" (2007) 35 *Australian Business Law Review* 235.

efficiency but also values such as justice, fairness, and responsibility. The blinkered approach prescribed by Chicagoans is not justifiable.

## CHAPTER SIX: INCREASING THE PROBABILITY OF DETECTION

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Some have argued that instead of increasing the maximum fine ( $f$ ) through criminalisation, the chance of prosecution should be increased ( $p$ ).<sup>257</sup> This is a Harvard approach; raising  $p$  closer to unity requires resources which make it less efficient.

### **Leniency**

To effectively deter anti-competitive behaviour, sufficient sanctions must be coupled with an effective means of detection. This effective means of detection is especially important when dealing with cartels.<sup>258</sup> The OECD's 2002 report states:

*"The challenge in attacking hard-core cartels is to penetrate their cloak of secrecy. To encourage a member of the cartel to confess and implicate its co-conspirators with first-hand, direct "insider" evidence about their clandestine meetings and communications, an enforcement agency may promise a smaller fine, shorter sentence, less restrictive order, or complete amnesty".*<sup>259</sup>

These approaches are all known as 'leniency'. Leniency works on a 'carrot or the stick' approach. The 'carrot' is that the first person to inform on other members of a cartel gets a reduced penalty (or complete amnesty). The parties that do not volunteer this information then get discovered. The rationale behind this is that without offering this incentive to provide information, the enforcement agency would not come to know about the existence of the cartel, and therefore could not prosecute any members of the cartel. So while objectors may raise the point that this allows a guilty person to profit from their crime it is important to note that in criminal activity such as cartels, where multiple parties will be involved, enforcement effectiveness may outweigh that concern.<sup>260</sup> "[L]eniency for a few participants makes it possible to apply the law more thoroughly to

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<sup>257</sup> Becker noted that it was a common generalisation for persons with judicial experience that a change in probability has a greater effect on the number of offences committed than a change in punishment. Becker, "Crime and Punishment: An Economic Approach", at 176.

<sup>258</sup> Because there are strong incentives for cartel members to keep the cartel secret.

<sup>259</sup> OECD, "Report on Nature and Impact of Hard Core Cartels and Sanctions against Cartels under National Competition Laws", at 7.

<sup>260</sup> *Ibid.*, at 10.

others".<sup>261</sup> Enforcement agencies are unapologetic in stating that the leniency policy is not to reward 'good corporate citizens', but is justified because of its use in uncovering cartels, prosecuting non-informants and preventing the harm which cartels cause.<sup>262</sup>

The 'stick' is that leniency is typically only offered on a 'first come first served' basis; even if the informant gets there second by a matter of minutes, the enforcement agency will not offer them leniency. Therefore, there is an incentive to inform an enforcement agency about the existence of the cartel as early as possible. For those persons who inform subsequently there may be incentives offered for their co-operation, especially where their information can make a stronger case against other offenders, but this level of leniency must not be as generous as to the first informant.<sup>263</sup>

A counterpoint has been made by some commentators that, because of the provision of smaller penalties, the existence of a leniency regime may actually increase participation in cartels.<sup>264</sup> However, it is the preceding point – that of only giving complete amnesty to the first to apply and allowing subsequent co-operation by other parties to have only a small bearing on penalty – that will negate this argument. This is because there is no certainty that a participant will be the first person to apply for amnesty.

### ***International experience***

Leniency programmes have proved incredibly effective overseas, especially in the United States. The United States comprehensively overhauled its leniency programme in 1993 with significant results.<sup>265</sup> "In the United States alone, companies have been fined over \$2.5 billion dollars for antitrust crimes since 1997 [until 2002] with over 90% of this tied to investigations assisted by leniency applications".<sup>266</sup> The amount of applications under leniency increased from about one application a year to over two a month after the 1993

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<sup>261</sup> Ibid.

<sup>262</sup> Australian Law Reform Commission, "Principled Regulation: Federal Civil & Administrative Penalties in Australia", at 630.

<sup>263</sup> Ibid.

<sup>264</sup> OECD, "Fighting Hard-Core Cartels: Harm, Effective Sanctions and Leniency Programmes" (OECD, Paris, 2002), at 27.

<sup>265</sup> Peter Taylor, "Commerce Commission Leniency Policy", at 1.

<sup>266</sup> Scott Hammond, "Cornerstones of an Effective Leniency Program" (2004) (Paper to the ICN Workshop on Leniency Programs, Sydney), at 2.

changes.<sup>267</sup> In other jurisdictions, leniency programmes have led to “the detection and dismantling of the largest global cartels ever prosecuted and resulted in record-breaking fines in the United States, Canada, [and] the EU”.<sup>268</sup>

### ***Characteristics of an effective leniency programme***

There are four ways a policy of leniency can fight collusion: by helping detect cartels; making conviction more likely by bringing forth evidence; destabilising cartels and making them more likely to collapse; deterring cartels by making them less profitable.<sup>269</sup> The Director of Criminal Enforcement of the Antitrust Division of the U.S. Department of Justice<sup>270</sup> identified three important ‘cornerstones’ to an effective leniency programme: severe sanctions; high risk of detection to those who did not report; and transparency and predictability. This was subsequently endorsed in a paper by Peter Taylor, General Counsel at the Commerce Commission.<sup>271</sup>

#### **1. Severe Sanctions**

As noted previously no criminal sanctions are available in New Zealand. Penalties for non-informing companies will be the higher of \$10,000,000, three times the value of the illegal gain or if this cannot be calculated 10% of the turnover of the company or group of companies.<sup>272</sup> Individuals can be fined up to \$500,000. The Director of Criminal Enforcement alluded to the threat of criminal sanctions deterring cartels from entering the United States, despite it being the world’s largest market.<sup>273</sup> Criminal sanctions can therefore have two effects, raising  $f$  as well as  $p$ .<sup>274</sup> However, he also complimented the EC systems, where criminal sanctions do not apply, because the magnitude of fines there did impose a significant deterrent.<sup>275</sup> Peter Taylor of the Commerce Commission denies that a lack of criminal sanctions would minimise the effectiveness of the leniency programme. As evidence, he produces the fact that the Commission has

<sup>267</sup> Joseph Harrington, “Corporate Leniency Programs and the Role of the Antitrust Authority in Detecting Collusion” (2006) *Competition Policy Research Centre Discussion Paper CPDP-18-E* <[www.econ.jhu.edu/People/Harrington/CPRC-1.06.pdf](http://www.econ.jhu.edu/People/Harrington/CPRC-1.06.pdf)> accessed 17 September 2007, at 23-24.

<sup>268</sup> *Ibid.*

<sup>269</sup> *Ibid.*, at 3.

<sup>270</sup> Hammond, “Cornerstones of an Effective Leniency Program”, at 3.

<sup>271</sup> Taylor, “Commerce Commission Leniency Policy”, at 5.

<sup>272</sup> Commerce Act 1986, S80(2B).

<sup>273</sup> Hammond, “Cornerstones of an Effective Leniency Program”, at 5.

<sup>274</sup> See Chapter Two for discussion about the optimal tradeoff between  $f$  and  $p$ .

<sup>275</sup> *Ibid.*, at 4.

received four leniency applications to date.<sup>276</sup> This shows that the leniency programme is working, but provides no support that the policy is working as well as it could.

## 2. Increased detection

This self-evident characteristic requires that the use of a leniency policy must increase the chance of apprehension. If people do not think they will be caught they will have no desire to provide information and apply for leniency.

"[A]ntitrust authorities must cultivate an environment in which business executives perceive a significant risk of detection by antitrust authorities".<sup>277</sup>

Tied into this is the notion that leniency (in the form of full amnesty) should only be available to the first informant. The United States takes a much harder line, allowing no leniency for the "second through the door", unlike the European Union which allows a 30-50% discount if subsequent informants come forward before investigation.<sup>278</sup>

## 3. Clear and transparent

This factor was also identified by the OECD.<sup>279</sup> The rationale here is that people will be much more forthcoming with information if they are certain or relatively certain that they will get amnesty. This was one of the major changes to the United States' leniency policy in 1993 which made the policy far more effective.<sup>280</sup> "What is important is that firms believe it is within their control to receive leniency".<sup>281</sup>

## ***Appraisal of New Zealand's leniency policy***

New Zealand's leniency policy stacks up well against international best practice. The policy promises complete amnesty,<sup>282</sup> heightening the incentive for people to inform. Leniency is only provided for the first person to "come forward with

<sup>276</sup> Taylor, "Commerce Commission Leniency Policy", at 3.

<sup>277</sup> Harrington, "Corporate Leniency Programs and the Role of the Antitrust Authority in Detecting Collusion", at 5.

<sup>278</sup> Ibid.

<sup>279</sup> OECD, "Fighting Hard-Core Cartels: Harm, Effective Sanctions and Leniency Programmes", at 8.

<sup>280</sup> Ibid.

<sup>281</sup> Harrington, "Corporate Leniency Programs and the Role of the Antitrust Authority in Detecting Collusion", at 19.

<sup>282</sup> Commerce Commission Leniency Policy, Principle 2, annexed to Taylor "Commerce Commission Leniency Policy", at 15.

information and co-operate fully".<sup>283</sup> This certainty and clarity will reassure informants and consequently encourage them to come forward. To add extra clarity, there is a provision which allows a person to communicate with the Commission on a 'hypothetical' or 'off the record'<sup>284</sup> basis to see if the policy would apply to them, and if it would not, any information supplied will not be used by the Commission for any other policy.<sup>285</sup>

The leniency policy also requires 'full co-operation' before leniency will be given. This involves access to all information<sup>286</sup> (meaning all information, documents, material and evidence of any kind whatsoever, including all oral, written and electronic information)<sup>287</sup> the maintenance of continuous, complete and expeditious co-operation,<sup>288</sup> and fully and truthfully co-operating with the Commission on a 'continuing basis'.<sup>289</sup> Furthermore, a company must 'encourage and facilitate' current and former directors, officers or employees to voluntarily provide the Commission with information.<sup>290</sup> An individual must make themselves available for interviews and respond fully and truthfully.<sup>291</sup>

In conclusion, the New Zealand leniency policy is based to a large extent on the successful United States model. The main point of difference is the severity of the sanctions offered, with the United States having criminal sanctions and New Zealand only pecuniary. However, I agree with Peter Taylor that criminal sanctions are not necessary to achieve an effective leniency programme. The '10% of turnover' maximum is incompatible with economic principles, but it does allow for a very high fine if the courts wish to implement it. Criminal sanctions would make leniency more effective, but are not desperately needed.

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<sup>283</sup> Ibid.  
<sup>284</sup> Ibid.  
<sup>285</sup> Ibid.  
<sup>286</sup> Ibid.  
<sup>287</sup> Ibid.  
<sup>288</sup> Ibid.  
<sup>289</sup> Ibid.  
<sup>290</sup> Ibid.  
<sup>291</sup> Ibid.

## CHAPTER SEVEN: RECOMMENDATIONS AND CONCLUSIONS

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The courts and the legislature have correctly recognised that deterrence is the key objective when setting penalties in competition law. However, the penalties have consistently been inadequate to achieve this goal. This is because economic principles have been largely ignored by both the legislature and the courts.

The problem stems from an incomplete statutory framework which provides little assistance to the courts. Given little guidance, the courts have tried to 'hedge their bets': by using some economic sentencing factors and some criminal sentencing factors. It is because of this that penalties have been below what is needed to achieve deterrence.

The 2001 Amendment introduced a new section 80. This section provided some guidance to the court by mentioning one of the key starting points to calculating a penalty. The real deficiency in this section is the maximum penalties that it introduces. The 'three times the commercial gain' maximum is legitimately criticised overseas because the multiplier of three does not properly represent the probability of detection. The '10% turnover' maximum potentially allows for very large fines, but may have the counterproductive effect of suggesting to the court that the *penalty* should be 10% of the turnover; in complete defiance of economic principles.

The Chicago school of competition economics is inconsistent with our legal system. Our legal system, like the Harvard school of competition economics, does not view efficiency as the key goal. Instead our legal system and the Harvard school view efficiency as *one* of the goals, along with other considerations such as proportionality, fairness and equity.

Through a Harvard lens, criminalisation of individuals can be justified. The harm caused is huge, and jail is a very strong deterrent. It is flawed to argue that just because there has not previously been a case which would have warranted criminal sanctions that legislation should not guard against this in the future. However, there is not a strong enough case to warrant the introduction of criminal penalties for corporations. This is because there is only negligible stigma

that attaches; corporate criminalisation makes offences harder to prove, for no real offsetting gain in penalty.

The legislation should be amended to include criminal penalties for serious cartel behaviour by individuals. Furthermore, sections 80 and 83 should be consistent. Any reference to a maximum penalty should be removed. The 'probability of detection' should be included alongside the 'illegal gain' to signal to the courts that this is the starting point for the calculation of penalties. A subsection should be added which includes economically justifiable considerations. A final subsection should indicate that a further penalty may be *added* to represent moral condemnation.

Despite the lofty aspirations of the Act to promote competition for the long-term benefit of consumers in New Zealand,<sup>292</sup> a law is only as good as its enforcement. Unfortunately, the enforcement of the Act has been deficient. While the paramount goal of deterrence has been recognised, the Act, and its application by the courts, have missed the mark by ignoring the economic principles necessary to achieve this goal.

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<sup>292</sup> Commerce Act 1986, s1A.

## APPENDIX

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### ***Appendix One: Penalty sections of the Commerce Act***

#### **80 Pecuniary penalties**

(1) If the Court is satisfied on the application of the Commission that a person—

(a) Has contravened any of the provisions of Part 2 of this Act; or

(b) Has attempted to contravene such a provision; or

(c) Has aided, abetted, counselled, or procured any other person to contravene such a provision; or

(d) Has induced, or attempted to induce, any other person, whether by threats or promises or otherwise, to contravene such a provision; or

(e) Has been in any way, directly or indirectly, knowingly concerned in, or party to, the contravention by any other person of such a provision; or

(f) Has conspired with any other person to contravene such a provision,—

the Court may order the person to pay to the Crown such pecuniary penalty as the Court determines to be appropriate

[...]

[(2A)

In determining an appropriate penalty under this section, the Court must have regard to all relevant matters, in particular,—

(a) any exemplary damages awarded under section 82A; and

(b) in the case of a body corporate, the nature and extent of any commercial gain.]

[(2B) The amount of any pecuniary penalty must not, in respect of each act or omission, exceed,—

(a) in the case of an individual, \$500,000; or

(b) in the case of a body corporate, the greater of—

(i) \$10,000,000; or

(ii) either—

(A) if it can be readily ascertained and if the Court is satisfied that the contravention occurred in the course of producing a commercial gain, 3 times the value of any commercial gain resulting from the contravention; or

(B) if the commercial gain cannot be readily ascertained, 10% of the turnover of the body corporate and all of its interconnected bodies corporate (if any).]

[...]

### **83 Pecuniary penalties**

(1) If the Court is satisfied on the application of the Commission that a person—

(a) Has contravened section 47 of this Act:

(b) Has attempted to contravene that section:

(c) Has aided, abetted, counselled, or procured any other person to contravene that section:

(d) Has induced, or attempted to induce, any other person, whether by threats or promises or otherwise, to contravene that section:

(e) Has been in any way, directly or indirectly, knowingly concerned in, or party to, the contravention by any other person of that section:

(f) Has conspired with any other person to contravene that section,—

the Court may order the person to pay to the Crown such pecuniary penalty as the Court determines to be appropriate, not exceeding \$500,000 in the case of a person not being a body corporate, or \$5,000,000 in the case of a body corporate, in respect of each such act or omission.

(2) In determining an appropriate penalty under this section, the Court shall have regard to all relevant matters, including—

(a) The nature and extent of the act or omission:

(b) The nature and extent of any loss or damage suffered by any person as a result of the act or omission:

(c) The circumstances in which the act or omission took place:

(d) Whether or not the person has previously been found by the Court in proceedings under this Part of this Act to have engaged in any similar conduct

[...]

### **Appendix Two: Penalty awards in New Zealand 1986-2007**

Type of Offence	Case Name	Penalty Imposed on Companies	Penalties Imposed on Individuals
Per se - Price fixing	<i>Otago and Southland</i>		\$5 x 14
	<i>BP Oil</i>	\$40,000	\$8,000
	<i>Country Fare</i>	\$150,000 x2	
	<i>North Albany</i>	\$50,000	\$50,000
	<i>Roadmarkers</i>	\$15,000	
	<i>Christchurch Transport</i>	\$380,000	\$10,000
	<i>Eli Lilly</i>	\$500,000; \$250,000	
	<i>Giltrap City</i>	\$100,000	
	<i>Koppers</i>	\$2.85 million (part)	
	Per se - boycotts	<i>Wrightson</i>	\$5,000
<i>Motor Body</i>		\$15,000	
Per se - resale price maintenance	<i>Herberts</i>	\$5,000	
	<i>Hewlett Packard</i>	\$35,000	
	<i>Accent Footware</i>	\$30,000	
	<i>Sealy</i>	\$30,000	
	<i>Toyota</i>	\$250,000	

	<i>DB Breweries</i>	\$110,000	
	<i>Acer</i>	\$82,000	
	<i>Aquanaut</i>	\$60,000	
Not per se - substantial lessening of competition	<i>NZ Milk</i>	\$200,000; \$30,000	
	<i>Port Nelson (HC,CA)</i>	\$100,000, \$100,000	
	<i>Taylor Preston</i>	\$70,000; \$90,000; \$225,000; \$250,000; \$375,000; \$1.5million x3	
	<i>Caltex</i>	\$450,000; \$350,000; 375,000	
	<i>Ophthalmological</i>	\$100,000	\$25,000; \$5,000
	<i>Ellingham</i>		\$15,000 x3; \$10,000
	<i>Koppers</i>	\$750,000 (part)	
Not per se - taking advantage of market power	<i>Port Nelson (HC, CA)</i>	\$300,000	
	<i>Carter Holt (CA)</i>	\$525,000	
Not per se - business acquisitions	<i>NZ Bus</i>	\$500,000	

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