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Serious Hardship Relief: In Need of a Serious Rethink?

Kevin O'Rourke,* Ann Kayis-Kumar† and Michael Walpole‡

Abstract


The COVID-19 pandemic and its economic aftershocks have put into strong focus the tax issues faced by financially vulnerable individuals and small business. With this economic backdrop, it is likely that more taxpayers will be in severe financial stress, which will in turn increase the need for release from tax debts on grounds of serious hardship. However, these provisions are outdated and in urgent need of reform. This article outlines their legislative background and the regulatory landscape, and explores the systemic issues faced by taxpayers in litigating serious hardship cases. Further, it makes four key recommendations to modernise the current tax policy and law, and the design of these provisions. These recommendations are designed to attain better outcomes for financially vulnerable individuals and small businesses while also maintaining trust and confidence in the Australian Taxation Office among the wider community.


I Introduction

Even before the COVID-19 outbreak in Australia, researchers estimated that 11% of the Australian population were experiencing severe or high financial stress.¹ Regardless of socio-economic grouping, between 30.1 and 40.6% of financially vulnerable people assisted by the financial counselling sector were not able to access the tax advice they needed.² These financially vulnerable people most often needed assistance with outstanding tax returns and tax debt collection matters.³

People experiencing financial hardship are at a further disadvantage as the fact of outstanding tax returns often prevents access to the full range of welfare

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¹ National-level estimates indicating 0.5% of the population was in severe financial stress and 10.5% in high financial stress: NAB Centre for Social Impact, *Financial Resilience in Australia 2018* (Report, December 2018) 60.

² Ann Kayis-Kumar, Michael Walpole and Gordon Mackenzie, UNSW Tax Clinic, Submission No 3 to the Standing Committee on Tax and Revenue, *Inquiry into the Commissioner of Taxation Annual Report 2018-19* (26 May 2020) 1 ('Submission to the Standing Committee on Tax and Revenue').

³ *Ibid.*

benefits and COVID-19 financial relief packages offered by the Australian Government. It is not surprising that registered tax agents refuse to assist this cohort out of fear that the client is too far in debt to be able to pay the agent's fees at the end of the engagement. This presents an access-to-justice issue for financially vulnerable people and small businesses.

Leading economists⁴ and social impact sector experts⁵ expect that many individuals and small businesses will be faced with a financial cliff upon termination of COVID-19 government financial support in March 2021,⁶ further exacerbating pre-existing problems and amplifying financial stress.

As a result of COVID-19, we anticipate that many people in severe and high financial stress will be pushed deeper into severe financial stress in the short-term. This would, in turn, have medium-to long-term consequences for socio-economic disadvantage, including increasing the need for release from tax debts on grounds of serious hardship.

For over 100 years there has been a discretion in taxation legislation to release taxpayers from tax-related liabilities on the ground they would otherwise suffer serious hardship. Despite its long history, there is a relative dearth of literature on the serious hardship relief provisions in Australia. The existing literature on serious hardship has, to date, focused on: examining the statutory sources of power, judicial precedent, and administrative guidance;⁷ exploring the debt collection framework of the Australian Taxation Office ('ATO') and offering proposals to address existing weaknesses;⁸ and, analysing the impact of the ATO's debt collection practices on procedural justice and perceptions of fairness.⁹

⁴ Including Philip Lowe, Governor of the Reserve Bank of Australia: Gareth Hutchens, 'RBA's Philip Lowe Says Rates Won't Rise "for Some Years" but JobKeeper May Need to Be Extended', *ABC News* (online, 28 May 2020) <<https://www.abc.net.au/news/2020-05-28/rba-governor-philip-lowesays-downturn-may-not-be-as-bad-as-fea/12295954>>.

⁵ Briana Shepherd, 'Fears over Drop in Demand for Financial Counsellors during Coronavirus Pandemic', *ABC News* (online, 17 April 2020) <<https://www.abc.net.au/news/2020-04-17/managing-your-finances-during-the-coronavirus-pandemic/12154264>>.

⁶ As at 19 January 2021, both JobKeeper and JobSeeker are being tapered out with their gradual termination scheduled for 28 March 2021 and 31 March 2021, respectively; see: 'Extension of the JobKeeper Payment', *Australian Taxation Office* ('ATO') (Web Page, 28 September 2020) <<https://www.ato.gov.au/Newsroom/smallbusiness/General/Extension-of-the-JobKeeper-Payment/>>; Jack Snape 'JobKeeper Subsidy Drops then Disappears Entirely in March, and Some Workers are Worried', *ABC News* (online, 4 January 2021) <<https://www.abc.net.au/news/2021-01-04/jobkeeper-subsidy-drops-final-phase-before-gone-in-march/13023486>>.

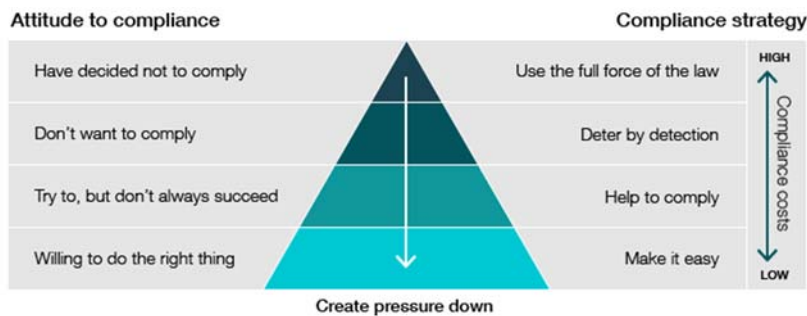
⁷ Rodney Fisher, 'Tensions in Tax Decision-Making: The Decision to Not Collect Tax' (2012) 27(4) *Australian Tax Forum* 885; Rodney Fisher and Cynthia Coleman, 'The Hardship Discretion: Building Bridges with the Community' (2010) 8(2) *eJournal of Tax Research* 162.

⁸ Sylvia Villios, 'Tax Collection, Recovery and Enforcement Issues for Insolvent Entities' (2016) 31(3) *Australian Tax Forum* 425.

⁹ 'Finally, perceptions of fairness are affected by whether the staffs [sic] involved with debt collection are compassionate, lenient, unbiased and just to taxpayers.': Lin Mei Tan and John Veal, 'Debt Collection by Tax Authorities: Tax Practitioners' Reactions to Procedures' (2003) 18(2) *Australian Tax Forum* 243, 258–9.

By comparison, the literature on debt collection and compliance contains a wealth of insights.¹⁰ The historical origins of its cooperative compliance model (Figure 1) exemplifies the ATO's ability to move away from a one-size-fits-all approach to tax administration¹¹ and take steps to mitigate harm to the ATO's reputation arising from community perceptions of its debt collection practices.¹² As observed by scholars such as Whait,¹³ the compliance model is consistent with the principles of responsive regulation and makes a clear distinction between taxpayers who are non-compliant due to various mitigating circumstances as opposed to taxpayers who are deliberately non-compliant.

Figure 1: Australian Taxation Office Compliance Model¹⁴



A continual process of gauging and adapting to the community's expectations is vital to maintaining trust and confidence, and protecting the ATO from reputational harm.

This article posits that the serious hardship relief landscape has not adequately adapted to the community's expectations on a number of aspects including: the impact of tax debts and debt collection on taxpayers' mental health;¹⁵ the futility and cost of chasing uncollectable debt;¹⁶ the imperative that the ATO

¹⁰ See, eg, Villios (n 8); Emily Millane and Miranda Stewart, 'Behavioural Insights in Tax Collection: Getting the Legal Settings Right' (2019) 16(3) *eJournal of Tax Research* 500. A detailed analysis of this literature is beyond the scope of this article.

¹¹ The cooperative compliance model is available at: 'Compliance Model', *Australian Taxation Office* (Web Page, 11 April 2019) <<https://www.ato.gov.au/About-ATO/Managing-the-tax-and-super-system/Strategic-direction/How-we-help-and-influence-taxpayers/Compliance-model/>>. See also Robert B Whait, 'Exploring Innovations in Tax Administration: A Foucauldian Perspective on the History of the Australian Taxation Office's Compliance Model' (2014) 12(1) *eJournal of Tax Research* 130, 144–7.

¹² Whait (n 11) 142.

¹³ Ibid.

¹⁴ 'Compliance Model' (n 11).

¹⁵ The past decade has seen an increase in government and policymaker awareness of the health, societal and economic impacts of impaired mental health. This heightened awareness has given rise to specialist support via both the ATO and the Australian Small Business and Family Enterprise Ombudsman (among others). See, eg, 'It's Never Too Late to Seek Help', *Australian Small Business and Family Enterprise Ombudsman* (Web Page, 11 July 2016) <<https://www.asbfeo.gov.au/media-release-ATO-mental-health>>.

¹⁶ While we recognise and acknowledge that the ATO already provides relief in circumstances where it has been determined that the debt is uneconomical to pursue, such decisions are especially important given the resultant reputational harm to the ATO from not doing so: see, eg, 'Mongrel

continue to foster willing participation in the tax system; and relief for those who have generally participated in the tax system, but may have dropped out due to health shocks or other shocks (such as loss of employment, business failure, relationship breakdown). Once these concerns are taken into account and considered by reference to the underlying rationale for tax debt forgiveness, the need for reform of the current provisions becomes clearer.

Accordingly, Part II of this article identifies current legislative and regulatory constraints on serious hardship relief. Part III considers systemic issues in litigating serious hardship cases and Part IV makes recommendations that, if adopted, would modernise the design and operation of the serious hardship provisions. Part V concludes the article.

II Legislative Background and Regulatory Landscape

A *Relief from Taxation Debts*

Only the Australian Government Finance Minister has the power to permanently extinguish a debt due to the Commonwealth.¹⁷ The Commissioner of Taxation has a general power of administration in relation to various taxation laws,¹⁸ pursuant to which they can settle disputes and choose not to pursue uneconomic debts.¹⁹ Additionally, the Commissioner will not seek to recover a debt that is irrecoverable at law, such as through extinguishment.²⁰ This article is concerned with a separate and specific statutory power enabling the Commissioner to release taxpayers from tax-related liabilities on the ground that they would suffer ‘serious hardship’.

B *Legislative Background*

The phrase ‘serious hardship’ has a lengthy legislative history.²¹ It first appeared in s 64(1) of the *Income Tax Assessment Act 1915* (Cth) as follows:

In any case where it is shown to the satisfaction of the Commissioner that a taxpayer liable to pay income tax has become bankrupt or insolvent, or has suffered such a loss that the exaction of the full amount of tax will entail serious hardship, [the] Board ... may release such taxpayer wholly or in part from his liability ...

Section 97 of the *Income Tax Assessment Act 1922* (Cth) was expressed in similar terms, but extended to cover the executor or administrator of a deceased person.

Bunch of Bastards’, *Four Corners* (Australian Broadcasting Corporation, 9 April 2018) <<https://www.abc.net.au/4corners/mongrel-bunch-of-bastards/9635026>>.

¹⁷ *Public Governance, Performance and Accountability Act 2013* (Cth) s 63.

¹⁸ See, eg, *Income Tax Assessment Act 1936* (Cth) s 8 (‘ITAA36’); *Income Tax Assessment Act 1997* (Cth) s 1–7; *Fringe Benefits Tax Assessment Act 1986* (Cth) s 3; *Taxation Administration Act 1953* (Cth) sch 1 s 356–5 (‘TAA’).

¹⁹ See generally *Precision Pools Pty Ltd v Federal Commissioner of Taxation* (1992) 37 FCR 554.

²⁰ *Public Governance, Performance and Accountability Rule 2014* (Cth) r 11.

²¹ *Van Grieken v Veilands* (1991) 21 ATR 1639, 1644 (Gummow J) (‘*Van Grieken*’).

Under both provisions, the ‘Board’ consisted of the Commissioner, the Secretary to the Treasury and the Comptroller-General of Customs.

Former s 265 of the *Income Tax Assessment Act 1936* (Cth) (‘ITAA36’) was also expressed in similar terms, but applied to ‘persons’, which effectively extended the relief to companies.²² The references to bankruptcy and insolvency were omitted, and the Board now consisted of the Commissioner, the Secretary of the Department of Finance and Administration and the Chief Executive Officer of the Australian Customs Service.

According to the Explanatory Memorandum that accompanied the Income Tax Assessment Bill 1935 (Cth), the removal of the reference to bankruptcy was because ‘the term “serious hardship” now qualifying the whole clause is an all embracing provision’.²³ As will be seen below, that is at odds with the interpretation of the current provision.²⁴

The Board had a busy workload. For the 2002–03 tax year, the Board considered 1,798 release applications. Of those applications, 636 were granted a full release, 270 a partial release, 835 were refused and 57 were either deferred or withdrawn. Approximately 30% of release applicants were small businesses.²⁵

As noted by Fisher, responsibility for administering the hardship provisions was transferred to the ATO in 2003, and occurrences of granting relief have risen in the period from 2003 to 2010.²⁶ This trend appears to have continued into the next two financial years, with 2,439 and 2,525 full or partial debt releases granted in the years 2011–12 and 2012–13, respectively.²⁷ However, aggregated data on the number of requests for relief and the quantum of relief granted since 2012–13 does not appear to be publicly available.

Since 1 September 2003, the discretion exercisable by the Commissioner to release taxpayers from tax-related liabilities on the ground that they would suffer serious hardship has been granted pursuant to s 340-5 of sch 1 to the *Taxation Administration Act 1953* (Cth) (‘TAA’): ‘[y]ou may apply to the Commissioner to release you, in whole or in part, from a liability of yours if section 340-10 applies to the liability’.²⁸ That application must be in the approved form.²⁹ Relevantly, the Commissioner ‘may release you, in whole or in part, from the liability’ if you are an individual and ‘would suffer serious hardship if you were required to satisfy the liability’.³⁰

²² ITAA36 (n 18) s 6 (definition of ‘person’ includes a company).

²³ Explanatory Memorandum, Income Tax Assessment Bill 1935 (Cth) 220.

²⁴ TAA (n 18) sch 1 s 340-5.

²⁵ Inspector-General of Taxation, *Review into the Tax Office’s Small Business Debt Collection Practices* (Report, April 2005) 107 [10.4].

²⁶ Fisher (n 7) 892.

²⁷ ATO, *Commissioner of Taxation Annual Report 2012–13* (Report, 2013) 35.

²⁸ TAA (n 18) sch 1 s 340-5(1).

²⁹ Ibid sch 1 s 340-5(2).

³⁰ Ibid sch 1 s 340-5(3). This provision also applies if you are a trustee of the estate of a deceased individual and the dependants of the deceased individual would suffer serious hardship if you were required to satisfy the liability.

Section 340-10 of sch 1 to the TAA applies to income tax, fringe benefits tax ('FBT') (including instalments), Medicare levy, Pay As You Go ('PAYG') instalments, and related General Interest Charge ('GIC') and penalties. Unless the tax is listed in the section it is not eligible for release. One notable exclusion is Goods and Services Tax ('GST'), which can affect small business applicants in particular. In *Burns and Commissioner of Taxation*,³¹ for example, the applicant was a floor installer who operated as a sole trader. More than half of his taxation liabilities related to GST, but these liabilities were not eligible for release. This is particularly problematic because observations of participants in the National Tax Clinic Program include that financially vulnerable small businesses (including sole traders) are, on average, seven years behind on lodgement of their Business Activity Statements ('BAS').³² For completeness, a BAS is an ATO-approved form issued to all GST-registered entities. The form includes the GST return that each registered entity is required to lodge and discloses all GST-related liabilities and entitlements.

As with the predecessor provisions discussed in Part II(C) below, serious hardship is now the sole criterion for deciding whether release of a tax debt should be granted. However, three significant changes were made in 2003. First, the merits of the Commissioner's decision became reviewable by the Administrative Appeals Tribunal ('AAT'). Previous challenges to decisions of the Boards had to be by way of judicial review. Second, the relief that previously extended to companies was abolished.³³ The Explanatory Memorandum which accompanied the new measures was silent on the reasons for this change. Third, the scope of the release arrangements was expanded to cover instalments of PAYG and FBT.

C The Meaning of 'Serious Hardship'

Academics such as Fisher³⁴ have observed that while the threshold test turns on the criterion of 'serious hardship', the legislation remains silent on the issue, providing no definition or criteria as to what may constitute serious hardship. Similarly, the Explanatory Memorandum accompanying the Taxation Laws Amendment Bill (No 6) 2003 (Cth) contains no interpretive guidance.³⁵ Thus, the meaning of serious

³¹ *Burns and Commissioner of Taxation* [2019] AATA 3860 ('Burns'). See also *Re Thomas and Commissioner of Taxation* (2014) 95 ATR 991 ('Thomas'); *Lipton and Commissioner of Taxation* [2015] AATA 754 ('Lipton').

³² Ann Kayis-Kumar, Fiona Anne Martin, Jack Noone and Michael Walpole, 'Performers and Sole Traders Find It Hard to Get JobKeeper in Part Because They Get Behind on Their Paperwork', *The Conversation* (online, 25 May 2020) <<https://theconversation.com/performers-and-sole-traders-find-it-hard-to-get-jobkeeper-in-part-because-they-get-behind-on-their-paperwork-137997>>. See also A Kayis-Kumar, J Noone, F Martin and M Walpole, 'Pro Bono Tax Clinics: An International Comparison and Framework for Evidence-based Evaluation' (2020) 49(2) *Australian Tax Review* 110 ('Pro Bono Tax Clinics').

³³ As noted above (n 22), former s 265 of the ITAA36 (n 18) applied to 'persons', which effectively extended the relief to companies. The current s 340-5 of sch 1 to the TAA (n 18) applies only to 'individuals' and, hence, excludes relief to companies.

³⁴ See, eg, Fisher (n 7) 893.

³⁵ Rather, the Explanatory Memorandum highlights a two-fold objective of this amendment:

[T]o streamline the procedures under which an individual taxpayer can be released from a tax liability where payment would entail serious hardship. Consistent with contemporary review practices, the amendments will also introduce a new right to have tax relief decisions reviewed

hardship is interpreted by reference to judicial considerations and administrative guidance, outlined below.

1 *Judicial Considerations*

The meaning of serious hardship has been considered in numerous decisions of the AAT and the Federal Court of Australia. Earlier Federal Court decisions under former s 265 of the *ITAA36* remain relevant because, according to Deputy President Forgie of the AAT, ‘the power given to [the] Board was similar to that given to the Commissioner in section 340-5(3). For present purposes, what appears in Items 1 and 2 of section 340-5(3) correlates with what appeared in sections 265(1)(a) and (b)’.³⁶

In *Powell v Evreniades*, Hill J explained that the expression ‘serious hardship’ is an ordinary English expression,³⁷ and that hardship that is ‘serious’ can be something less than ‘extreme’:

Clearly there would be serious financial hardship if the dependants of a deceased person were left destitute without any means of support. That is not to say that in any particular case something less than that will not constitute serious hardship.³⁸

There is a two-stage process described by Hill J as follows:

As the language of s 265 discloses, ... the Board acting under s 265 must proceed in two steps. Where, as here, the case is one arising after the death of a taxpayer the Board must first decide whether owing to the death of the original taxpayer that person's dependants are in such circumstances that the exaction of the full amount of tax would entail serious hardship. If that question is answered favourably to the applicant for relief the Board must then address the next set of issues, namely whether there should be release in the circumstances and if so whether that release will be of the whole or part of the liability. It is obvious that the factors that may be relevant to the second of these steps could be a great deal wider than the factors which are relevant to the first of the steps.³⁹

The Federal Court has also referred with approval to the description of the ‘two stage process’ discussed by Member Trowse in the AAT:

In the Tribunal’s opinion, the language of the legislation requires a two stage approach. First, the decision-maker must decide whether the settlement of the liability will result in serious hardship. If that decision is favourable to the

internally under the ATO objections process, and externally by the AAT sitting as the Small Taxation Claims Tribunal.

Explanatory Memorandum, Taxation Laws Amendment Bill (No 6) 2003 (Cth) 5.

³⁶ *Re Rasmussen and Commissioner of Taxation* (2013) 95 ATR 155, 160 [15] (‘Rasmussen’).

³⁷ *Powell v Evreniades* (1989) 21 FCR 252, 258 (‘Powell’). See also *Van Grieken* (n 21); *Spicer and Commissioner of Taxation* [2004] AATA 960.

³⁸ *Powell* (n 37) 259. See also *Commissioner of Taxation v A Taxpayer* (2006) 63 ATR 450, 454 [17] (Stone J) (‘A Taxpayer’).

³⁹ *Powell* (n 37) 264.

applicant, the discretion offered by sub-section 340-5(3) then falls for consideration.⁴⁰

2 *Administrative Guidance*

The Commissioner of Taxation's policy on the application of s 340-5 is explained in a practice statement entitled 'Debt Relief, Waiver and Non-pursuit'.⁴¹ Although the policy is not strictly binding on the AAT, it has regard to the policy in making its decisions.⁴²

The Practice Statement has been referred to with approval by Deputy President Forgie of the AAT in the following terms:

In the Policy, the Commissioner has addressed the concept of serious hardship in terms that I find are consistent with s 340-5(3), the TAA and the more general taxation law of which it is a part. What the Commissioner has gone on to do is to set out a 3-step approach to determine whether a person is suffering serious hardship.⁴³

Under the Practice Statement, the Commissioner considers serious hardship 'to exist where the payment of a tax liability would result in a person being left without the means to afford basics such as food, clothing, medical supplies, accommodation or reasonable education'.⁴⁴

The Commissioner applies three tests in evaluating whether serious hardship exists: the income and outgoings test; the assets and liabilities test; and other relevant factors.⁴⁵ Each test needs to be satisfied. According to the Commissioner, the object of the tests 'is to determine whether the consequences of paying the tax would be so burdensome that the person would be deprived of what are considered necessities according to normal community standards'.⁴⁶ These three tests are outlined below.

(a) *The Income and Outgoings Test*

The income and outgoings test takes into account household income and expenditure as well as the taxpayer's capacity to pay in a reasonable timeframe. It also considers any scope for the taxpayer to increase their income, whether all expenditure could be considered reasonable, and whether the taxpayer has made attempts to defer or reschedule other financial commitments.⁴⁷

⁴⁰ *Re Filsell and Commissioner of Taxation* [2004] AATA 1012, [14], referred to with approval in *Commissioner of Taxation v Milne* (2006) 153 FCR 52, 61–2 [17] (Conti J) ('*Milne*') and *Lau and Commissioner of Taxation* [2016] AATA 46, [65] (Deputy President McDermott) ('*Lau*').

⁴¹ ATO, 'Practice Statement Law Administration – PS LA 2011/17: Debt Relief, Waiver and Non-pursuit' (15 October 2020) <<https://www.ato.gov.au/law/view/document?docid=PSR/PS201117/NAT/ATO/00001&PiT=20201015000001>> ('PS LA 2011/17').

⁴² The importance of doing so has been explained in different contexts including by Brennan J in *Re Drake and Minister for Immigration and Ethnic Affairs (No 2)* (1979) 2 ALD 634, 640.

⁴³ *Rasmussen* (n 36) 172 [56]. See also *Re BFCB and Commissioner of Taxation* (2017) 106 ATR 456, 468 [35] (Deputy President Forgie) ('*BFCB*').

⁴⁴ ATO, 'PS LA 2011/17' (n 41) [8] (definition of serious hardship).

⁴⁵ *Ibid.*

⁴⁶ *Ibid.*

⁴⁷ *Ibid* [9].

In assessing serious hardship, it is appropriate to consider the full resources of the household, rather than just the resources of the applicant:

[T]he determination of whether the exaction of the full amount of the tax would entail serious hardship properly involves a consideration of the financial affairs of the taxpayer, including his financial relations with the other members of his household, and with any family company.⁴⁸

This issue arose in *Burns*.⁴⁹ The applicant lived with his de facto partner and argued that the Commissioner's application of the income and outgoings test was flawed because it included 100% of his partner's income. The AAT rejected the argument stating that 'it is reasonable to expect her to contribute to household expenses in proportion to her income'.⁵⁰ The applicant also argued that a period of some 3.8 years to pay off his taxation liability was unreasonable. The AAT disagreed, noting that the applicant was a relatively young man with no dependants.⁵¹

Sometimes income simply exceeds expenditure and can be used to pay off taxation debts. In *Power and Commissioner of Taxation*,⁵² the applicant's outstanding tax liabilities amounted to \$57,566. Based on his own figures, he had a fortnightly surplus of income less expenditure of \$422. According to the AAT, the applicant had the capacity to pay over time, which, again on his own figures, would take approximately five years to pay the current liability. However, as his expenses were overstated and there was room to reduce discretionary spending, it should not take this long. Accordingly, this was not a case of serious hardship.⁵³

Having to live on the age pension does not of itself amount to serious hardship. In *Schweitzer and Commissioner of Taxation*⁵⁴ the applicant was married and she and her husband each received an age pension that, at the time of the hearing, was a combined fortnightly payment of \$1,296. Their estimated fortnightly expenses were \$1,321.

In responding to a submission that the applicant could sell the family home, Deputy President Forgie stated:

[The applicant] and her husband would no longer have to pay rates on the ... property and that amount would contribute to the rent. [The applicant] would be living the life that many people receiving an Age Pension must live. Those on the Age Pension living in rental accommodation are not, by reason of that fact alone, regarded as suffering serious hardship. If she were required to contribute a significant sum from her Age Pension each fortnight, I might have a different view.⁵⁵

In assessing income and outgoings, the applicant's expenditure must be reasonable. In *Re Moriarty and Commissioner of Taxation*, the Commissioner referred to the applicant's unusually high level of discretionary spending, including

⁴⁸ *Van Grieken* (n 21) 1646 (Gummow J).

⁴⁹ *Burns* (n 31).

⁵⁰ *Ibid* [35] (Senior Member Evans).

⁵¹ *Ibid* [38].

⁵² *Power and Commissioner of Taxation* [2014] AATA 343 ('Power').

⁵³ *Ibid* [32]–[35] (Deputy President Molloy).

⁵⁴ *Schweitzer and Commissioner of Taxation* [2019] AATA 1100 ('Schweitzer').

⁵⁵ *Ibid* [132].

on holidays, dining out, and entertainment, which could be reduced.⁵⁶ The applicant did not agree with the Commissioner's description, pointing out, among other things, that he had only taken two holidays in seven years. However, the AAT agreed with the Commissioner's description of the applicant's discretionary spending and also that what he was previously paying by way of rent was unreasonable.⁵⁷

Leaving to one side considerations such as the reasonableness of expenditure, the analysis of an applicant's income and outgoings by the AAT has largely affirmed that an applicant who is not reasonably capable of satisfying taxation debts from his or her net income is thus suffering serious hardship.

(b) *The Assets and Liabilities Test*

The assets and liabilities test takes into account a taxpayer's equity in, or access to, assets that may be indicative of their capacity to pay. Consideration is given to any property owned wholly or jointly by the taxpayer and their partner, privately or within a business structure.

The Commissioner does not expect taxpayers to surrender 'normal and reasonable possessions' to pay tax debts, including the taxpayer's home, a motor vehicle, furniture and household goods, tools of trade, and cash-on-hand sufficient to meet immediate day-to-day living expenses.⁵⁸

The issue that arises most often here is whether the applicant needs to sell the family home. The following two AAT decisions cast light on when a home should be sold. In *Schweitzer*,⁵⁹ the applicant's assets were not sufficient to cover her tax-related liabilities, which were substantial and exceeded \$7 million. Her assets included a home valued at over \$1.3 million. Deputy President Forgie observed: 'would the loss of her ... property in which she lives ... amount to serious hardship within the meaning of Item 1 of s 340-5(3)? I think that it does not'.⁶⁰

In *Lau and Commissioner of Taxation*,⁶¹ the applicants jointly owned a luxury apartment in a prestige location in the central business district. The AAT noted that the applicants may well have been correct in saying that the apartment may not reach the suggested value of \$3.5 million. Nevertheless, the property could not be regarded as a residence of modest value.⁶²

The analysis of an applicant's assets and liabilities by the AAT, as with the income and outgoings analysis, again largely affirms that an applicant who is not reasonably capable of satisfying taxation debts from his or her net assets is suffering serious hardship. The exclusion of the family home as an asset, if of a reasonable nature, is significant in that analysis. There is little guidance, however, on what constitutes a 'reasonable' home.

⁵⁶ *Re Moriarty and Commissioner of Taxation* (2016) 104 ATR 190 ('*Moriarty*').

⁵⁷ *Ibid* 193–4 [21] (Deputy President Molloy).

⁵⁸ ATO, 'PS LA 2011/17' (n 41) [10].

⁵⁹ *Schweitzer* (n 54).

⁶⁰ *Ibid* [132] (Deputy President Forgie).

⁶¹ *Lau* (n 40).

⁶² *Ibid* [93] (Deputy President McDermott).

(c) *Other Relevant Factors Test*

In circumstances where a taxpayer can demonstrate that serious hardship may be caused by payment of their liability, the Commissioner may on discretionary grounds decide against granting release, such as where:

- a taxpayer appears to have unreasonably acquired assets ahead of meeting their tax liabilities
- a taxpayer appears to have disposed of funds or assets without giving consideration to their tax liability
- release would not alleviate hardship, such as where the person has other liabilities or creditors
- a taxpayer has paid other debts (either business or private), in preference to their tax debt
- the taxpayer, without good reason, has not pursued debts owed to them
- serious hardship is likely only to be short term (which is determined on a case by case basis)
- the taxpayer has a poor compliance history
- the taxpayer is unable to show that they have planned for future debts
- the taxpayer has structured their affairs to place themselves in a position of hardship (for example, placing all assets in trusts or related entities over which they have control)
- the taxpayer has delayed lodgement of returns resulting in the accumulation of a large debt that they are unable to pay.⁶³

Additionally, the Commissioner must make a decision about the extent to which, if any, release should be granted: 'Release from the full amount of the liability would not generally be appropriate where partial release is sufficient to avoid serious hardship.'⁶⁴

D *Serious Hardship Caused by the Requirement to Satisfy the Liability*

It will be recalled that the Commissioner of Taxation may release you from a tax liability if you would suffer serious hardship if required to satisfy the liability.⁶⁵ It is said that this establishes a causal relationship between the requirement to satisfy the tax liability and the serious hardship. However, it seems an extraordinary proposition that the more serious the financial hardship generally the less likely it is that release of the tax debt will be granted. That a causal relationship exists was affirmed by Deputy President Forge in *Re Rasmussen and Commissioner of Taxation*:

Even if [the Applicant] and his wife were to sell the former family home ... he is likely to continue to face serious hardship but it is not serious hardship

⁶³ ATO, 'PS LA 2011/17' (n 41) [11].

⁶⁴ Ibid [12].

⁶⁵ See above n 30 and accompanying text.

that arises from his being required to satisfy his tax liability. It is serious hardship that arises because his liabilities, of which his tax liability is but one, exceed his assets and the outgoings required to service those liabilities exceed his income. It is not serious hardship that [the Applicant] would suffer because he is required to satisfy his tax liability. That means that [the Applicant] does not meet the criterion in item 1 of s 340-5(3) of Sch 1 of the TAA. As he does not meet that criterion, I do not have power to release him from whole or part of his tax liability.⁶⁶

It should be immediately observed that this is not part of the exercise of a discretionary power, as will be discussed in more detail below, but is a statutory criterion that must be satisfied if release is to be granted. The application of this criterion in individual cases might be viewed as leading to harsh outcomes.

There are numerous AAT cases illustrating the point. For example, in *XLPZ and Commissioner of Taxation*,⁶⁷ the applicant was unemployed and separated from his former wife. Protracted litigation with his former wife over access to his sons had left him 'in ruinous financial circumstances'.⁶⁸ His taxation debt related to his income tax liabilities and arose because of his early access to superannuation benefits to meet legal expenses associated with Family Court proceedings.

The applicant's taxation debt was \$57,939 and, on his own figures, his liabilities exceeded assets by at least \$300,000. His monthly expenses were capable of being met only through a combination of his Newstart allowance and regular advances from his father. The AAT refused relief on the basis that the applicant would still suffer serious hardship because of his other financial commitments.⁶⁹

A rationale for this criterion can be found in the Explanatory Memorandum that accompanied the 2003 legislative changes:

Release would not normally be granted where it would not relieve hardship. A common example would be where the existence of other creditors made bankruptcy inevitable and granting release from tax liabilities would merely assist those other creditors at the expense of the Commonwealth.⁷⁰

In *Re Thomas and Commissioner of Taxation*, Deputy President Forgie refused relief on the same basis:

[T]he release of [the applicant] from the tax related liability ... will not alter his situation. He will be in precisely the same position. His liabilities will still exceed his assets. Any one of his creditors could take steps to institute proceedings leading to his becoming bankrupt whether he is released from that sum or not. If he were to be released and one was to do so, the outcome would be that no part of the amount that was released could be recovered in the bankruptcy. That would be to the detriment of the Australian community.⁷¹

⁶⁶ *Rasmussen* (n 36) 157–8 [3]. See also *Huckle and Commissioner of Taxation* [2014] AATA 362 ('Huckle'); *XLPZ and Commissioner of Taxation* [2016] AATA 466 ('XLPZ').

⁶⁷ *XLPZ* (n 66).

⁶⁸ *Ibid* 2.

⁶⁹ *Ibid* 40–43.

⁷⁰ Explanatory Memorandum, Taxation Laws Amendment (No 6) Bill 2003 (Cth) 64 [4.26].

⁷¹ *Thomas* (n 31) 1010 [62]. See also *Corlette v Mackenzie* (1996) 62 FCR 597 ('Corlette').

Nevertheless, we respectfully contend that the proposition is unsound for the following four reasons.

First, the proposition is not supported by the history of the legislative provision. As was discussed above, the phrase ‘serious hardship’ appeared in income tax legislation in 1915 and 1922. The removal of the reference to bankruptcy in the *ITAA36* was because the term ‘serious hardship’ was considered to be ‘an all embracing provision’.⁷² Apart from the statement extracted above from the Explanatory Memorandum, there is nothing to suggest that the meaning of the term changed when div 340 was inserted into the *TAA* in 2003.

Second, it is entirely possible that the drafters of the Explanatory Memorandum misstated the law. As Wigney J recently cautioned in the Federal Court,

[u]ltimately, the task of statutory construction must begin and end with a consideration of the text itself ... The Explanatory Memorandum cannot supplant the text of the relevant provisions. It is also the case that sometimes Explanatory Memoranda misstate the law.⁷³

Third, there seems a lack of logic in refusing release from a taxation debt owed by a taxpayer suffering serious hardship on the ground that their hardship is too serious to warrant release.

Finally, refusing relief on the basis that the applicant would still suffer serious hardship because of their other financial commitments is disconnected from the realities of financial vulnerability for many taxpayers. Tax debts are often a sub-component of overall debts. This has recently been shown empirically with researchers finding that, regardless of socio-economic grouping, 30.1–40.6% of financially vulnerable people seeking assistance from financial counsellors also need independent tax advice, but are unable to access it.⁷⁴ Of these taxpayers, nearly all (that is, 88%) need assistance with tax debt discussions.⁷⁵

Given these considerations, Part IV(A) proposes a solution to this issue that both ensures that relief is available in appropriate cases and that the Commissioner is not, in the event of a later bankruptcy or insolvency, prejudiced in having granted relief.

E *Discretionary Factors*

Section 340-5(3) states that the Commissioner ‘may’ release you from the liability. The question of whether this was a mandatory or discretionary power was discussed by Hill J in *Powell* in the context of former s 265 of the *ITAA36*, in which his Honour noted the difficulty in reading ‘may’ as being mandatory:

One difficulty with such an interpretation however, would be that it leaves open the question of what the Board is in fact bound to do, given that under

⁷² See above n 23 and accompanying text.

⁷³ *Travelex Ltd and Commissioner of Taxation* (2018) 108 ATR 278, 294 [105].

⁷⁴ Kayis-Kumar, Walpole and Mackenzie, ‘Submission to the Standing Committee on Tax and Revenue’ (n 2).

⁷⁵ *Ibid.*

the section it has a choice to remit the tax in whole or in part. Therefore the word 'may' presumably encompasses that choice which lies in the discretion of the Commissioner.⁷⁶

When exercising a discretion, it is important for a decision-maker to have regard to all relevant factors. In the context of serious hardship, the following eight factors have received prominence in AAT decisions:

- (1) Disclosure and dishonesty.
- (2) Tax compliance history.
- (3) Availability of payment arrangements with the Commissioner.
- (4) Giving priority to expenditure other than tax liabilities.
- (5) Giving priority to creditors over the Commissioner.
- (6) Possible bankruptcy of the applicant.
- (7) Inheritances.
- (8) The misfortune is of the applicant's own making.

The remainder of Part II(E) explores each of these factors.

1 *Disclosure and Dishonesty*

The importance of making full disclosure to the AAT was emphasised in *Thomas*:

Review of an application to release a tax-related liability is a situation in which the facts relating to an individual's income, expenditure, assets and debts will usually be peculiarly within the possession and knowledge of that individual and not of the Commissioner. It is the task of the individual, and not that of the Commissioner, to gather together and produce all relevant material.⁷⁷

In *Lau*,⁷⁸ the AAT concluded that the applicants failed to make full disclosure about their financial circumstances and, further, that the information the applicants did provide was not correct, but rather in the nature of assertions contradicted by the documentary evidence.⁷⁹ Additionally, the applicants had significantly understated income on tax returns by amounts ranging from \$74,552 to \$2,353,369.⁸⁰ These were all factors that weighed against release.

In *Schweitzer*,⁸¹ the applicant's tax-related liabilities exceeded \$7 million. The Commissioner submitted that the applicant had been dishonest in lodging tax returns that substantially understated her taxable income over a 12-year period, giving false evidence to the AAT in income tax review proceedings in relation to the ownership of a property, and omitting to reveal her interest in her late mother's estate when making her application for release.

⁷⁶ *Powell* (n 37) 261. See also *Corlette* (n 71) 598 (Wilcox J, Einfeld and Foster JJ agreeing).

⁷⁷ *Thomas* (n 31) 997 [18] (Deputy President Forgie).

⁷⁸ *Lau* (n 40).

⁷⁹ *Ibid* [89].

⁸⁰ *Ibid* [90].

⁸¹ *Schweitzer* (n 54).

Deputy President Forgie, while not making specific findings on all contentions, found that

she tried to conceal her interest in her late mother's estate from the Commissioner. Furthermore, she has not taken reasonable steps to put herself in a position where she would receive her inheritance so that she could reduce her debt to the Commissioner.⁸²

This was a factor against exercising the discretion to release her from tax liability.

Even conduct less than dishonesty might still weigh against an applicant. In *ZDCW and Commissioner of Taxation*,⁸³ the applicant's household's combined assets had a value of \$843,699, with liabilities of \$225,000, leaving a balance of \$618,699. On this basis, the Commissioner contended that the applicant and his wife had sufficient equity to discharge his income tax liability. The applicant contended that, as a result of mortgages over two properties in favour of his wife, he was unable to dispose of either property to raise any amount to pay the taxation liability.

Some two months before his release application, the applicant and his wife entered into a 'Contractual Will Arrangement' by executing: (1) a Deed for Contractual Will; (2) an Option Deed granting the applicant's wife an option to purchase the applicant's share of each property for \$1 if any of a series of defined default events occurred; and (3) mortgages in favour of the applicant's wife over the applicant's interest in the two properties, securing her rights under the Deed for Contractual Will and Option Deed.

The AAT was not satisfied that the applicant was under any obligation to enter into the Contractual Will Arrangement. Nor was the AAT satisfied that his wife would seek to enforce her rights under that arrangement in the face of recovery action by the Commissioner against the applicant or that the properties would not be available to him to meet his tax liability.⁸⁴

The Commissioner submitted that the Contractual Will Arrangement appeared to be a conscious attempt to put assets beyond the reach of the Commissioner. Although that was not a finding the AAT was prepared to make without first hearing the applicant or his wife give evidence on the point, it did find 'that the arrangement was entered into by the applicant without making provision to meet his tax liability',⁸⁵ and that was sufficient for relief to be refused.

2 Tax Compliance History

Somewhat related to honesty and disclosure is an applicant's tax compliance history. In *Burns*, the applicant had a poor compliance history, especially for BAS lodgments in the financial years 2010 through to 2017.⁸⁶ He submitted that there were mitigating factors, including personal injury, alcohol dependence and relationship

⁸² Ibid [136].

⁸³ *ZDCW and Commissioner of Taxation* (2016) 103 ATR 975 ('ZDCW').

⁸⁴ Ibid 979 [30].

⁸⁵ Ibid 981 [43] (Deputy President Molloy).

⁸⁶ *Burns* (n 31) 48.

issues, especially from 2014 onwards.⁸⁷ The AAT concluded that this history weighed against the exercise of the discretion to release the applicant from his taxation liability and concluded that ‘the Applicant’s poor compliance history is somewhat mitigated, but not cancelled out entirely, by these unfortunate personal circumstances’.⁸⁸ This seemed to be so even though some taxation liabilities on the BASs, being GST, were not eligible for release.

Similarly, in *Re Watson and Commissioner of Taxation*⁸⁹ relief was refused to an applicant with a poor compliance history evidenced by his failure to lodge his income tax returns and BASs by the required date for numerous periods.

Illegally accessing superannuation benefits will also count against release. In *Moriarty*, the applicant had illegally accessed his superannuation benefits in the income years 2007 and 2008, accessing \$16,497 and \$147,600 respectively.⁹⁰ The AAT observed that the applicant ‘accessed these funds apparently without thought to his outstanding taxation lodgements and subsequent liabilities that would arise’.⁹¹

We contend that some care should be taken by decision-makers in using a poor tax compliance history against an applicant and that it is important to understand the reasons behind the compliance history, which are often the cause of the hardship itself. Later in this article we contend that a new approach is needed to distinguish better between different levels of moral culpability.

3 *Availability of Payment Arrangements with the Commissioner*

Relief may be refused on discretionary grounds if entering into a payment arrangement with the Commissioner is realistically open as an alternative. Such was the case in *Lipton and Commissioner of Taxation*,⁹² where the applicant husband and wife owed \$23,116 and \$1,885 in primary tax respectively. On the evidence, the applicants had an excess of income over outgoings of approximately \$1,520 per fortnight available to them such that, according to the AAT, they could enter into appropriate payment arrangements with the Commissioner, who had previously indicated his willingness to do so.⁹³

A similar issue arose in *Thomas*.⁹⁴ The applicant had requested the Commissioner to release him from payment of tax amounting to \$64,047. Based on a number of assumptions, the AAT found that the applicant’s income exceeded his expenditure by almost \$3,500 each month. However, his liabilities exceeded his assets such that he clearly could not meet his debts from his assets.⁹⁵ The AAT considered that the applicant could explore whether the option of payment to creditors, including the ATO, by instalments was open to him:

⁸⁷ Ibid 7.

⁸⁸ Ibid [49] (Senior Member Evans).

⁸⁹ *Re Watson and Commissioner of Taxation* (2014) 99 ATR 908 (‘*Watson*’).

⁹⁰ *Moriarty* (n 56).

⁹¹ Ibid 195–6 [31] (Deputy President Molloy).

⁹² *Lipton* (n 31).

⁹³ Ibid 45. See also below nn 117–18 and accompanying text.

⁹⁴ *Thomas* (n 31).

⁹⁵ Ibid 1005 [41]–[42].

While that option remains open in relation to each of his creditors and while they are not pressing for payment and have not taken steps to, for example, garnishee his bank account ... he is not facing serious hardship. He can meet his day to day expenses and, by means of his savings and his income, he can make a contribution to the payment of his debts. In view of that, the criterion that must exist before the Commissioner has power to release the whole or part of the tax related liability has not arisen.⁹⁶

Once a payment arrangement has been entered into, an applicant's compliance with it becomes a relevant factor. In *Watson*,⁹⁷ the applicant had previously entered into three formal payment arrangements with the Commissioner, but had abandoned the repayment plans without any real explanation being provided either in writing or at the hearing. According to the AAT, all three plans were generous to the applicant, providing modest repayment schedules over extended periods of time. This suggested 'a more than reasonable approach on the part of the [Commissioner] which now reflects poorly on the Applicant and his somewhat seemingly disdainful abandonment of those repayment plans'.⁹⁸

A similar consideration arose in *Power*, in which the AAT observed:

[The applicant] has not made any sustained effort to clear arrears and achieve compliance. Since 2009 he has entered into three separate payment arrangements with the Tax Office. He has defaulted under two of those arrangements and cancelled the third. Since the middle of last year he has been paying \$150 per fortnight but he has not been meeting current assessments.⁹⁹

Of course, if the Commissioner makes clear that he does not propose to recover a debt from an applicant, the existence of the debt, in notional terms, cannot be said to impose serious hardship, since there is no present requirement to make payments to satisfy it.¹⁰⁰

Again, absent special circumstances, it seems entirely reasonable to explore reasonable payment arrangements with the Commissioner and to have regard to the outcomes of any arrangements entered into.

4 *Giving Priority to Expenditure Other Than Tax Liabilities*

In *Moriarty*, the applicant had applied for, and was released from, taxation liabilities in an earlier year and was now applying again.¹⁰¹ The Commissioner pointed out that after the applicant was granted release from his earlier tax liabilities, he borrowed funds and purchased the first of two properties for \$230,000, which he later sold for \$601,000. A second property was purchased for \$492,000 and subsequently sold for \$397,500.

The applicant contended that he and his former spouse purchased the first property using borrowed funds and that the property was sold because he could no

⁹⁶ Ibid 1006 [45] (Deputy President Forgie).

⁹⁷ *Watson* (n 89).

⁹⁸ Ibid 918 [48] (Deputy President Deutsch).

⁹⁹ *Power* (n 52) [38] (Deputy President Molloy).

¹⁰⁰ *XLFPZ* (n 66) [31] (Deputy President Humphries).

¹⁰¹ *Moriarty* (n 56).

longer afford the mortgage repayments. While there was little money left over from the sale, he was able to 'transport' the loan to another, less expensive property, which he later sold because he was in a 'dire financial situation'.¹⁰² He and his former wife did not receive any proceeds from the sale. The AAT agreed with the Commissioner's submission that the applicant

apparently with insufficient cash or other assets to address his tax liabilities, and in the context of having recently obtained a release, gave priority to obtaining finance to purchase a property, to borrow more money to carry out improvements to that property when its value rose, and to continue his borrowing against a second property.¹⁰³

Relief was refused.

Similarly, in *KNNW and Commissioner of Taxation*, the evidence disclosed 'the acquisition of unnecessary assets and reduction of amounts owed to creditors has been put ahead of meeting tax liabilities'.¹⁰⁴ These included the purchase of a second car for \$4,500 and its subsequent repairs of about \$3,500; the purchase of a replacement television for about \$3,200; and the reduction of a line of credit by \$31,607. The AAT observed: 'Such circumstances weigh heavily against exercise of any discretion.'¹⁰⁵

Expenditure on overseas travel seems especially frowned upon, even to visit a dying relative. In *Rasmussen*,¹⁰⁶ the applicant's wife had for many years been suffering from illness and he was increasingly required to care for her as well as their children. One of the consequences of caring for his wife was that the applicant had more limited time for his income-producing activities, which meant a significant reduction in his income. According to the AAT, the applicant was 'in straightened circumstances'.¹⁰⁷ During this period, the applicant had taken an overseas holiday with his family to visit his dying sister. This was a factor that counted against him in the exercise of the AAT's discretion:

[The applicant] acknowledged that he chose to take the family to visit his dying sister in Denmark in 2009 at a time when he had an outstanding tax liability. It might seem harsh to describe this as a choice that he made to prefer his family above meeting his tax liability. Taken in isolation, his need to visit his sister is entirely understandable. His going to visit her would have been entirely understandable even in straitened financial circumstances. His decision to take his whole family at a time when he was not able to meet his tax liability represents a clear choice to place his family above his obligation to the Australian community to pay his tax liability. His choice is a matter for him entirely but it is a matter that does not favour the exercise of a discretion releasing him from paying a tax liability he chose to put to one side in making his personal decisions.¹⁰⁸

¹⁰² Ibid 195 [27] (Deputy President Molloy).

¹⁰³ Ibid 195 [29] (Deputy President Molloy).

¹⁰⁴ *KNNW and Commissioner of Taxation* [2014] AATA 691, 56 ('*KNNW*').

¹⁰⁵ Ibid [60] (Senior Member O'Loughlin).

¹⁰⁶ *Rasmussen* (n 36).

¹⁰⁷ Ibid 157 [2].

¹⁰⁸ Ibid 181 [97] (Deputy President Forgie).

Previous levels of expenditure by the applicant must also be seen as reasonable, as distinct from current levels of expenditure which is assessed as part of the income and outgoings test. In *KNNW*,¹⁰⁹ the applicant had outstanding tax liabilities of approximately \$26,045, which was the balance owing after an application for release was allowed in part, to the extent of \$70,000. There was some debate about the appropriateness of the applicant's expenditure and projected expenditure, which, after he became aware of his tax debts, included: annual holidays away from the capital city; children's sporting competitions and music lessons; regular, but modestly priced alcohol for personal consumption; gifts for family and friends; two cars available for family use; an 18th birthday celebration; interstate travel for one of the children to visit a friend; and a replacement television for about \$3,200. The applicant contended that all of his family's expenditures were not discretionary by ordinary community standards. The AAT disagreed:

With the exception of the television and possibly the second car, all of these expenditures are probably best characterised as discretionary but not extravagant expenditures of a family living a comfortable middle class life style in a comfortable middle class suburb of an Australian capital city.

The television is probably best characterised as something above 'not extravagant' as there are many models of television receivers that could be acquired for much less than \$3,200.

A second car, even one that costs \$8,000, is something that is also best characterised as a little above 'not extravagant'.

There are probably many in the community who cannot afford a lifestyle that includes spending money on the items listed above who do not receive government assistance and concessions.¹¹⁰

The AAT concluded:

Where there has been ... maintenance of a lifestyle that can be seen as enjoying the comforts of middle class Australian life with a degree of discretionary, albeit not all extravagant, expenditure, the correct and preferable conclusion is that a relieving discretion ought not be exercised.¹¹¹

5 *Giving Priority to Creditors over the Commissioner*

Giving priority to creditors over the Commissioner weighs against applicants in a manner similar to giving priority to expenditure other than tax liabilities. In *Rasmussen*, the applicant had made payments in respect of the family's two assets. Deputy President Forgie stated that

when choosing to maintain payments on privately acquired assets but not to maintain any payments to meet a tax liability, a taxpayer is saying that the community should support him or her for his or her share of the costs of

¹⁰⁹ *KNNW* (n 104).

¹¹⁰ *Ibid* [44]–[47] (Senior Member O'Loughlin).

¹¹¹ *Ibid* [62] (Senior Member O'Loughlin).

meeting the infrastructure and services that are met out of taxpayers' meeting their tax liabilities.¹¹²

The notion of giving priority to creditors over the Commissioner extends to the payment of credit cards. In *Watson*,¹¹³ the applicant's taxation debt related to his self-assessed income tax liabilities between 2008 and 2012, according to which he owed \$52,109. The Commissioner conceded that the applicant would suffer serious financial hardship if the tax liabilities in question were to be satisfied. However, one of the factors that weighed against the exercise of the discretion was that he had made six payments in 2013 in respect of credit cards, together with some bank liabilities.¹¹⁴ *Cox and Commissioner of Taxation* is the first case to have been decided in the context of the COVID-19 pandemic.¹¹⁵ In this case, the AAT found that an applicant refinancing a property to save his home was not unreasonable, nor would he have been expected to access those funds to pay his taxation liabilities or accept a deferral of mortgage repayments as part of the COVID-19 relief offered by his lender.¹¹⁶

Accordingly, we contend that some care should be taken by decision-makers in making judgements about applicants who 'prioritise' certain expenditures or creditors over tax liabilities. Such expenditures might be a reaction to the causes of hardship itself rather than a deliberate attempt to defeat the Commissioner, and it is again important to distinguish between different levels of moral culpability.

6 Possible Bankruptcy of the Applicant

The possible bankruptcy of an applicant if an application for relief is refused does not, of itself, constitute serious hardship. The issue was discussed in *Corlette v Mackenzie*,¹¹⁷ where the applicant had contended that he was a chartered accountant and that bankruptcy might jeopardise his ability to work. Einfeld J concluded that there was no evidence that bankruptcy would prevent him from working in that capacity even if it prevented him from owning his own practice.¹¹⁸

7 Inheritances

A future inheritance is unlikely to count as an asset, however, the likelihood of receiving an inheritance has been taken into account as a discretionary factor in refusing release. In *Lipton*, the applicant wife's mother had passed away some two years before the hearing.¹¹⁹ Under cross-examination, the applicant agreed that she

¹¹² *Rasmussen* (n 36) 181 [98]. See also *Vagh and Commissioner of Taxation* [2007] AATA 32, [25], [47]; *Adams and Commissioner of Taxation* [2010] AATA 744, [35] (Senior Member Ettinger); *XLPH* (n 66) [41] (Deputy President Humphries).

¹¹³ *Watson* (n 89).

¹¹⁴ *Ibid* 916 [34] (Deputy President Deutsch). See also *Thomas* (n 31) 1009 [59] (Deputy President Forgie).

¹¹⁵ *Cox and Commissioner of Taxation* [2020] AATA 3857 ('Cox').

¹¹⁶ *Ibid* [32]–[33] (Senior Member Evans-Bonner).

¹¹⁷ *Corlette* (n 71).

¹¹⁸ *Ibid* 600. See also *A Taxpayer* (n 38); *Milne* (n 40).

¹¹⁹ *Lipton* (n 31).

would inherit approximately \$200,000 from her mother's estate. The AAT noted that it would not be appropriate to grant discretionary relief in those circumstances.¹²⁰

8 *The Misfortune is of the Applicant's Own Making*

The AAT has occasionally stated that the discretion ought to be refused if the misfortune is of an applicant's own making. In *Watson*,¹²¹ for example, the AAT took the view that any hardship that the applicant would experience was largely of his own making, and not the result of a misfortune beyond his control. The applicant had at times earned in excess of \$4,000 a week, which supported a finding that he was at those times in a position to pay his taxation debts as and when they fell due, but elected not to do so.¹²²

Similar language was employed in *Power*.¹²³ The AAT noted that the applicant's outstanding tax liabilities had

been brought about by his own failure to meet his tax obligations. It is not a situation that has been forced upon him. He has simply failed to give proper priority to paying his tax. Since entering the PAYG instalment system in 2008 he has paid only four of 22 assessments.¹²⁴

It is doubtful whether an applicant's misfortune, which is or is not of their own making, is an independent factor that counts against them. It might perhaps be more accurate to say of the applicant in *Watson* that he gave priority to expenditure other than his tax liabilities, and of the applicant in *Power* that he had a poor tax compliance history.

III Systemic Issues in Litigating Serious Hardship Cases

A *Historical Trends in Case Law*

It is a daunting task for an applicant to litigate an adverse decision of the Commissioner on a serious hardship application. We have examined AAT and Federal Court of Australia cases since the introduction of the serious hardship relief provisions in 1915.

An overview of decisions across tribunals and courts over the past 50 years is provided in the Appendix to this article. Specifically, the Appendix includes for each case: the total tax liability involved with a breakdown for tax liability, interest and penalties; both positive and negative factors involved in the decision-making process of the tribunals and courts; and the outcome.

Of the 34 cases decided in the past 50 years, all but four found in favour of the Commissioner. These four cases were *A Taxpayer*,¹²⁵ *Commissioner of Taxation*

¹²⁰ Ibid [46]. See also above nn 92–3 and accompanying text; *Schweitzer* (n 54) discussed below.

¹²¹ *Watson* (n 89).

¹²² Ibid 917 [39] (Deputy President Deutsch).

¹²³ *Power* (n 52).

¹²⁴ Ibid [37] (Deputy President Molloy).

¹²⁵ *A Taxpayer* (n 38).

v Milne,¹²⁶ *GSJW and Commissioner of Taxation*,¹²⁷ and *Cox*.¹²⁸ This is despite the majority of cases being conducted under full merits review, with only five cases decided under former s 265 of the *ITAA36* when only a judicial review was available.

Of the four cases where relief was granted, only *Milne* and *Cox* resulted in a full release from liability. In *Milne*, the taxpayer was able to establish both serious hardship, and the fact that said hardship arose from misfortune for which the taxpayer was not responsible.¹²⁹ In *Cox*, the taxpayer was granted full release of the eligible portion of his taxation liabilities (with the ineligible portion comprising GST debts and penalties for failure to lodge on time). The AAT found that it would not be possible for the taxpayer to repay his full taxation debts in his lifetime without suffering substantial and long-term serious hardship, and the weight of his taxation debt was also likely to be causing some detriment to his mental health.¹³⁰

It might reasonably be inferred that the Commissioners past and present have done a good job in their decision-making processes given nearly all decisions have been affirmed. Indeed, the majority of the applicants over the past 50 years failed at the first hurdle of the two-stage approach.¹³¹ That is, many simply did not suffer from serious financial hardship as found by the AAT based on the facts of cases such as *Re Balens and Commissioner of Taxation*,¹³² *Huckle and Commissioner of Taxation*,¹³³ *Lipton*,¹³⁴ *Lau*,¹³⁵ *ZDCW*,¹³⁶ *Schweitzer*,¹³⁷ *GSJW*,¹³⁸ among others. However, as discussed above in Part II(C), many other cases failed for the fact that the taxpayer would suffer serious financial hardship *regardless* of being granted relief; that is, on the second hurdle of the two-stage approach. This includes cases such as *Rasmussen*,¹³⁹ *Thomas*,¹⁴⁰ *Re Hulsen and Commissioner of Taxation*,¹⁴¹ *KNNW*,¹⁴² and *Moriarty*.¹⁴³

B Systemic Barriers to Serious Hardship Relief

Further, there are three systemic issues that do not favour applicants, quite apart from the legislative constraints discussed above in Part II.

¹²⁶ *Milne* (n 40).

¹²⁷ *GSJW and Commissioner of Taxation* [2019] AATA 5170 ('*GSJW*').

¹²⁸ *Cox* (n 115).

¹²⁹ Fisher and Coleman (n 7) 170.

¹³⁰ *Cox* (n 115) [35] (Senior Member Evans-Bonner).

¹³¹ As to the two-stage test, see above nn 39–40 and accompanying text.

¹³² *Re Balens and Commissioner of Taxation* (2013) 93 ATR 917.

¹³³ *Huckle* (n 66).

¹³⁴ *Lipton* (n 31).

¹³⁵ *Lau* (n 40).

¹³⁶ *ZDCW* (n 83).

¹³⁷ *Schweitzer* (n 54).

¹³⁸ *GSJW* (n 127).

¹³⁹ *Rasmussen* (n 36).

¹⁴⁰ *Thomas* (n 31).

¹⁴¹ *Re Hulsen and Commissioner of Taxation* (2014) 98 ATR 402.

¹⁴² *KNNW* (n 104).

¹⁴³ *Moriarty* (n 56).

The first systemic issue is that the applicant bears the burden of proving that the decision concerned should not have been made or should have been made differently.¹⁴⁴ In *Rasmussen*, Deputy President Forgie made the following observations about the nature of the burden and its discharge in the context of serious hardship:

The individual who carries the burden of proof in relation to this decision must produce to the Tribunal evidence on which it can be satisfied, on the balance of probabilities, of the findings of fact that are relevant, first, to the ultimate finding that a person would suffer serious hardship if required to satisfy the liability and, if so, then to the exercise of the discretion. The individual can satisfy that burden by producing evidentiary material and calling witnesses.¹⁴⁵

It should be noted that for tax appeals more generally, an applicant will bear the burden of proof, which is appropriate when evidentiary matters are wholly within the knowledge of the applicant, rather than the Commissioner. However, this often creates an insurmountable task for unrepresented applicants.

It follows that the second systemic issue is the financial circumstances of applicants who are suffering financial hardship is such that most cannot afford representation. This is shown in the Appendix to this article, with self-represented taxpayers comprising the majority (that is, 64.5%) of applicants for hardship relief. They are faced with presenting a case before the AAT in which the Commissioner is invariably represented, often by legal counsel. Most will not properly understand the burden of proof and what it entails, and will not have gathered the necessary evidence. Many such cases are doomed to fail from the outset. This article presents a suggestion for associated reform in Part IV(D) below.

The third systemic issue is that over the past 50 years there are disproportionately fewer taxpayers from ‘blue-collar’ occupations seeking relief compared to ‘white-collar’ occupations. As shown in the Appendix, taxpayers in ‘white-collar’ occupations comprise the majority (that is, 65.4%) of all applicants for hardship relief and 75% of all successful applicants. This suggests that inequalities of educational opportunities and outcomes make it less likely for taxpayers suffering from structural disadvantage to pursue serious hardship relief through to the litigation stage. However, confirming a causal relationship from this finding requires further research.

C Case Study of Re BFCB and Commissioner of Taxation

In distilling AAT cases to their essential propositions, the nuances and complexities of individual cases can be lost. We therefore describe here one case more fully to capture the complexity of a case and illustrate the principles discussed above.

In *Re BFCB and Commissioner of Taxation*,¹⁴⁶ the Commissioner had issued a notice of assessment to the applicant showing a taxation liability of \$70,571. The applicant partially paid the tax debt leaving the sum of \$61,108 of the primary tax

¹⁴⁴ TAA (n 18) s 14ZZK(b).

¹⁴⁵ *Rasmussen* (n 36) 167 [36].

¹⁴⁶ *BFCB* (n 43).

outstanding and \$13,540 of GIC. Much of that liability had arisen from the inclusion of a net capital gain on the sale of an investment unit.

The applicant had been self-employed since 1992 and had always met her taxation liabilities. She had suffered chronic health problems, including major fatigue and depression for most of her life, although, as a self-employed person, she could match her hours of work to her physical condition. She had been a single parent since 1998 and had brought up her daughter, who was born in 1993, without child support payments.

In 2008, the applicant was diagnosed as suffering from breast cancer. In January 2013, she lost her major business client with the result that she no longer had a reliable source of income and used all of her financial resources, including credit cards, to support her daughter and herself. She was unable to borrow further from the Bank of Melbourne, which was the mortgagee of her home, or on her credit cards, and had not been able to find work whether as a self-employed management consultant or as an employee.

In February 2013, the applicant decided to sell her home and her investment unit 'to sort out ... [her] finances'.¹⁴⁷ It was the sale of the investment unit that had given rise to the net capital gain.

In August 2013, she purchased a house to live in for \$630,000, relying on a loan of \$350,000 from the Bank of Melbourne. She was required to make a minimum repayment of \$615 on the mortgage each fortnight. She also purchased a 1999 Subaru Liberty Sedan, which she valued at \$2,500, and separately retained for her daughters' use a 1999 Ford Fairmont, which she had purchased in 2005 and which she also valued at \$2,500.

In January 2015, the applicant approached Anglicare, which assisted her in exploring options to resolve her financial problems and, in the meantime, she continued to meet only those of her financial commitments relating to her accommodation, health and food. In December 2014, she applied to Centrelink for benefits, but had, until then, relied on her savings.

On 26 May 2015, the applicant's doctor certified that the applicant had numerous, chronic health issues including a history of cancer. These all contributed to excessive fatigue, which affected her daily physical and cognitive functioning.

At the date of the hearing, the applicant's daughter was 23 years of age and a full-time tertiary student in Melbourne but then studying in France on a scholarship for another month or so. The applicant received a pension of \$250 per fortnight paid by the Irish Government and, from the beginning of 2015, a social security payment of \$250 per fortnight from Centrelink. The applicant had been working since August 2016 for about 20 hours each week earning just under \$24 per hour.

On the evidence, the applicant was well short of meeting her day-to-day living expenses, and that was so whether she owed the tax liability or not. If the house were sold for \$650,000, she would have a surplus of \$217,000 once her debts,

¹⁴⁷ Ibid 14.

other than the tax liability, were paid. Only then would she have enough remaining to pay her tax liability.

At the hearing in the AAT, the applicant was unrepresented and appeared in person while the Commissioner was represented by counsel. The AAT found against the applicant and denied relief.

One can always debate the exercise of a discretion, but, with respect to the AAT, greater emphasis appeared to be placed on the 'negative' factors over the 'positive' factors in the weighing process.

It is worth synthesising some of the positive factors. The applicant had met her taxation liabilities for many years. She was a single parent and had brought up her daughter without child support payments. When she no longer had a reliable source of income, she used all of her financial resources, including credit cards, to support her daughter and herself, rather than relying upon welfare. She sold her home and investment unit to sort out her finances. She then approached Anglicare, which assisted her in exploring options to resolve her financial problems. In the meantime, she continued to meet only those of her financial commitments relating to her accommodation, health and food. Only later did she apply to Centrelink for benefits.

All of the above was done despite her personal circumstances, in particular, that she had suffered chronic health problems, including major fatigue and depression, for most of her life, and the diagnosis that she was suffering from breast cancer. These had all contributed to excessive fatigue which affected her daily physical and cognitive functioning.

Against this background, any 'negative' factors should bear some scrutiny. There was essentially one, that in August 2013 she purchased a house and a second car. The house was purchased for \$630,000, with a mortgage of \$350,000, and the car was valued at \$2,500.

As to the house, it will be recalled that just a few months earlier, in February 2013, she had sold her home and her investment unit to sort out her finances. In that circumstance, it seems understandable that she might have purchased a more modest home to live in. It was the sale of the investment unit that had given rise to the net capital gain. At that time, she was aware that there would be a capital gains tax ('CGT') liability, but was later 'shocked' to learn of its magnitude. It may not have been wise to commit to a mortgage when her income had fallen, but the bank was obviously prepared to lend and she needed a place to live.

As to the car, the purchase in 2013 of a 1999 Subaru Liberty Sedan, valued at \$2,500, could not be viewed as extravagant and, again, the size of the CGT liability was not then known.

With all due respect to the AAT, it is difficult to see how the one negative factor could have outweighed the positive factors in the exercise of the discretion, unless it is viewed as a disqualifying factor. We suggest in Part IV(B) below a different approach that might be taken to exercising the discretion.

IV Recommendations

This section makes four recommendations to modernise the current law and policy design given the legislative constraints identified in Part II and the systemic issues identified in Part III. It is hoped that these recommendations will assist policymakers in improving the operation of the serious hardship provisions. The recommendations are:

- The amendment of the causal relationship requirement;
- The implementation of a sliding scale for negative discretionary factors;
- The expansion of serious hardship relief to other taxation liabilities (including GST) and other entities; and,
- Improving access to free and (where possible) independent tax advice across the dispute resolution lifecycle.

Each recommendation is detailed below.

A *Amendment of the Causal Relationship Requirement*

The proposition that there must be a causal relationship between the requirement to satisfy the tax liability and the serious hardship is open to doubt. As detailed above in Part II(D), this article outlines multiple reasons why this proposition is unsound. One of these reasons is the emerging empirical evidence that tax debts are often a sub-component of overall debts for financially vulnerable people.¹⁴⁸ Refusing relief on the basis that the applicant would still suffer serious hardship due to their other financial commitments is disconnected from the realities of financial vulnerability for many taxpayers in modern-day Australia. This issue is especially timely and topical considering the economic aftermath of the COVID-19 pandemic.¹⁴⁹

Accordingly, we respectfully suggest that this area of the law be clarified so that the phrase ‘serious hardship’ returns to its ‘all embracing’ meaning.¹⁵⁰

The policy rationale supporting the existing regime is that, if relief were granted, other creditors would benefit over the Commissioner. To overcome the notion that other creditors might benefit, consideration should be given to inserting a provision that permits the Commissioner, in the event of an applicant’s bankruptcy within, say, five years of release, to prove as a debt in the bankruptcy the amount released to the taxpayer. This proposed legislative mechanism would ensure the Commissioner is not disadvantaged by releasing the taxpayer from the debt, which would automatically be deemed provable as a debt in circumstances involving voluntary administration, liquidation or bankruptcy, but not otherwise.

¹⁴⁸ See above nn 74–5 and accompanying text.

¹⁴⁹ ‘Australia is officially in its first recession for almost three decades, with the June quarter GDP [gross domestic product] numbers showing the economy went backwards by 7 per cent — the worst fall on record and slightly worse than most economists had predicted.’: Michael Janda and Phillip Lasker, ‘Australian Recession Confirmed as COVID-19 Triggers Biggest Economic Plunge on Record’, *ABC News* (online, 2 September 2020) <<https://www.abc.net.au/news/2020-09-02/australian-recession-confirmed-as-economy-shrinks-in-june-qtr/12619950>>.

¹⁵⁰ See above n 23 and accompanying text.

Consideration should also be given to permitting the Commissioner to meet with other creditors before any administration, liquidation or bankruptcy. The Commissioner is currently constrained by the ‘secrecy’ provisions of the taxation laws found in div 355 of sch 1 to the TAA. These provisions essentially prevent the disclosure of information about the tax affairs of taxpayers except in certain specified circumstances, and it is an offence for taxation officers to make such a disclosure.¹⁵¹ Significantly, it is not a defence to a prosecution of a taxation officer if the taxpayer has consented to the disclosure.¹⁵² We suggest the secrecy provisions be amended to permit disclosure to creditors for the purpose of reaching agreement on releasing the taxpayer from debts, including taxation debts, but only in relation to a serious hardship application and with the written consent of the taxpayer.

Further analysis and research is needed in this area, especially to avoid any unintended outcomes in changing insolvency and secrecy laws. It would be important, for example, to ensure that vulnerable taxpayers were not effectively denied credit on future occasions or felt improperly pressured to give consent about disclosure of their financial affairs.

The Inspector-General of Taxation (‘IGoT’) is currently investigating undisputed tax debts in Australia.¹⁵³ These debts have increased significantly in the 2019–20 tax year.¹⁵⁴ While the IGoT’s review is focused on identifying the segments of the economy experiencing increases in undisputed debt collections, it would be meaningful to also explore the underlying drivers for these debts. For example, if no such analysis has already been conducted internally by the ATO, it would also be useful to determine indicators of potential recovery of debts, and determine relative success rates of payment plans by taxpayer cohorts to then target debt collection more strategically given the ATO’s limited resources.

B *Implementation of a Sliding Scale for Negative Discretionary Factors*

This article highlights the range of factors taken into account in the exercise of the discretion. Too often these factors seem like de facto disqualifying factors — as

¹⁵¹ TAA (n 18) sch 1 s 355-25(1).

¹⁵² Ibid sch 1 s 355-35.

¹⁵³ See the terms of reference at ‘An Investigation and Exploration of Undisputed Tax Debts in Australia’, *Australian Government Inspector-General of Taxation and Taxation Ombudsman* (Web Page) <<https://www.igt.gov.au/news-and-publications/reports-reviews-1>>. For completeness, even though the ATO uses the term ‘collectable debt’, this term is not used by the IGT because ‘the expression itself may be confusing without the related defined meaning - debt that is not subject to objection or appeal or to some form of solvency administration’: ‘Investigation and Exploration of Undisputed Tax Debts in Australia’, *Inspector-General of Taxation and Taxation Ombudsman* (Web Page) <<https://www.igt.gov.au/news-and-publications/reports-reviews-1>>.

¹⁵⁴ ‘IGoT News! - Edition 14, November 2020’, *Inspector-General of Taxation and Taxation Ombudsman* (Web Page) <<https://www.igt.gov.au/news-and-publications/newsletters/november2020>>:

Overall, the ATO has reported that, as at 30 June 2020, its collectable debt balance is \$34.1 billion, a 28.2% increase from 30 June 2019. ... Activity statement collectable debt (which includes GST and PAYGW [PAYG withholding]) accounts for the largest component (58%) as at 30 June 2020. It was also the debt type which recorded the largest increase (39%) since the prior year.

demonstrated in cases such as *BFCB*.¹⁵⁵ It weighs heavily against an applicant, for example, that they have paid other creditors in preference to the Commissioner. This includes, in practice, cases where a taxpayer in financial hardship pays off the credit card in preference to the taxation liability. This is likely to happen because the credit card is needed to purchase life's essentials. It is difficult to see why this should necessarily be a de facto disqualifying factor.

The existing approach fails to distinguish between different levels of moral culpability for failure to pay tax. This article suggests that legislative reform is needed to clarify that a failure to take reasonable care (in paying off credit cards before tax, for example) is not a disqualifying factor, while deliberate attempts to evade the payment of tax debts would be a disqualifying factor. Accordingly, an applicant might intentionally pay off a credit card before tax, but is not thereby seeking to intentionally disregard any taxation obligations.

These degrees of culpability would distinguish between the taxpayer who in difficult times failed to lodge several tax returns (and thus failed to take reasonable care) and the taxpayer who deliberately and intentionally disregarded their obligations (such as the senior barrister who fails to pay tax over many years).

A complementary benefit of a 'sliding scale' approach would be to codify in the serious hardship relief provisions the ATO's existing compliance model (Figure 1). As noted in Part I, this model makes a clear distinction between taxpayers who are non-compliant due to various mitigating circumstances as opposed to taxpayers who deliberately decide to be non-compliant, and is responsive to this nuance.

Considerations that can assist in guiding the operation of a sliding scale already exist in the case law. For example, as outlined in *Re David and Commissioner of Taxation*, the seven criteria relevant to the proper exercise of the discretion are:

- the circumstances out of which the hardship arose;
- whether those circumstances could have been foreseen and controlled by the applicant;
- whether the applicant has overcommitted themselves financially;
- whether the applicant or dependants had suffered any serious illness or accident involving irrevocable financial loss to the applicant;
- whether the applicant has been in regular employment;
- whether the circumstances of hardship are likely to be of a temporary or recurring nature; and
- whether a decision to remit the debt would place the applicant in a preferred position to other taxpayers.¹⁵⁶

Further, a sliding scale approach would also be in the public interest, which is an element of relevance in the exercise of the discretion. As noted by Stone J in *A Taxpayer*, '[the public interest] is relevant for the Commissioner or, in this case

¹⁵⁵ See above Part III(C) case study of *BFCB* (n 43).

¹⁵⁶ *Re David and Commissioner of Taxation* (2005) 60 ATR 1072, 1076–7 [14] citing *Re Wilson and Minister for Territories* (1985) 3 AAR 60.

the AAT, to consider how the goal of collecting public revenue would best be served.¹⁵⁷

C *Expansion of Serious Hardship Relief to Other Taxation Liabilities (including GST) and Other Entities*

As noted in Part II(B), not all types of tax liability are eligible for release. Section 340-10 of sch 1 to the TAA applies only to income tax, FBT (including instalments), Medicare levy, PAYG instalments, and related GIC and penalties.

One notable exclusion, as mentioned previously, is GST. For example, more than half of the applicant's tax liabilities in *Burns*¹⁵⁸ related to GST, but these liabilities were not eligible for release. At present, businesses experiencing serious financial hardship can request priority processing of their BAS,¹⁵⁹ but this is very different to them being granted relief in relation to unpaid GST liabilities.

The existing policy justification for the exclusion of GST is likely that this type of tax is an indirect tax, the economic burden of which is generally not intended to be borne by the 'taxpayer'; but is intended to be passed on to the final consumer.¹⁶⁰ In this way, the taxpayer effectively acts as an unpaid agent of the Commissioner in collecting the tax.

This is out of step with the modern composition of the workforce. Specifically, the past few decades have seen the emergence of non-traditional forms of work including engagement of independent contractors as hiring options for employers.¹⁶¹ So, rather than exclusively operating with the personal income tax system, these independent contractors may select other structures for conducting their business, such as corporate or trust entities.¹⁶²

Accordingly, this article proposes the legislation be amended to expand the scope of serious hardship relief to other taxation liabilities (including GST) and to all small businesses (whether operating as sole traders or through corporate or trust entities).

Even before the COVID-19 crisis, small businesses accounted for around 60% of total collectable debt.¹⁶³ The initial six-month period of managing the

¹⁵⁷ *A Taxpayer* (n 38) 463 [63].

¹⁵⁸ *Burns* (n 31). See also *Thomas* (n 31); *Lipton* (n 31).

¹⁵⁹ 'Businesses with Financial Difficulties', *Australian Taxation Office* (Web Page, 12 November 2020) <<https://www.ato.gov.au/General/Financial-difficulties-and-serious-hardship/Businesses-with-financial-difficulties/>>.

¹⁶⁰ See *Avon Products Pty Ltd v Commissioner of Taxation* (2006) 230 CLR 356, 362 [7] (Gleeson CJ, Gummow, Kirby, Hayne and Heydon JJ) in relation to the former sales tax regime.

¹⁶¹ 'There were just over one million people working as independent contractors in Australia in August 2018.' Geoff Gilfillan, 'Trends in Use of Non-standard Forms of Employment' (Research Paper Series 2018–19, Parliamentary Library, Parliament of Australia, 10 December 2018) 1.

¹⁶² 'Working as a Contractor', *Australian Taxation Office* (Web Page, 4 July 2018) <<https://www.ato.gov.au/individuals/working/working-as-a-contractor/>>.

¹⁶³ Villios (n 8) 427. For completeness, this article used the historical definition of small business; namely, businesses with a \$2 million turnover threshold. This definition has since been expanded: 'What's New for Small Business' *Australian Taxation Office* (Web Page, 21 December 2020)

economic aftershocks of the COVID-19 pandemic in Australia was marked by the introduction of an array of temporary relief measures recommended by government or mandated by state and federal parliaments, including the freezing of Australian Government debt recovery action¹⁶⁴ and bank loan repayment deferrals.¹⁶⁵ The next phase involves the reduction and removal of these measures. Commentators from industry,¹⁶⁶ the community sector¹⁶⁷ and academia¹⁶⁸ have observed that this is likely to result in a ‘financial cliff’. With the ATO gradually recommencing debt collection action,¹⁶⁹ pre-existing tensions and sources of dissatisfaction¹⁷⁰ between small businesses and the ATO are likely to resurface.¹⁷¹

D *Improving Access to Free and (Where Possible) Independent Tax Advice across the Dispute Resolution Lifecycle*

While the ATO’s Tax Help Program currently exists, it is limited in scope and duration, and is run by volunteers rather than tax professionals.¹⁷² Further, the ATO’s Dispute Assist Service is available to unrepresented individuals and small businesses to provide assistance with any dispute resolution issues, mediation or conciliation — but these services, under the regulatory system, can neither provide tax advice nor can they represent individuals.

Emerging research indicates that there currently exists a lack of access to tax justice across all stages of the tax dispute resolution lifecycle in Australia.¹⁷³ Specifically, Kayis-Kumar, Walpole and Mackenzie found that financial counsellors believe that free and independent tax advice is needed particularly for debt/hardship

<<https://www.ato.gov.au/Business/Small-business-entity-concessions/What-s-new-for-small-business/#Lowercompanytaxratechanges1>>.

¹⁶⁴ Stuart Robert (Australian Government Minister for Government Services), ‘Media Release: Pausing Debt Activity during the Coronavirus Pandemic’ (Media Release, 3 April 2020) <<https://minister.servicesaustralia.gov.au/media-releases/2020-04-03-pausing-debt-activity-during-coronavirus-pandemic>>.

¹⁶⁵ Michael Janda, ‘Coronavirus Bank Loan Repayment Deferral Guidance Issued by Regulator ASIC’, *ABC News* (online, 14 August 2020) <<https://www.abc.net.au/news/2020-08-14/coronavirus-bank-assistance-guidance-issued-by-asic/12556482>>.

¹⁶⁶ Matthew Cranston, ‘Lowe Gives Green Light for Budget Blowout’, *The Australian Financial Review* (online, 21 July 2020) <<https://www.afr.com/policy/economy/lowe-gives-green-light-for-budget-blowout-20200721-p55e3n>>.

¹⁶⁷ Shepherd (n 5).

¹⁶⁸ Ben Phillips, Matthew Gray and Nicholas Biddle, ‘Winding Back JobKeeper and JobSeeker Will Push 740,000 Australians into Poverty’, *The Conversation* (online, 11 September 2020) <<https://theconversation.com/winding-back-jobkeeper-and-jobseeker-will-push-740-000-australians-into-poverty-145308>>; Evidence to House of Representatives Standing Committee on Tax and Revenue, Parliament of Australia, Canberra, 26 June 2020, 5 (Ann Kayis-Kumar).

¹⁶⁹ Jotham Lian, ‘ATO Kicks Off ‘Soft’ Debt Collection Restart’, *Accountants Daily* (online, 9 September 2020) <<https://www.accountantsdaily.com.au/tax-compliance/14809-ato-kicks-off-soft-debt-collection-restart>>.

¹⁷⁰ Villios (n 8) 427–8.

¹⁷¹ See, eg, ‘Agenda 2020: Reform the ATO’, *Self-Employed Australia* (Web Page) <<https://www.selfemployedaustralia.com.au/Current-Issues/Taxation/index.html>>.

¹⁷² See ‘Tax Help Program’, Australian Taxation Office (Web Page, 19 October 2020) <<https://www.ato.gov.au/individuals/lodging-your-tax-return/tax-help-program/>>.

¹⁷³ Kayis-Kumar, Walpole and Mackenzie, ‘Submission to the Standing Committee on Tax and Revenue’ (n 2).

discussions for individuals and small businesses located in communities with relatively higher levels of socio-economic disadvantage.¹⁷⁴

Consideration should be given to funding applicants in AAT proceedings who would otherwise be self-represented, except perhaps in the most egregious of cases. This is particularly important since the situations faced by those in financial hardship are disproportionately burdensome given the legal obligation to comply with the incredibly complex Australian tax and transfer system.¹⁷⁵

A further benefit is that funding representation would reduce the burden on the already scarce resources of the AAT and might result in better outcomes. This is particularly important because tax law is not conceptualised as a specialist service by Legal Aid.¹⁷⁶ Despite the absence of a platform for legal help in relation to tax law, small businesses are given dispute resolution support through the Australian Small Business and Family Enterprise Ombudsman's ('ASBFEO') 'Small Business Concierge Service'.¹⁷⁷ This service helps taxpayers decide if an application to the AAT for review of an ATO decision is an appropriate pathway to resolution. In conjunction with the new Small Business Taxation Division of the AAT, the Small Business Concierge Service provides targeted support to small businesses in dispute with the ATO.

For example, one of the authors has represented an applicant for relief through funding provided by ASBFEO. After a consideration of the law and evidence, the applicant was advised to abandon the AAT proceedings (saving considerable expense for both the AAT and the Commissioner) and enter into a payment plan with the ATO. This seemed to achieve a better result for both the applicant and the Commissioner, and at a much lower overall cost.

Further, as noted above in Part IV(C), the advent of both the casualisation of the workforce and the gig economy gives rise to unintended consequences for low-income taxpayers who are increasingly conceptualised as earning business income. This disqualifies them from accessing the ATO's Tax Help Program. Accordingly, expansion of the criteria for access to the ATO's Tax Help Program to include independent contractors (including sole traders) would likely provide more accessible tax services and greater engagement with the ATO, while also bolstering tax literacy and improving tax morale.¹⁷⁸ This would likely assist the ATO's mission of fostering a culture of voluntary compliance in the medium-term, and may

¹⁷⁴ Ibid.

¹⁷⁵ 'Australia's tax and transfer system is too complex ... Policy inconsistency across the tax and transfer system has eroded the underlying principles in some areas.': Ken Henry, Jeff Harmer, John Piggott, Heather Ridout and Greg Smith, *Australia's Future Tax System: Report to the Treasurer* (Final Report, December 2009) pt 1, 23.

¹⁷⁶ 'Legal Aid NSW provides one-off free legal advice to people about a range of legal issues': 'Legal Advice', *Legal Aid New South Wales* (Web Page, 30 July 2020) <<https://www.legalaid.nsw.gov.au/get-legal-help/advice>>.

¹⁷⁷ 'Small Business Concierge Service', *Australian Small Business and Family Enterprise Ombudsman* (Web Page, 2020) <<https://www.asbfeo.gov.au/assistance/concierge-service>>. See also 'Dispute Support', *Australian Small Business and Family Enterprise Ombudsman* (Web Page, 2020) <<https://www.asbfeo.gov.au/disputesupport>>.

¹⁷⁸ Kayis-Kumar, Noone, Martin and Walpole, 'Pro Bono Tax Clinics' (n 32) 126–7.

contribute to reduced instances of tax debts arising from small business compliance obligations (including BAS) in the longer-term.

V Conclusion

For over 100 years there has been a discretion in taxation legislation to release taxpayers from tax-related liabilities on the ground they would suffer serious hardship. Despite its long history, there is a relative dearth of literature both on the serious hardship relief provisions in Australia and relevant cases brought to a tribunal or court hearing. Other aspects of tax administration have evolved in the past two decades, including the ATO's focus on mitigating reputational harm arising from community perceptions of its debt collection practices.

This article detailed the legislative background and regulatory landscape in relation to these provisions, including exploring the meaning of 'serious hardship', outlining the administrative guidance and detailing the eight discretionary factors that have often received prominence in AAT decisions.

In doing so, this article identified four problematic aspects of the existing regime and makes recommendations for reform.

First, there should be an amendment to the requirement that serious hardship relief can be granted only in instances where said hardship is predicated by the tax liability. This requirement is disconnected from the realities of financial vulnerability for many taxpayers, given tax debts are often a sub-component of overall debts.

Second, the existing regime fails to distinguish between different levels of moral culpability. This article recommends the introduction of a sliding scale for negative discretionary factors. This provides relief for those who have generally participated in the tax system, but dropped out due to health or other shocks.

Third, this article proposes the legislation be amended to allow serious hardship relief for other taxation liabilities (including GST) and for small businesses (whether operating as sole traders or through corporate or trust entities). This reform would modernise this element of the tax law to reflect the shifting parameters of the labour market (including the increasing use of Australian Business Numbers among taxpayers in precarious employment).

Fourth, there is a pressing need for greater access to free and independent tax advice across the dispute resolution lifecycle. This is particularly important in the context of debt and hardship discussions for individuals and small businesses located in communities with relatively higher levels of socio-economic disadvantage.

These four recommendations are designed to modernise the current policy and law design of the serious hardship relief provisions and, in doing so, result in better outcomes for financially vulnerable individuals and small businesses, while also maintaining trust and confidence in the ATO among the wider community.

Appendix: Overview of Serious Hardship Tribunal and Court Decisions

Case	Tax liability	Positive factors	Negative factors	Relief granted?	Self-represented?	Professional background
Section 64(1) of the <i>Income Tax Assessment Act 1915</i> (Cth)						
N/A						
Section 97 of the <i>Income Tax Assessment Act 1922</i> (Cth)						
N/A						
Section 265 of the <i>Income Tax Assessment Act 1936</i> (Cth)						
<i>Hissink v Taxation Relief Board</i> (1982) 12 ATR 728	unknown	unknown	unknown	No	Yes	Medical practitioner
<i>Powell v Evreniades</i> (1989) 21 FCR 252	\$175,183	<ul style="list-style-type: none"> • Physical injury (car accident). • Family difficulties (with daughter). • Dependent children. 	<ul style="list-style-type: none"> • Sufficient equity (estate). • Sufficient cash (\$12,000). • Large discretionary spending. • Can reduce weekly outlays (mortgage). • Receive benefits and subsidies (work compensation & rental assistance). 	No: Remitted for reconsideration	No	Not specified
<i>Van Grieken v Veilands</i> (1991) 21 ATR 1639	\$19,660	unknown	<ul style="list-style-type: none"> • Significant equity. • Prioritising non-tax debts. • Excess income over expenditure. • Can reduce weekly outlays (mortgage). 	No	No	Finance broker and consultant
<i>Rollo v Morrow</i> (1992) 23 ATR 477	\$1,786,917	unknown	<ul style="list-style-type: none"> • Worked as a registered tax agent and tax consultant. • Deliberately did not meet tax liabilities. • High income. • Did not recover debts owed to him. 	No	No	Registered tax agent

Case	Tax liability	Positive factors	Negative factors	Relief granted?	Self-represented?	Professional background
Section 265 of the <i>Income Tax Assessment Act 1936</i> (Cth) (continued)						
<i>Corlette v Mackenzie</i> (1996) 62 FCR 597	unknown	unknown	<ul style="list-style-type: none"> • Granting relief would not alleviate hardship. • Significant debt (\$1 million to Equiticorp Financial Services Ltd). • Providing relief would make amount irrecoverable. 	No	No	Sales manager (& chartered accountant)
Section 340-5 of sch 1 to the <i>Taxation Administration Act 1953</i> (Cth)						
<i>Ferguson and Commissioner of Taxation</i> [2004] AATA 779	\$35,000	<ul style="list-style-type: none"> • Very straitened circumstances. 	<ul style="list-style-type: none"> • Not deprived of necessities. • Reasonable chance for instalment payments. • Reasonable chance for uplift in farm profitability. 	No	Not specified	Farmer
<i>Re Filsell and Commissioner of Taxation</i> [2004] AATA 1012	Case not published			No	Case not published	
<i>Re David and Commissioner of Taxation</i> (2005) 60 ATR 1072	\$17,313	<ul style="list-style-type: none"> • Illness. • Unemployed. • Marital breakdown. 	<ul style="list-style-type: none"> • Financial support (son). • Sufficient equity (half of matrimonial home in Greece). • Receives welfare benefits (pension). • Superannuation. • Situation caused by voluntarily changing his affairs and not seeking taxation advice. 	No	Yes	Pensioner

<i>Federal Commissioner of Taxation v A Taxpayer</i> (2006) 63 ATR 450	\$133,000	<ul style="list-style-type: none"> • Real risk of unemployment if made bankrupt. • Wife's chronic medical condition. • Dependent children (one with learning difficulty). • Historically tax compliant. • Worked long hours. 	<ul style="list-style-type: none"> • Earn significant income (\$250,000 per annum). 	Yes: Partial relief (partial release of income tax liability)	No	Solicitor
<i>Commissioner of Taxation v Milne</i> (2006) 153 FCR 52	\$187,430	<ul style="list-style-type: none"> • Financial misconduct of former business partner. • Real risk of unemployment if made bankrupt. • Few remaining years in work life. • Deteriorating health including heart attacks, hip surgery and Parkinson's disease. • Marital breakdown. • Dependent children. • Reduced investment property value (bushfires). 	<ul style="list-style-type: none"> • Large discretionary spending. 	Yes: Full relief	Yes	Solicitor

Case	Tax liability	Positive factors	Negative factors	Relief granted?	Self-represented?	Professional background
Section 340-5 of sch 1 to the Taxation Administration Act 1953 (Cth) (continued)						
<i>Re Rollason and Commissioner of Taxation</i> (2006) 64 ATR 1210	\$600,610		<ul style="list-style-type: none"> • Prior relief granted (\$522,000). • Did not pay for instalments and moved for bankruptcy. • Made no payments voluntarily. • Used the GST tax monies for his own benefit. • Poor compliance record. • Solicitor of much seniority and experience. 	No	No	Solicitor
<i>Vagh and Commissioner of Taxation</i> [2007] AATA 32	Case not published			No	Case not published	
<i>Re Nair and Commissioner of Taxation</i> (2008) 73 ATR 458	\$60,292	<ul style="list-style-type: none"> • Real risk of unemployment if made bankrupt. • Illness. 	<ul style="list-style-type: none"> • Poor compliance history. • Granting relief would not alleviate hardship. 	No	Yes	Solicitor
<i>Adams and Commissioner of Taxation</i> [2010] AATA 744	\$16,847	<ul style="list-style-type: none"> • Physical injury (knee). • Marital breakdown. • Dependent child. 	<ul style="list-style-type: none"> • Job not at risk. • Significant equity (property). • Alternative accommodation options available. • Child schooling not at risk. • Not deprived of basic necessities. 	No	Yes	Police officer

<i>Re Neimanis and Commissioner of Taxation</i> (2012) 91 ATR 235	\$130,961	<ul style="list-style-type: none"> • Business deterioration for sole practitioner. • Health issues including cancer. 	<ul style="list-style-type: none"> • Experienced, self-employed solicitor aware of obligations. • Granting relief would not alleviate hardship (Outstanding GST debt). • Able to meet necessities. • Large discretionary expenditures. • Hardship due to own fault. 	No	Yes	Solicitor
<i>Re Balens and Commissioner of Taxation</i> (2013) 93 ATR 917	\$13,256	<ul style="list-style-type: none"> • Marital breakdown. 	<ul style="list-style-type: none"> • Poor compliance history • Prioritising non-tax debts • No dependents (no more child support) • Scope for improvement in financial situation. 	No	No	Sole trader – hospitality
<i>Re Fay and Commissioner of Taxation</i> (2013) 94 ATR 476	\$49,780	unknown	<ul style="list-style-type: none"> • Capacity to pay. • Sufficient equity. • Large discretionary spending. • Insufficient evidence (household income situation). 	No	No	Not specified
<i>Re Rasmussen and Commissioner of Taxation</i> (2013) 95 ATR 155	\$30,519	<ul style="list-style-type: none"> • Wife's illness (physical). • Dependent children. 	<ul style="list-style-type: none"> • Granting relief would not alleviate hardship. • Large discretionary spending (visiting sister overseas dying of cancer). • Providing relief would make amount irrecoverable. 	No	Yes	Energy auditor

Case	Tax liability	Positive factors	Negative factors	Relief granted?	Self-represented?	Professional background
Section 340-5 of sch 1 to the Taxation Administration Act 1953 (Cth) (continued)						
<i>Re Thomas and Commissioner of Taxation</i> (2014) 95 ATR 991	\$74,265	<ul style="list-style-type: none"> • Assets cannot meet debt (\$105,834.93 shortfall). • Mental health illness (depression). 	<ul style="list-style-type: none"> • Excess debts (\$36,000). • Ability to work. • Can meet day to day expenses. • Poor compliance history. • No initiative in making arrangements. • Granting relief would not alleviate hardship. 	No	Yes	Not specified
<i>Re Hulsen and Commissioner of Taxation</i> (2014) 98 ATR 402	\$103,284	<ul style="list-style-type: none"> • Marital breakdown. • Mental health illness (depression). • Physical injury (arm). 	<ul style="list-style-type: none"> • Poor compliance history. • Prioritising non-tax debts. 	No	Yes	Sole trader – retail
<i>Power and Commissioner of Taxation</i> [2014] AATA 343	\$57,567	unknown	<ul style="list-style-type: none"> • Net income surplus (\$422) • Ignored tax liabilities • Capacity to pay • Large discretionary spending • Expenses overstated 	No	Yes	Sales representative
<i>Huckle and Commissioner of Taxation</i> [2014] AATA 362	\$81,387	<ul style="list-style-type: none"> • Gambling addiction (\$666,200 debt) • Sought financial counselling 	<ul style="list-style-type: none"> • Temporary financial difficulties • Sufficient equity (investment property) • High income 	No	Yes	Metallurgist

<i>KNNW and Commissioner of Taxation</i> [2014] AATA 691	\$26,045	None mentioned in decision	<ul style="list-style-type: none"> • Granting relief would not alleviate hardship • Providing relief would make amount irrecoverable • Large discretionary spending • Reduction in unnecessary assets available 	No	Yes	Not specified
<i>Re Watson and Commissioner of Taxation</i> (2014) 99 ATR 908	\$52,112	<ul style="list-style-type: none"> • Medical condition (temporary). 	<ul style="list-style-type: none"> • Prioritising non-tax debts • Poor compliance history • Hardship due to own fault • Abandoned prior repayment plans • Insufficient information provided (ability to work) 	No	Yes	Sole trader – construction
<i>Lipton and Commissioner of Taxation</i> [2015] AATA 754	\$25,001	<ul style="list-style-type: none"> • Mental health illness (depression). • Personal injuries. 	<ul style="list-style-type: none"> • Significant equity (inheritance of \$200,000) • Ability to work • Son is less financially dependent • Access to repayment facility (Home Loan redraw facility: \$16,742) • Excess income over expenditure 	No	Yes	Small business – construction

Case	Tax liability	Positive factors	Negative factors	Relief granted?	Self-represented?	Professional background
Section 340-5 of sch 1 to the Taxation Administration Act 1953 (Cth) (continued)						
<i>Lau and Commissioner of Taxation</i> [2016] AATA 46	\$3,579,209	unknown	<ul style="list-style-type: none"> • Insufficient evidence (financial circumstances) • Understated income • False information in evidence • Sufficient equity (expensive apartment) • Potential increase in the profitability of owned company • Reduction in expenses (mortgage payments) 	No	No	Small business – technology
<i>XLPZ and Commissioner of Taxation</i> [2016] AATA 466	\$57,940	<ul style="list-style-type: none"> • Unemployed. • Protracted litigation with former spouse. • Business failure. 	<ul style="list-style-type: none"> • Prioritising non-tax debts. • Granting relief would not alleviate hardship. 	No	Yes	Solicitor
<i>Re ZDCW and Commissioner of Taxation</i> (2016) 103 ATR 975	\$130,416	<ul style="list-style-type: none"> • Serious illness (Parkinson’s Disease). • Forced into early retirement. • Dependent children (one with schizophrenia). 	<ul style="list-style-type: none"> • No real financial distress. • Sufficient equity (holiday home). • Financial support (wife). 	No	Yes	CEO
<i>Re Moriarty and Commissioner of Taxation</i> (2016) 104 ATR 190	\$437,682	<ul style="list-style-type: none"> • Marital breakdown. 	<ul style="list-style-type: none"> • Prioritised other finances (acquiring properties). • Large discretionary spending. • Poor tax compliance history. • Job not at risk. • Hardship due to own fault. 	No	Yes	Real estate salesperson

<i>Re BFCB and Federal Commissioner of Taxation</i> (2017) 106 ATR 456	\$61,109	<ul style="list-style-type: none"> •Historically tax compliant. •Historically did not receive welfare payments. •Chronic health problems (major fatigue). •Mental health condition (depression). •Serious illness (breast cancer). •Single parent. •Dependent child. •Sought financial counselling. •Sold property to resolve financial issues. •Suffering serious financial hardship. 	<ul style="list-style-type: none"> •Prioritised other finances (acquiring property). •Hardship due to own fault (acquired property despite reduced income). •Purchased a second car (second-hand). •Granting relief would not alleviate hardship. 	No	Yes	Sole trader – management consulting
<i>Schweitzer and Commissioner of Taxation</i> [2019] AATA 1100	\$4,704,285	<ul style="list-style-type: none"> •Unlikely to find remunerative work. •Psychiatric condition (but no psychiatric help sought). •Historically did not receive welfare payments. 	<ul style="list-style-type: none"> •Disingenuous (concealed interest in inheritance and deferred payment of income tax via legal means). •Sufficient equity (property). •No reasonable steps taken to receive inheritance. •Understated taxable income over a 12-year period. 	No	No	Not specified

Case	Tax liability	Positive factors	Negative factors	Relief granted?	Self-represented?	Professional background
Section 340-5 of sch 1 to the Taxation Administration Act 1953 (Cth) (continued)						
<i>Burns and Commissioner of Taxation</i> [2019] AATA 3860	\$98,000	<ul style="list-style-type: none"> • Assets could not meet debt (\$89,000 shortfall). • Physical injury (back). • Family problems (de facto partner, passing of grandmother and cousin). • Dependence on alcohol. 	<ul style="list-style-type: none"> • Net income surplus. • Poor compliance history. • Not deprived of basic necessities. 	No	No	Sole trader – construction
<i>GSJW and Commissioner of Taxation</i> [2019] AATA 5170	\$949,365	<ul style="list-style-type: none"> • Mental health condition (ADHD), supported by detailed evidence. • Wife's ill-health. • Few remaining years in work life. 	<ul style="list-style-type: none"> • Net income surplus. • Prioritised other finances (acquiring property). 	Yes: Partial relief (release of GIC portion of the debt)	Yes	Sole trader – instrumentation consulting
<i>Cox and Commissioner of Taxation</i> [2020] AATA 3857	\$123,829	<ul style="list-style-type: none"> • Mental health issue (no evidence provided). • Only source of income- Newstart Allowance. • Engaged services of accounting firm for future tax obligations. 	<ul style="list-style-type: none"> • Granting relief would not reduce hardship. • Poor compliance history. • Prioritised other debts (to private creditors). 	Yes: Full relief (release of eligible portion of debt)	Yes	Sub-contractor – construction

Regulating Artificial Intelligence in Finance: Putting the Human in the Loop

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Abstract

This article develops a framework for understanding and addressing the increasing role of artificial intelligence ('AI') in finance. It focuses on human responsibility as central to addressing the AI 'black box' problem — that is, the risk of an AI producing undesirable results that are unrecognised or unanticipated due to people's difficulties in understanding the internal workings of an AI or as a result of the AI's independent operation outside human supervision or involvement. After mapping the various use cases of AI in finance and explaining its rapid development, we highlight the range of potential issues and regulatory challenges concerning financial services AI and the tools available to address them. We argue that the most effective regulatory approaches to addressing the role of AI in finance bring humans into the loop through personal responsibility regimes, thus eliminating the black box argument as a defence to responsibility and legal liability for AI operations and decisions.

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I Introduction

Artificial intelligence ('AI') is a focus of global attention.¹ While AI has a long history of development, recent technological advances and digitisation have underpinned rapid and unprecedented evolution. Algorithmic trading, an early and leading AI use case, has, in the words of the European Central Bank, 'been growing steadily since the early 2000s and, in some markets, is already used for around 70% of total orders'.² In 2019, a major official survey of the United Kingdom ('UK') financial services industry revealed that machine learning — a form of AI — is used by two-thirds of respondents in the UK in a range of front-office and back-office applications, most commonly in anti-money laundering, fraud detection, customer services and marketing.³ A similar survey in Hong Kong revealed that 89% of banks had adopted or planned to adopt AI applications, most often in cybersecurity, client-facing chatbots, remote onboarding, and biometric customer identification.⁴ Central to this is the rise of datafication — manipulation of digitised data through quantitative data analytics, including AI.⁵

In most sectors, AI is expected to contribute to problem solving and development. Pricewaterhouse Coopers ('PwC'), probably optimistically, expects AI will boost global gross domestic product by 14% by 2030.⁶ Accenture estimates that banks can save 20–25% across information technology ('IT') generally.⁷ Cost savings, enhanced efficiency, entirely new opportunities and business models explain why financial services companies are expected to spend US\$11 billion on AI in 2020, more than any other industry.⁸

A 2018 World Economic Forum ('WEF') report highlighted that AI-enabled systems in finance can deliver 'new efficiencies' and 'new kinds of value'.⁹ However, a tight focus on these new capabilities risks overlooking a fundamental shift as financial institutions become 'more specialised, leaner, highly networked and dependent on the capabilities of a variety of technology players'.¹⁰ The WEF suggests multiple stakeholder collaboration is required to counter the potential social

¹ See generally Bonnie G Buchanan, *Artificial Intelligence in Finance* (The Alan Turing Institute, Report, April 2019).

² European Central Bank, 'Algorithmic Trading: Trends and Existing Regulation' (Media Release, 13 February 2019). In Part IV(B) below, we discuss Joint Committee of the European Supervisory Authorities ('ESAs'), *Joint Committee Final Report on Big Data* (JC/2018/04, 15 March 2018) ('ESAs Joint Committee Final Report on Big Data').

³ Bank of England and Financial Conduct Authority, *Machine Learning in UK Financial Services* (Report, October 2019) 8.

⁴ Hong Kong Monetary Authority, 'Artificial Intelligence (AI) in Retail Banking' (Fact Sheet, November 2019).

⁵ UK Finance and Microsoft, *Artificial Intelligence in Financial Services* (Report, June 2019) 5.

⁶ PwC, *Sizing the Prize: What's the Real Value of AI for Your Business and How Can You Capitalise?* (Report, 2017) 4.

⁷ Accenture, *Redefine Banking with Artificial Intelligence* (Report, 2018) 9.

⁸ Amy Zirkle, 'The Critical Role of Artificial Intelligence in Payments Tech', *Fintech News* (online, 27 May 2019) <<https://www.fintechnews.org/the-critical-role-of-artificial-intelligence-in-payments-tech/>>.

⁹ World Economic Forum, *The New Physics of Financial Services: Understanding How Artificial Intelligence is Transforming the Financial Ecosystem* (Report, 15 August 2018) 18.

¹⁰ *Ibid* 19.

and economic risks of AI-enabled systems in finance.¹¹ Similarly, in 2019, the WEF addressed responsible AI use in finance, focusing on governance requirements and risks. Specifically, AI explainability, systemic risk, AI biases, and algorithmic collusion have been identified as prominent sources of risk in finance.

AI and automation raise major broader concerns, ranging from widespread job losses,¹² to ‘the singularity’ — when the capacities of AI surpass those of humans. These concerns have triggered many analyses of the ethical¹³ and legal¹⁴ implications of AI, yet few from the perspective we take here, of AI’s impact in finance.¹⁵

Central to many of these concerns is the role of humans in the evolution of AI: the necessity of involving people in using, monitoring and supervising AI. This article develops a regulatory framework for understanding and addressing the increasing role of AI in finance. It focuses on human responsibility, the ‘human in the loop’, as central to tackling the AI ‘black box’ problem, that is: the risk that AI results in processes and operations unknown to and uncontrolled by human beings, producing undesirable results for which, arguably, only the AI may be responsible.

Part II maps the various use cases of AI in finance, and explains its rapid development. Part III highlights the risks the increasing reliance on AI in finance creates. Part IV summarises the regulatory challenges concerning financial services AI and the tools available to address them, highlighting the need to address the black box problem.

Part V presents our solution to the black box problem. We argue that the most effective regulatory approach is to bring humans into the loop, enhancing *internal* governance where financial supervision as *external* governance is unlikely to be effective. We thus propose to address AI-related issues by requiring three internal governance tools: (1) AI due diligence; (2) AI explainability; and (3) AI review committees. These tools would operate both directly and via the mechanism of personal responsibility embedded in an increasing range of financial regulatory systems, including in Australia, the European Union (‘EU’), and the UK.

Part VI concludes, suggesting that this framework offers the potential to address black box issues in the context not only of AI in finance, but also in any regulated industry.

¹¹ World Economic Forum (n 9) 51. See also UK Finance and Microsoft (n 5) 15.

¹² Shelly Hagan, ‘More Robots Mean 120 Million Workers Need to be Retrained’, *Bloomberg* (online, 6 September 2019) <<https://www.bloomberg.com/news/articles/2019-09-06/robots-displacing-jobs-means-120-million-workers-need-retraining>>.

¹³ See generally Dirk Helbing, ‘Societal, Economic, Ethical and Legal Challenges of the Digital Revolution: From Big Data to Deep Learning, Artificial Intelligence, and Manipulative Technologies’ in Dirk Helbing (ed), *Towards Digital Enlightenment — Essays on the Dark and Light Sides of the Digital Revolution* (Springer, 2018) 47.

¹⁴ See generally Harry Surden, ‘Machine Learning and the Law’ (2014) 89(1) *Washington Law Review* 87.

¹⁵ Tom CW Lin, ‘Artificial Intelligence, Finance, and the Law’ (2019) 88(2) *Fordham Law Review* 531.

II AI and Finance

The term AI covers a series of technologies and approaches, ranging from ‘if-then’ rule-based expert systems,¹⁶ to natural language processing, to the marriage of algorithms and statistics known as machine learning. Machine learning involves pattern recognition and inference trained by data rather than explicit human instructions. It progressively reduces the role of humans as AI systems expand from supervised learning to unsupervised deep learning neural networks.

A *Technical Preconditions for AI in Finance*

AI has existed since the 1970s. However, five key factors have empowered the rapid evolution of AI in the last decade: data, storage, communication, computing power, and analytics.

The role of data has been transformed by digitisation. Once data are available digitally, datafication — the application of analytics including AI — becomes effective. Thus, the ‘digitisation of everything’, which underpins the idea of the ‘Fourth Industrial Revolution’, is central to the rapid evolution of AI.¹⁷ Larger volumes of data and datafication improve machine learning processes and the ‘training’ of AI systems.

Meanwhile, in line with Kryder’s law, data storage quality and capacity have dramatically increased and costs decreased, resulting in ever-increasing volumes of digitally captured and stored data.¹⁸ The internet, mobile phones and the internet of things make it easier to capture, store, manipulate, and analyse data. Further, many cloud-connected devices effectively provide unlimited data collection and storage capacity.

Computing power has also increased dramatically following Moore’s Law: that the number of transistors on a microchip doubles every two years.¹⁹ If realised, the emergence of quantum computing will open incredible new avenues of processing. Datafication also benefits from the rapid innovations in algorithms and analytical processes.

Ever-falling storage prices including cloud ubiquity, telecommunications linkages, ever-increasing computing power, and innovative algorithmic and analytical development underlie the explosion in datafication processes. This, in turn, fuels AI growth that looks set to continue, to the extent where discussions of the singularity are no longer the realm of science fiction.

¹⁶ In rule-based expert systems, knowledge is represented as a set of rules. For example, IF ‘traffic light’ is ‘green’ THEN the action is go: see Jiri Panyr, ‘Information Retrieval Techniques in Rule-based Expert Systems’ in Hans-Hermann Bock and Peter Ihm (eds), *Classification, Data Analysis, and Knowledge Organization* (Springer, 1991) 196.

¹⁷ Klaus Schwab, ‘The Fourth Industrial Revolution’, *World Economic Forum* (online, 14 January 2016) <<https://www.weforum.org/agenda/2016/01/the-fourth-industrial-revolution-what-it-means-and-how-to-respond/>>.

¹⁸ Chip Walter, ‘Kryder’s Law’ (2005) 293(2) *Scientific American* 32.

¹⁹ Gordon E Moore, ‘Cramming More Components onto Integrated Circuits’ (1965) 38(8) *Electronics* 114.

B *AI in Financial Services*

While financial services have always integrated technical innovation,²⁰ the trend is more pronounced in the latest wave of financial technology (‘fintech’) innovation. Financial services, in particular, is a fertile field for the application of AI.

A major pillar of recent digital financial transformation is the large-scale use of data. Finance has long cultivated the extensive structured collection of many forms of data (for example, stock prices). Such data have been standardised and digitised since the 1970s, with new forms of capture and collection constantly emerging.

Furthermore, AI tends to perform best in rule-constrained environments, such as games like chess or Go, where there are finite ways of achieving specified objectives. In this environment, AI is outperforming humans with increasing rapidity. This is often the environment in finance — for example, stock market investment involves specific objectives (maximising profit), fixed parameters of action (trading rules and systems) and massive amounts of data. Adding technological possibility to the financial and human resources and incentives explains why finance is already transforming so rapidly as a result of digitisation and datafication, and is likely to continue.

The financial resources, human resources and incentives are clear: financial intermediaries generate massive amounts of income for their stakeholders, including management, investors and employees. Accordingly, they attract some of the very best human resources. Those human and financial resources have strong reasons to continually search for advantages and opportunities for profit, and thus invest substantially in research, analytics and technology, to the extent that an entire academic field — finance — focuses on research in the area along with major teams at financial institutions and advisory firms. This makes finance unique from an AI perspective.

Due to ever-improving performance in data gathering, processing, and analytics, AI increasingly affects all operational and internal control matters of financial intermediaries, from strategy setting,²¹ to compliance,²² to risk management and beyond.²³

²⁰ Douglas W Arner, János Barberis and Ross P Buckley, ‘The Evolution of FinTech: A New Post-Crisis Paradigm?’ (2016) 47(4) *Georgetown Journal of International Law* 1271.

²¹ John Armour and Horst Eidenmüller, ‘Self-driving Corporations?’ (2020) 10(1) *Harvard Business Law Review* 87, 96–7.

²² Kenneth A Bamberger, ‘Technologies of Compliance: Risk and Regulation in a Digital Age’ (2010) 88(4) *Texas Law Review* 669, 690–93, 701–2.

²³ Saqib Aziz and Michael Dowling, ‘Machine Learning and AI for Risk Management’, in Theo Lynn, John G Mooney, Pierangelo Rosati and Mark Cummins (eds), *Disrupting Finance: FinTech and Strategy in the 21st Century* (Palgrave, 2019) 33.

C *AI Use Cases*

For that reason, algorithms and AI are frequently used on the front-end or back-end of an increasing range of processes and functions in finance.²⁴ AI use cases span a range of customer processes from on-boarding to instant responses to credit applications,²⁵ and also include operations and risk management,²⁶ trading and portfolio management,²⁷ payments and infrastructure,²⁸ data security and monetisation,²⁹ and regulatory and monetary oversight and compliance.³⁰

Skyrocketing costs of compliance and sanctions have induced financial institutions to focus on back-office AI-solutions, in the form of regulatory technology ('regtech'). Regtech solutions include Amazon Alexa-like voice bots used for compliance queries,³¹ and bots to review commercial loan contracts performing reportedly the equivalent of 360,000 hours of work each year by lawyers and loan officers.³² AI is being applied to equities trade execution for maximum speed at best price,³³ post-trade allocation requests,³⁴ and to calculate policy payouts.³⁵ AI also drives the trend to seek alternative data for investment and lending decisions,³⁶ prompting the mantra 'all data is credit data'.³⁷

²⁴ Hong Kong Monetary Authority and PwC, *Reshaping Banking with Artificial Intelligence* (Report, December 2019) 33; Bank of England and Financial Conduct Authority (n 3) 4.

²⁵ Accenture (n 7) 13, 15, 17.

²⁶ Buchanan (n 1) 2; Financial Stability Board, *Artificial Intelligence and Machine Learning in Financial Services* (Report, November 2017) 16; Oliver Wyman and China Securities Credit Investment Company, *China Credit-tech Market Report: Technology-Driven Value Generation in Credit-Tech* (Report, 2019) 11, 13; Dirk A Zetsche, William A Birdthistle, Douglas W Arner and Ross P Buckley, 'Digital Finance Platforms: Towards A New Regulatory Paradigm' (2020) 23(1) *University of Pennsylvania Journal of Business Law* 273, 298 ('Digital Finance Platforms').

²⁷ Financial Stability Board (n 26) 15; Tom Baker and Benedict Dellaert, 'Regulating Robo Advice across the Financial Services Industry' (2018) 103(2) *Iowa Law Review* 713; Andrei A Kirilenko and Andrew W Lo, 'Moore's Law versus Murphy's Law: Algorithmic Trading and its Discontents' (2013) 27(2) *Journal of Economic Perspectives* 51.

²⁸ Zirkle (n 8).

²⁹ Buchanan (n 1) 2; Financial Stability Board (n 26) 21.

³⁰ Financial Stability Board (n 26) 19–20; Okiriza Wibisono, Hidayah Dhini Ari, Anggraini Widjanarti, Alvin Andhika Zulen and Bruno Tissot, 'The Use of Big Data Analytics and Artificial Intelligence in Central Banking' (IFC Bulletin No 50, May 2019).

³¹ Olivia Oran, 'Credit Suisse has Deployed 20 Robots within Bank, Markets CEO Says', *Reuters* (online, 2 May 2017) <<https://www.reuters.com/article/milken-conference-creditsuisse-idCNL1N1I31PJ>>.

³² Hugh Son, 'JPMorgan Software Does in Seconds What Took Lawyers 360,000 Hours', *Bloomberg* (online, 28 February 2017) <<https://www.bloomberg.com/news/articles/2017-02-28/jpmorgan-marshals-an-army-of-developers-to-automate-high-finance>>.

³³ Laura Noonan, 'JPMorgan Develops Robot to Execute Trades', *Financial Times* (online, 31 July 2017) <<https://www.ft.com/content/16b8ffb6-7161-11e7-aca6-c6bd07df1a3c>>.

³⁴ Martin Arnold and Laura Noonan, 'Robots Enter Investment Banks' Trading Floors', *Financial Times* (online, 7 July 2017) <<https://www.ft.com/content/da7e3ec2-6246-11e7-8814-0ac7eb84e5f1>>.

³⁵ Kevin Lui, 'This Japanese Company is Replacing its Staff with Artificial Intelligence', *Fortune* (online, 6 January 2017) <<https://fortune.com/2017/01/06/japan-artificial-intelligence-insurance-company/>>.

³⁶ Anthony Malakian, 'AI and Alternative Data: A Burgeoning Arms Race', *WatersTechnology* (online, 20 June 2017) <<https://www.waterstechnology.com/trading-tools/3389631/ai-and-alternative-data-a-burgeoning-arms-race/>>; Zetsche et al (n 26).

³⁷ Mikella Hurley and Julius Adebayo, 'Credit Scoring in the Era of Big Data' (2016) 18(1) *Yale Journal of Law and Technology* 148, 151.

AI's potential to process data, seemingly without human bias, is central to its utility. First, AI treats past data with the same precision as more recent data; in contrast, humans tend to overly prioritise more recent data. Second, correctly programmed AI treats all data objectively, while humans tend to discriminate among datapoints based on their experience, values and other non-rational judgements. AI can be unbiased in not following its own agenda or having cognitive biases.³⁸ Yet, the nature of AI creates other risks.

III Risks: AI in Finance

Analysed in terms of traditional financial regulatory objectives,³⁹ major AI-related risks arise in data, financial stability, cybersecurity, law and ethics.⁴⁰ We deal with each in turn.

A Data Risks

Key functions of AI include data collection, data analysis, decision-making and the execution of those decisions.⁴¹ Not all AI technology performs all of these functions, and their use varies across industries and different areas of finance. Nonetheless, the centrality of data to the deployment of any useful AI model cannot be overstated,⁴² and it is therefore necessary to analyse the risks created by data-dependent functions.

1 AI Data Collection and Analysis

Data collection has long been a major bottleneck in machine learning, for two reasons.⁴³ First, data collection is expensive. Second, large providers of data collection and analysis services may be unwilling to share data they have with other providers, which may sell the data or become future competitors of the data originator — one of the problems open banking is designed to address.⁴⁴ Data availability therefore intersects with data privacy and protection.

³⁸ Sergio Gramitto Ricci, 'The Technology and Archeology of Corporate Law', *LawArXiv* (16 August 2018) 37–8 <<https://doi.org/10.31228/osf.io/zcqn7>>.

³⁹ Douglas W Arner, *Financial Stability, Economic Growth and the Role of Law* (Cambridge University Press, 2007).

⁴⁰ The French prudential regulatory authority, Autorité de Contrôle Prudentiel et de Résolution ('ACPR'), identified four similar risk categories, in ACPR, *Artificial Intelligence: Challenges for the Financial Sector* (Report, December 2018).

⁴¹ See Dirk Nicolas Wagner, 'Economic Patterns in a World with Artificial Intelligence' (2020) 17(1) *Evolutionary and Institutional Economics Review* 111.

⁴² Henri Arslanian and Fabrice Fischer, *The Future of Finance: The Impact of FinTech, AI, and Crypto on Financial Services* (Springer, 2019) 167, 177; Accenture Federal Services, *AI: All About the Data* (Report, 2020) 4 <<https://www.accenture.com/us-en/insights/us-federal-government/ai-all-about-data>>.

⁴³ Yuji Roh, Geon Heo and Steven Euijong Whang, 'A Survey on Data Collection for Machine Learning: A Big Data — AI Integration Perspective' (2019) *IEEE Transactions on Knowledge and Data Engineering* 1 <<https://doi.org/10.1109/TKDE.2019.2946162>>.

⁴⁴ Treasury (Cth), *Review into Open Banking: Giving Customers Choice, Convenience and Confidence* (Report, December 2017) <https://treasury.gov.au/sites/default/files/2019-03/Review-into-Open-Banking_-_For-web-1.pdf>.

The availability of highly structured machine-readable data — a major obstacle for AI advancements elsewhere, including healthcare⁴⁵ — has increased the ease of adoption of AI in many areas of financial services.⁴⁶ However, other challenges remain.

First, data quality may be poor. An oft-repeated example is the use of training data by Enron for compliance AI.⁴⁷ From a legal perspective, protected factors come under threat if AI discriminates based on factors, proxies for these factors, or other factors altogether, that describe little more than *a* part of social and financial relations within society. For instance, an algorithm that determines creditworthiness based on consistency of telephone use (rather than complete economic and financial data) may discriminate against members of religions who tend not to use their phones one day per week.⁴⁸ Quality is a pervasive problem.⁴⁹ As both the value of high-quality information and the threats posed by information gaps continue to grow, regulators should focus on the development of widely used and well-designed data standards.⁵⁰

Second, the data may be biased, either from data selection issues (‘dashboard myopia’) or data reflecting biases in society at large.⁵¹ Prejudiced decision-makers may mask their biases by wittingly or unwittingly using biased data.⁵² Biased data could likewise be selected in efforts to enhance an executive’s personal bonus or reduce organisational oversight.⁵³ For this reason, understanding the context of the data — when, where, and how it was generated — is critical to understanding its utility and potential risks.⁵⁴

Of course, bad data will result in bad AI analysis, the age-old adage of ‘garbage in, garbage out’.⁵⁵ Similarly, inappropriately or suboptimally selected AI model architecture and parameters can distort analysis.⁵⁶ For example, in 2019 it was

⁴⁵ Moritz Lehne, Julian Sass, Andrea Essenwanger, Josef Schepers and Sylvia Thun, ‘Why Digital Medicine Depends on Interoperability’ (2019) 2 *npj Digital Medicine* 79:1–5, 1 <<https://www.nature.com/articles/s41746-019-0158-1>>.

⁴⁶ Tapestry Networks and EY, *Data Governance: Securing the Future of Financial Services* (Report, January 2018) 17.

⁴⁷ Luca Enriques and Dirk A Zetzsche, ‘Corporate Technologies and the Tech Nirvana Fallacy’ (2020) 72(1) *Hastings Law Journal* 55, 76.

⁴⁸ Dirk A Zetzsche, Ross P Buckley, Douglas W Arner and János Barberis, ‘From FinTech to TechFin: The Regulatory Challenges of Data-Driven Finance’ (2018) 14(2) *New York University Journal of Law and Business* 393, 417–18.

⁴⁹ See Tadhg Nagle, Thomas C Redman and David Sammon, ‘Only 3% of Companies’ Data Meets Basic Quality Standards’, *Harvard Business Review* (online, 11 September 2017) <<https://hbr.org/2017/09/only-3-of-companies-data-meets-basic-quality-standards>>.

⁵⁰ Richard Berner and Kathryn Judge, ‘The Data Standardization Challenge’ in Douglas W Arner, Emiliós Avgouleas, Danny Busch and Steven L Schwarcz (eds), *Systemic Risk in the Financial Sector: Ten Years after the Great Crash* (McGill-Queen’s University Press, 2019) 135, 148–9.

⁵¹ Lin (n 15) 536–7.

⁵² Solon Barocas and Andrew D Selbst, ‘Big Data’s Disparate Impact’ (2016) 104(3) *California Law Review* 671, 692.

⁵³ Enriques and Zetzsche (n 47) 75–7.

⁵⁴ Lin (n 15) 536.

⁵⁵ Alberto Artasánchez and Prateek Joshi, *Artificial Intelligence with Python* (Packt Publishing, 2nd ed, 2020) 46.

⁵⁶ Deloitte, *AI and Risk Management: Innovating with Confidence* (Report, 2018) 8.

revealed that two parameters in Deutsche Bank's anti-financial crime systems (in effect since 2010) were defined incorrectly, potentially allowing suspicious transactions to avoid detection.⁵⁷ Such deficiencies may expose financial services organisations to competitive harm, legal liability, or reputational damage.⁵⁸

Finally, the process of cleaning data is typically very demanding in terms of human resources.⁵⁹

2 *AI Decision-Making and the Execution of Decisions*

AI systems may perform similar calculations simultaneously, and one AI's decisions may influence the tasks performed by another. 'Herdning' results when actors make use of similar models to interpret signals from the market.⁶⁰ Algorithms trading simultaneously in millisecond trading windows have caused extreme volatility events, referred to as 'flash crashes', when unexpected situations arise.⁶¹ This has resulted in worldwide regulatory efforts that address algorithmic trading.⁶²

Similar problems can arise with robo-advisors, where one AI may front-run another AI's recommendation. While risk management tools such as price limits and stop loss-commands (themselves algorithms) can mitigate some of the risks, these tools are costly and do not address all risks generated by multiple AI performing similar tasks.

The alternative to uncoordinated behaviour is more frightening: tacit collusion. If several self-learning algorithms discover that cooperation in capital markets is more profitable than competition, they could cooperate and manipulate information and prices to their own advantage. There is evidence for self-learning AI colluding in price setting.⁶³ Multiple AI colluding in financial markets pricing is likely.

⁵⁷ Olaf Storbeck, 'Deutsche Bank Glitch Blocked Reporting of Suspicious Transactions', *Financial Times* (online, 22 May 2019) <<https://www.ft.com/content/d537f416-7c71-11e9-81d2-f785092ab560>>.

⁵⁸ Fernanda Torre, Robin Teigland and Liselotte Engstam, 'AI Leadership and the Future of Corporate Governance: Changing Demands for Board Competence' in Anthony Larsson and Robin Teigland (eds) *The Digital Transformation of Labor: Automation, the Gig Economy and Welfare* (Routledge, 2020) 116, 127.

⁵⁹ Thomas C Redman, 'If Your Data Is Bad, Your Machine Learning Tools Are Useless', *Harvard Business Review* (online, 2 April 2018) <<https://hbr.org/2018/04/if-your-data-is-bad-your-machine-learning-tools-are-useless>>.

⁶⁰ World Economic Forum, *Navigating Uncharted Waters: A Roadmap to Responsible Innovation with AI in Financial Services* (Report, 23 October 2019) 62.

⁶¹ Buchanan (n 1) 6.

⁶² Kirilenko and Lo (n 27) 53–5.

⁶³ Ariel Ezrachi and Maurice E Stucke, 'Artificial Intelligence and Collusion: When Computers Inhibit Competition' [2017] (5) *University of Illinois Law Review* 1775.

B *Financial Stability Risks*

In 2017, the Financial Stability Board analysed and summarised a broad range of possible financial stability implications of AI and machine learning.⁶⁴ The Board noted their substantial promise, contingent upon proper risk management. Its report stressed that oligopolistic or monopolistic players may surface as a result of additional third-party dependencies caused by ‘network effects and scalability of new technologies’.⁶⁵ Some of these new market participants are currently unregulated and unsupervised.⁶⁶ These third-party dependencies and interconnections could have systemic effects.⁶⁷ Further, the lack of interpretability or ‘auditability’ of AI and machine learning methods has the potential to contribute to macroeconomic risk unless regulators find ways to supervise the AI.⁶⁸ This is particularly challenging because of the opacity of models generated by AI or machine learning,⁶⁹ and AI-related expertise beyond those developing the AI is limited, in the private sector and among regulators.⁷⁰

C *Cybersecurity*

AI could be used to attack, manipulate, or otherwise harm an economy and threaten national security either directly through its financial system and/or by effecting the wider economy.⁷¹ Algorithms could be manipulated to undermine economies to create unrest, or to send wrong signals to trading units to seek to trigger a systemic crisis.⁷² The cybersecurity dimension is more serious as many financial services firms rely on a small group of technology providers, creating a new form of risk we term ‘techrisk’.⁷³ That many AI-enabled systems have not been tested in financial crisis scenarios further amplifies this risk.⁷⁴

Important ways to address cybersecurity include:

- (a) investing in cybersecurity resources, including in-house expertise and training of employees;

⁶⁴ Financial Stability Board (n 26). The Board is ‘an international body that monitors and makes recommendations about the global financial system’: ‘About the FSB’, *Financial Stability Board (FSB)* (Web Page) <<https://www.fsb.org/about/>>.

⁶⁵ Ibid 33–4.

⁶⁶ European Banking Federation (‘EBF’), *EBF Position Paper on AI in the Banking Industry* (Report EBF_037419, 1 July 2019) 26.

⁶⁷ Lin (n 15) 544.

⁶⁸ Financial Stability Board (n 26) 33.

⁶⁹ Ibid 33–4.

⁷⁰ Ibid.

⁷¹ Lin (n 15) 538–9.

⁷² Ross P Buckley, Douglas W Arner, Dirk A Zetsche and Eriks Selga, ‘TechRisk’ [2020] (1) *Singapore Journal of Legal Studies* 35, 43–4.

⁷³ Douglas W Arner, Ross P Buckley, and Dirk A Zetsche, ‘Fintech, Regtech and Systemic Risk: The Rise of Global Technology Risk’ in Douglas W Arner, Emiliós Avgouleas, Danny Busch and Steven L Schwarcz (eds), *Systemic Risk in the Financial Sector: Ten Years after the Great Crash* (McGill-Queen’s University Press, 2019) 69.

⁷⁴ Buchanan (n 1) 29.

- (b) having protocols in place to cooperate swiftly with other financial intermediaries, to ensure fast detection of, and responses to, these attacks, with or without involvement of regulators; and
- (c) building national and international systems for sharing information as well as contingency and defence planning.⁷⁵

D Legal Risks

One acronym often used to describe AI and machine learning governance considerations is ‘FAT’, meaning ‘fairness, accountability and transparency’.⁷⁶

In relation to accountability for the use of AI, many scholars and practitioners start with an analysis of how existing liability regimes, such as product liability, tort and vicarious liability, may be used to address the legal risks and liability.⁷⁷ The foundational concepts of those regimes, like causation and damages, are not easily applied to AI and its corporate and individual creators.⁷⁸

Since the 2008 Global Financial Crisis, the legal and regulatory compliance of many financial institutions around the world has been found wanting. Boston Consulting Group reported that as of 2019, financial institutions, including 50 of the largest European and North American banks, had paid US\$381 billion in cumulative financial penalties since the GFC.⁷⁹

Regtech is increasingly seen as a way to address legal and regulatory requirements, and many solution providers are using AI and machine learning in areas such as on-boarding, anti-money laundering and fraud detection. Yet, some of

⁷⁵ Buckley et al (n 72) 61–2.

⁷⁶ FAT-ML conferences have been held by Princeton University since 2014: FAT / ML, *Fairness, Accountability, and Transparency in Machine Learning* (Web Page) <<https://www.fatml.org/>>. However, some other acronyms have emerged, such as the FEAT principles (adding ‘ethics’) of the Monetary Authority of Singapore (‘MAS’): see Monetary Authority of Singapore, ‘MAS Introduces New FEAT Principles to Promote Responsible Use of AI and Data Analytics’ (Media Release, 12 November 2018): <<https://www.mas.gov.sg/news/media-releases/2018/mas-introduces-new-feat-principles-to-promote-responsible-use-of-ai-and-data-analytics>>.

⁷⁷ See Greg Swanson, ‘Non-Autonomous Artificial Intelligence Programs and Products Liability: How New AI Products Challenge Existing Liability Models and Pose New Financial Burdens’ (2019) 42(3) *Seattle University Law Review* 1201; Iria Giuffrida, ‘Liability for AI Decision-Making: Some Legal and Ethical Considerations’ (2019) 88(2) *Fordham Law Review* 439; Andrea Bertolini, *Artificial Intelligence and Civil Liability* (European Parliament, Policy Department for Citizens’ Rights and Constitutional Affairs, Directorate-General for Internal Policies, PE 621.926, July 2020) <[https://www.europarl.europa.eu/RegData/etudes/STUD/2020/621926/IPOL_STU\(2020\)621926_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2020/621926/IPOL_STU(2020)621926_EN.pdf)>; Brian W Tang, ‘Forging a Responsibility and Liability Framework in the AI Era for RegTech’ in János Barberis, Douglas W Arner and Ross P Buckley (eds), *The REGTECH Book: The Financial Technology Handbook for Investors, Entrepreneurs and Visionaries in Regulation* (Wiley, 2019) 235.

⁷⁸ See, eg, European Commission Report from the Expert Group on Liability and New Technologies – New Technologies Formation, *Liability for Artificial Intelligence and Other Emerging Digital Technologies* (2019) <<https://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupMeetingDoc&docid=36608>>.

⁷⁹ Boston Consulting Group, *Global Risk 2020: It’s Time for Banks to Self-Disrupt* (April 2020) 20 <https://image-src.bcg.com/Images/BCG-Global-Risk-2020-It%E2%80%99s-Time-for-Banks-to-Self-Disrupt-Apr-2020_tcm9-243862.pdf>.

the largest recent bank fines have arisen from legal risks related to the use of technology. For example, in 2020 the Federal Court of Australia confirmed the largest civil penalty in Australian history; namely, Westpac's fine of A\$1.3 billion by the Australian Transaction Reports and Analysis Centre. The penalty was largely attributed to systemic risk management failures including those related to several programming 'glitches' leading to 23 million breaches of financial crime laws over five years for not reporting suspicious bank transfers (such as customers paying for child exploitation abroad), and failure to retain back-up files.⁸⁰ The result of such large-scale regtech failures has been increasing attention from regulators in terms of the adequacy of technology systems in financial institutions, with a leading example being a 2020 action against Citigroup that resulted in a US\$400 million fine by the United States ('US') Office of the Comptroller of the Currency and a direction to Citigroup to improve its internal technological systems.⁸¹

As more financial institutions, fintechs and crypto-asset service providers incorporate AI into their systems, including their regtech infrastructure, the legal risks for such regulated entities may well increase.

E *Ethics and Financial Services*

Ethics in finance are crucial. Ethical issues became prominent following the 2008 Global Financial Crisis and have received continued attention due to subsequent scandals, including those relating to the London InterBank Offered Rate ('LIBOR'),⁸² foreign exchange⁸³ and most recently the entire Australian financial system.⁸⁴ Some financial services ethical questions will likely be addressed by future regulatory or self-regulatory efforts that fall into three areas: (1) AI as non-ethical actor; (2) AI's influence on humans; and (3) artificial stupidity and maleficence.

⁸⁰ *Chief Executive Officer of the Australian Transaction Reports and Analysis Centre v Westpac Banking Corporation* [2020] FCA 1538. See also Brian Monroe, 'After Months of Court Battles, Westpac Settles with Austrac, Agrees to pay \$1.3 billion for Millions of AML Failings, Ties to Child Exploitation Network', *Association of Financial Crime Specialists* (Web Page, 6 October 2020) <<https://www.afcs.org/after-months-of-court-battles-westpac-settles-with-austrac-agrees-to-pay-1-3-billion-for-millions-of-aml-failings-ties-to-child-exploitation-network/>>; Charlotte Grieve, 'The Westpac Scandal: How Did It Happen?', *The Sydney Morning Herald* (online, 9 December 2019) <<https://www.smh.com.au/business/banking-and-finance/the-westpac-scandal-how-did-it-happen-20191206-p53ho2.html>>; James Evers, 'How a Software Bug Triggered Westpac's Woes', *Australian Financial Review* (online, 21 November 2019) <<https://www.afr.com/companies/financial-services/how-a-software-bug-triggered-westpac-s-woes-20191121-p53csx>>.

⁸¹ Jesse Hamilton and Jennifer Surnane, 'Citigroup Pays \$400 Million Penalty, Must Get U.S. Approval on Deals', *Bloomberg* (online, 4 October 2020) <<https://www.bloomberg.com/news/articles/2020-10-07/citigroup-pays-400-million-must-get-u-s-approval-on-deals?sref=IP8hg7Cm>>.

⁸² See HM Treasury, *The Wheatley Review of LIBOR* (Final Report, September 2012) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf>.

⁸³ Byron Kaye, 'FX Collusion Scandal Reaches Australia, Class Action Launched', *Reuters* (online, 27 May 2019) <<https://www.reuters.com/article/us-australia-banks-idUSKCN1SX06V>>.

⁸⁴ *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Final Report, February 2019) ('*Banking Royal Commission Final Report*').

1 *AI as Non-Ethical Actor*

Algorithms per se neither ‘feel’ nor have ‘values’. Training machines in values is difficult, since humans often lack insights into the human psyche: that is, people often cannot tell why they act as they do.⁸⁵ While some ethical concerns, such as banning interest under Shariah law, can be codified in ways that suit algorithms, drivers for most human actions are more subtle and contextual, and subject to change with circumstances.

AI’s lack of ethical foundations could seriously harm portfolio values of financial assets if, as is likely, the AI misprices reputational risk. For instance, Microsoft’s AI bot, Tay, designed and deployed to engage in casual online conversation with users, learned from the interactions and exhibited severely anti-Semitic and misogynistic behaviour within 16 hours due to user mischief.⁸⁶ A broader deployment would have been even more devastating. Volkswagen’s severe ethical shortcomings in using technology to evade regulatory requirements were all too human, but software controlling engine performance in test situations could foreseeably be programmed by AI in the future,⁸⁷ including in a way that optimises cost savings over regulatory compliance.

This risk is intensified by access to vast data about individual human users. The more data an AI has about a certain person, the greater the risk the AI may nudge the person into buying an unsuitable financial product or profile the person for credit determinations. The advent and rise of unsupervised learning, generative adversarial networks that generate their own data and powerful autoregressive language models, such as Generative Pre-trained Transformer 3, increase the potential impact of AI that operates with limited human intervention. While unethical conduct can be mitigated by more diverse and broadly trained technical teams programming the AI, the core issue remains that the code itself is a non-ethical actor that does not necessarily constantly review, revise and reflect on its performance as we hope humans do.⁸⁸ AI needs human monitoring and guidance for ethical decision-making: humans in the loop are essential so that a human or group of humans is responsible for the actions of AI.

2 *AI’s Influence on Humans*

AI can enhance or diminish human capacity. AI as augmented intelligence could turn an unskilled person into a skilled investor, via recommendations. The same applies to human decision-making errors revealed in behavioural finance: for example, AI could be programmed to address certain human biases (such as

⁸⁵ Enriques and Zetsche (n 47) 78.

⁸⁶ Elle Hunt, ‘Tay, Microsoft’s AI Chatbot, Gets a Crash Course in Racism from Twitter’, *The Guardian* (online, 24 March 2016) <<https://www.theguardian.com/technology/2016/mar/24/tay-microsofts-ai-chatbot-gets-a-crash-course-in-racism-from-twitter>>.

⁸⁷ Capgemini Research Institute, *Accelerating Automotive’s AI Transformation: How Driving AI Enterprise-wide Can Turbo-charge Organizational Value* (Report, March 2019) 17–18.

⁸⁸ Lin (n 15) 537–8.

confirmation bias, optimism bias and negativity bias) when making investment decisions.⁸⁹

Conversely, AI could decrease human capacity. As the need to develop advanced maths and other sophisticated data analytical capacities decreases with appropriate programmes being widely available, humans' data analytic capacities may atrophy. This is supported by the WEF's suggestion that increasing reliance on AI in the future could lead to the erosion of 'human financial talent' as humans lose the skills required to challenge AI-enabled systems or to respond well to crises.⁹⁰ Accordingly, while coaching AI could be used to enhance financial and technological literacy of staff and investors, resulting in better resource allocation, exploitative AI could ask or nudge clients to invest in overpriced financial products that benefit only the product originator.

Research into how humans respond to computer-generated incentives is ongoing and hints at serious risks.⁹¹ Humans respond to certain communications with an enhanced degree of trust. As AI becomes more pervasive in its interaction with users, disclosed or otherwise, it may implicitly generate an increasing level of trust. AI developers thus bear a high level of responsibility and there is a strong need for ethical restrictions through rules and internal controls of financial institutions and their management.

3 *Artificial Stupidity and Maleficence*

Protection against AI mistakes and unethical behaviour is a major concern. Errors and unethical behaviour can arise from poor or criminally motivated programming, or from inadequate datasets, or correlations with other events resulting in harmful unforeseen consequences. Another important example could arise if certain conduct results in liability for which consumers sue far more than institutional clients, as an algorithm could decide to avoid consumer relationships, thereby financially excluding them.

F *Risk Typology: Framework of Analysis*

The risks of AI in finance fall into three major categories: (1) information asymmetry; (2) data dependency; and (3) interdependency.⁹²

First, AI enhances information asymmetry about the functions and limits of certain algorithms. Third-party vendors often understand the algorithms far better

⁸⁹ Chau Duong, Gioia Pescetto and Daniel Santamaria, 'How Value-Glamour Investors Use Financial Information: UK Evidence of Investors' Confirmation Bias' (2014) 20(6) *The European Journal of Finance* 524.

⁹⁰ World Economic Forum (n 60) 69–71.

⁹¹ See Andrea Ferrario, Michele Loi and Eleonora Viganò, 'In AI We Trust Incrementally: A Multi-layer Model of Trust to Analyze Human-Artificial Intelligence Interactions' (2020) 33(3) *Philosophy & Technology* 523; Omri Gillath, Ting Ai, Michael S Branicky, Shawn Keshmiri, Robert B Davison and Ryan Spaulding, 'Attachment and Trust in Artificial Intelligence' (2021) 115 *Computers in Human Behavior* 106607 <<https://doi.org/10.1016/j.chb.2020.106607>>.

⁹² Enriques and Zetzsche (n 47) 75–90.

than the financial institutions that buy and use them and their supervisors. However, for proprietary and competitive reasons, technology vendors traditionally fail to fully explain how their creations work. Increased transparency through explainability and interpretability needs to be demanded by users, financial institutions and regulators alike.

Second, AI enhances data dependency as data sources are critical for its operation. The effects and potentially discriminatory impact of AI may change with a different data pool.

Third, AI enhances interdependency. AI can interact with other AI with unexpected consequences, enhancing or diminishing its operations in finance.⁹³

The law will need to address the risks of AI by preventive regulation and corrective liability allocation. Given the rapid developments in AI, drafting and enforcing these rules is a serious challenge. Rather than the much-discussed private law dimension and liability allocation,⁹⁴ we focus on regulatory tools in Parts IV–V below.

IV Regulating AI in Finance: Challenges for External Governance

As we have pointed out above (Part I), the use of AI in finance has become a focus of regulatory attention. We summarise general frameworks proposed by regulators (including data protection and privacy), before turning to financial regulators' approaches to AI. We then argue that traditional regulatory approaches to financial supervision, such as external governance frameworks, are not likely to be effective in this context and, instead, external governance must require internal governance, in particular personal responsibility.

A General AI Frameworks

General frameworks addressing degrees of human responsibility in developing and dealing with AI, are evolving worldwide.

1 *AI Principles*

The first development in what was to be a remarkable flurry of activity in this space was the UK House of Lords Select Committee on Artificial Intelligence defining five general principles of AI development and treatment in late 2017.⁹⁵

The most influential of all the subsequent initiatives occurred in May 2019, with the adoption of the Organisation for Economic Co-operation and Development ('OECD') AI Recommendation and its five principles:

⁹³ Lin (n 15) 542.

⁹⁴ Mark A Lemley and Bryan Casey, 'Remedies for Robots' (2019) 86(5) *University of Chicago Law Review* 1311, 1313. See also above n 77.

⁹⁵ Select Committee on Artificial Intelligence, *AI in the UK: Ready, Willing and Able?* (House of Lords Paper No 100, Session 2017–19) 125 [417].

- (i) AI must be beneficial for people and the planet;
- (ii) AI system design must comply with general legal principles such as the rule of law;
- (iii) AI systems must be transparent and explainable;
- (iv) AI systems should be robust, secure and safe; and
- (v) all AI actors (including system developers) must be accountable for compliance with these principles.⁹⁶

Drawing on the OECD AI Recommendation, the G20 endorsed the G20 AI Principles in June 2019.⁹⁷ In September 2019, endorsing the OECD AI Recommendation, the US Chamber of Commerce released ‘Principles on Artificial Intelligence’, calling for US businesses to abide by these standards.⁹⁸

In November 2019, the Australian Government Department for Industry, Innovation and Science announced the *AI Ethics Framework*, based on eight key principles: human, social and environmental wellbeing; human-centred values; fairness; privacy protection; reliability and safety; transparency and explainability; contestability; and accountability.⁹⁹

In China, the Beijing Academy of Artificial Intelligence released its AI Principles in May 2019¹⁰⁰ and the Ministry of Science and Technology National New Generation Artificial Intelligence Governance Expert Committee published its Governance Principles for a New Generation of AI in June 2019.¹⁰¹

Numerous parallel AI ethics initiatives were also generated by the private sector and by many researchers.¹⁰²

2 *Data Protection and Privacy*

Data protection and privacy commissioners have increasingly viewed the governance of AI as within their purview. For instance, the 40th International Conference of Data Protection and Privacy Commissioners in 2018 endorsed six guiding principles as core values to preserve human rights in the development of AI:

⁹⁶ Organisation for Economic Co-operation and Development (‘OECD’), *Recommendation of the Council on Artificial Intelligence* (OECD/LEGAL/0449, 22 May 2019) paras 1.1–1.5 <<https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0449>> (‘OECD AI Recommendation’).

⁹⁷ G20, ‘G20 AI Principles’ in annex to *G20 Ministerial Statement on Trade and Digital Economy* (8–9 June 2019) <<https://www.g20-insights.org/wp-content/uploads/2019/07/G20-Japan-AI-Principles.pdf>>.

⁹⁸ US Chamber of Commerce, ‘US Chamber of Commerce Principles on Artificial Intelligence’ (Press Release, 23 September 2019).

⁹⁹ Department of Industry, Science, Energy and Resources (Cth), ‘AI Ethics Principles’ (Web Page) <<https://www.industry.gov.au/data-and-publications/building-australias-artificial-intelligence-capability/ai-ethics-framework/ai-ethics-principles>>.

¹⁰⁰ Beijing Academy of Artificial Intelligence, ‘Beijing AI Principles’ (Web Page, 28 May 2019) <<https://www.baai.ac.cn/news/beijing-ai-principles-en.html>>.

¹⁰¹ Ministry of Science and Technology National New Generation Artificial Intelligence Governance Expert Committee, *Governance Principles for a New Generation of Artificial Intelligence: Develop Responsible Artificial Intelligence* (Report, 17 June 2019).

¹⁰² See, eg IEEE, *Ethically Aligned Design: A Vision for Prioritizing Human Well-being with Autonomous and Intelligent Systems, Version II* (Report, 2018); Future of Life Institute, ‘Asilomar AI Principles’ (Web Page, 2017) <<https://futureoflife.org/ai-principles/?cn-reloaded=1>>.

- (1) Fairness;
- (2) Continued attention, vigilance, and accountability;
- (3) AI system transparency and intelligibility;
- (4) AI system responsible development and design by applying the principles of privacy by default and privacy by design;
- (5) Empowerment of individuals; and
- (6) Reduction and mitigation of unlawful biases/discrimination arising from AI data use.¹⁰³

The Conference called for AI common governance principles and a permanent working group on Ethics and Data Protection in AI.¹⁰⁴

Article 22 of the *European General Data Protection Regulation* ('GDPR')¹⁰⁵ also requires ethical AI performance.¹⁰⁶ Entitled 'Automated individual decision-making, including profiling', art 22(1) states that a data subject has 'the right to not be subject to a decision based solely on automated processing, including profiling, which produces legal effects'. Caveats apply under art 22(2) if the decision 'is necessary for the entering into, or performance of, a contract between the data subject and the data controller', or in other specific cases. It has been argued that the data subject has the right to insist on human intervention in purely AI-driven decisions, and to contest the decision,¹⁰⁷ although any 'right to explanation' under the *GDPR* has been found wanting.¹⁰⁸ At the same time, the UK Information Commissioner's Office has issued guidance on AI and data protection, and has conducted a public consultation on an auditing framework for AI.¹⁰⁹

B Financial Regulation and AI

Globally, regulators have started considering how AI impacts financial services and to issue regulatory guidance.

In 2016, the European Supervisory Authorities ('ESAs') (European Banking Authority, European Securities and Markets Authority and European Insurance and

¹⁰³ 40th International Conference of Data Protection and Privacy Commissioners, *Declaration on Ethics and Data Protection in Artificial Intelligence* (23 October 2018) 3–6 <http://globalprivacyassembly.org/wp-content/uploads/2019/04/20180922_ICDPPC-40th_AI-Declaration_ADOPTED.pdf>.

¹⁰⁴ Ibid 5–6.

¹⁰⁵ *Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation)* [2016] OJ L 119/1 ('GDPR').

¹⁰⁶ Jimmie Franklin, 'GDPR Has Kept AI Ethical, Despite Concerns', *International Financial Law Review* (online, 2 October 2019) <<https://www.iflr.com/Article/3896942/GDPR-has-kept-AI-ethical-despite-concerns.html>>.

¹⁰⁷ Paul Voigt and Axel von dem Bussche, *The EU General Data Protection Regulation (GDPR): A Practical Guide* (Springer, 2017) 180–2.

¹⁰⁸ Sandra Wachter, Brent Mittelstadt and Luciano Floridi, 'Why a Right to Explanation of Automated Decision-Making Does Not Exist in the *General Data Protection Regulation*' (2017) 7(2) *International Data Privacy Law* 76.

¹⁰⁹ Information Commissioner's Office (UK), *Guidance on AI and Data Protection* (30 July 2020); Information Commissioner's Office (UK), *Guidance on the AI Auditing Framework: Draft Guidance for Consultation* (14 February 2020).

Occupational Pensions Authority) published a discussion paper on Big Data risks for the financial sector, which included discussion on AI.¹¹⁰

The 2018 *ESAs Joint Committee Final Report on Big Data* found that Big Data risks are best addressed by existing legislation on data protection, cybersecurity and consumer protection, even though such legislation may not have been written specifically to address Big Data risks.¹¹¹ This legislation includes: the *GDPR*,¹¹² the second *Payment Services Directive* ('*PSD2*');¹¹³ the second *Markets in Financial Instruments Directive* ('*MiFID II*');¹¹⁴ and the *Insurance Distribution Directive* ('*IDD*').¹¹⁵

The ESAs' organisational and prudential requirements involve sound internal control mechanisms, market activity monitoring, record-keeping, and management of conflicts of interest.¹¹⁶ The requirements emphasise business principles such as: acting honestly, fairly and professionally; refraining from misleading conduct; ensuring products suit the needs of clients; and establishing fair claims/complaints handling processes.¹¹⁷ Further, to ensure fair and transparent consumer treatment, the ESAs encourage Big Data good practices, such as regularly monitored robust processes, transparent consumer compensation mechanisms, and compliance with the *GDPR*.¹¹⁸

Other financial regulators are likewise increasingly engaging with AI. These include (in chronological order):

¹¹⁰ Joint Committee of the European Supervisory Authorities, *Discussion Paper on the Use of Big Data by Financial Institutions* (Discussion Paper No JC/2016/86, 19 December 2016).

¹¹¹ *ESAs Joint Committee Final Report on Big Data* (n 2) 23.

¹¹² *GDPR* (n 105).

¹¹³ *Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on Payment Services in the Internal Market* [2015] OJ L 337/35 ('*PSD2*').

¹¹⁴ *Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments* [2020] OJ L 173/349 ('*MiFID II*').

¹¹⁵ *Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on Insurance Distribution* [2020] OJ L 26/19 ('*IDD*').

¹¹⁶ *MiFID II* (n 114) arts 17, 23; *Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms* [2018] OJ L 176/338, art 79 ('*CRD IV*'); *IDD* (n 115) arts 17, 27–8; *Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on Credit Agreements for Consumers relating to Residential Immovable Property* [2018] OJ L 60/34 art 7 ('*MCD*').

¹¹⁷ *MiFID II* (n 114) arts 16, 24; *IDD* (n 115) arts 14, 17(1), 25; *MCD* (n 116) art 7(1); *AIFMD* art 12; *Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities* [2020] OJ L 302/32, arts 13–14; *PSD2* arts 19(6), 101; *Delegated Regulation (EU) 2017/565 of 25 April 2016 Supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards Organisational Requirements and Operating Conditions for Investment Firms and Defined Terms for the Purposes of that Directive* [2019] OJ L 87/1, art 26.

¹¹⁸ *ESAs Joint Committee Final Report on Big Data* (n 2) 24.

- The Monetary Authority of Singapore introduced the new Fairness, Ethics, Accountability and Transparency ('FEAT') Principles to promote responsible use of AI and data analytics in November 2018.¹¹⁹
- De Nederlandsche Bank issued a discussion paper on principles for responsible use of AI, namely soundness, accountability, fairness, ethics, skills and transparency (or 'SAFEST') in July 2019.¹²⁰
- The Bank of England and the Financial Conduct Authority ('FCA') published a survey entitled *Machine Learning in UK Financial Services* in October 2019.¹²¹
- The Hong Kong Monetary Authority issued its twelve 'High-level Principles on Artificial Intelligence' in November 2019.¹²²

Singapore's FEAT Principles were updated in February 2019 and again in January 2020 to reflect Singapore's Personal Data Protection Commission's Proposed AI Governance Framework, which has two guiding principles: (i) that organisations must ensure that decision-making using AI is explainable, transparent and fair, and (ii) that AI solutions should be human-centric.¹²³ This Framework provides guidance in the following areas:

- (1) Internal governance structures and measures;
- (2) Appropriate AI decision-making models, including determining acceptable risk appetite and circumstances for human-in-the-loop, human-over-the-loop and human-out-of-the-loop approaches;
- (3) Operations management, including good data accountability practices and minimising inherent bias; and
- (4) Customer relationship management, including disclosure, transparency, and explainability.¹²⁴

In November 2019, the Monetary Authority of Singapore announced the creation of the Veritas framework to promote the responsible adoption of AI and data analytics by financial institutions using open source tools as a verifiable way for financial institutions to incorporate the FEAT Principles.¹²⁵ The first phase of Veritas initiative, involving an expanded consortium membership of 25, focused on the development of fairness metrics in customer marketing and credit risk scoring.¹²⁶

¹¹⁹ Monetary Authority of Singapore, *Principles to Promote Fairness, Ethics, Accountability and Transparency (FEAT) in the Use of Artificial Intelligence and Data Analytics in Singapore's Financial Sector* (Report, November 2018).

¹²⁰ De Nederlandsche Bank, *General Principles for Use of Artificial Intelligence in Finance* (Discussion Paper, 25 July 2019).

¹²¹ Bank of England and Financial Conduct Authority (n 3).

¹²² Hong Kong Monetary Authority, 'High-Level Principles on Artificial Intelligence' (Media Release, 1 November 2019).

¹²³ Singapore Personal Data Protection Commission, *A Proposed Artificial Intelligence Governance Model* (Report, January 2019); Singapore Info-Communications Media Development Authority and Personal Data Protection Commission, *Model Artificial Intelligence Governance Framework: Second Edition* (January 2020).

¹²⁴ Singapore Info-Communications Media Development Authority and Personal Data Protection Commission (n 123) 20–63.

¹²⁵ Monetary Authority of Singapore, 'MAS Partners Financial Industry to Create Framework for Responsible Use of AI' (Media Release, 13 November 2019).

¹²⁶ Monetary Authority of Singapore, "'Fairness Metrics' to Aid Responsible AI Adoption in Financial Services' (Media Release, 28 May 2020).

The initiative is now in the second phase, which will develop the ethics, accountability and transparency assessment methodology for the two phase one use cases, plus insurance industry use cases.¹²⁷

Similarly, the Hong Kong Monetary Authority encouraged authorised institutions in May 2019¹²⁸ to adopt and implement the Hong Kong Privacy Commissioner Ethical Accountability Framework,¹²⁹ and 2018 Data Stewardship Accountability, Data Impact Assessments and Oversight Models.¹³⁰ This was followed by the Hong Kong Monetary Authority's November 2019 High-Level Principles on AI.¹³¹ Specifically, the Principles reinforce that banks should:

- possess sufficient expertise;
- ensure explainability of AI applications;
- use data of good quality;
- conduct rigorous model validation;
- ensure auditability of AI applications;
- implement effective management oversight of third-party vendors;
- be ethical, fair and transparent;
- conduct periodic reviews and ongoing monitoring;
- comply with data protection requirements;
- implement effective cybersecurity measures; and
- implement risk mitigation and contingency plans.

The Hong Kong Monetary Authority's Banking Conduct Department also issued Guiding Principles on Consumer Protection in respect of Use of Big Data Analytics and AI by Authorised Institutions.¹³² Reinforcing a risk-based approach to Big Data analytics and AI, the principles focus on governance/accountability, fairness, transparency/disclosure, and data privacy and protection.

C *The Inadequacy of External Governance*

Financial supervisory authorities find it increasingly difficult to tackle AI-related risks through traditional means of financial supervision, that is: external governance.

We draw on five examples to support our thesis on the inadequacy of external governance regimes in addressing the risks of AI in finance: (1) the authorisation of AI; (2) the outsourcing of rules and e-personhood; (3) the role of AI with regard to key functions; (4) the qualifications of core personnel; and (5) sanctioning rules.

¹²⁷ Monetary Authority of Singapore, 'Veritas Initiative Addresses Implementation Challenges in the Responsible Use of Artificial Intelligence and Data Analytics' (Media Release, 6 January 2021).

¹²⁸ Hong Kong Monetary Authority, 'Use of Personal Data in Fintech Development' (Media Release, 3 May 2019).

¹²⁹ Information Accountability Foundation and Hong Kong Privacy Commissioner for Personal Data, *Ethical Accountability Framework for Hong Kong China* (Report, October 2018).

¹³⁰ Information Accountability Foundation and Hong Kong Privacy Commissioner for Personal Data, *Data Stewardship Accountability, Data Impact Assessments and Oversight Models: Detailed Support for an Ethical Accountability Framework* (Report, October 2018).

¹³¹ Hong Kong Monetary Authority (n 122).

¹³² Hong Kong Monetary Authority, 'Consumer Protection in Respect of Use of Big Data Analytics and Artificial Intelligence by Authorized Institutions' (Media Release, 5 November 2019).

1 *The Authorisation of AI*

Enhanced AI use influences the conditions for authorisation. If a business model seeking authorisation relies on AI, the business and operations plan must detail the functioning of the AI, the client protection features, the regulatory capital assigned to financial and operational risks for the AI-performed services, and the back-up structure in case the AI fails. Regulatory frameworks across the globe already require IT contingency plans and multiple data storage and cybersecurity strategies. These regulatory approaches are unlikely to change fundamentally, but will become even more important in practice.

One potential response to AI-based threats is a licensing requirement for AI used by financial institutions.¹³³ A mandatory AI insurance scheme is another.

Financial services authorities worldwide are increasingly seeking to upskill and introduce technology to perform meaningful reviews of AI.¹³⁴ To our knowledge, software to monitor a self-learning AI's conduct does not yet exist. Moreover, outcome-based testing depends on the data pools available for testing; if the test pools differ from the real-use case data pools, the results of testing may be of little value.

AI authorisation may also have several undesirable side-effects. The most important is that it may limit innovation given authorisation is costly and slow. Rules would also struggle to cope with the (often, almost daily) minor amendments and improvements to AI programmes. Re-authorisation of the code is expensive, meaning minor improvements, or a series of minor improvements together representing a major step, of existing AI may be uneconomic. Finally, for unsupervised self-learning AI, the authorised code will not be performing in practice, as by definition such self-learning AI develops while performing its services. Thus, authorisations will always be outdated.¹³⁵ Regulatory sandboxes provide a risk-controlled environment where regulatory restrictions are relaxed to foster innovation. While in some settings, sandboxes may support innovation and effective regulation,¹³⁶ assessment of performance under sandbox conditions remains a relatively poor substitute for performance under real world conditions.¹³⁷

2 *Regulatory Outsourcing of Rules and e-Personhood*

In regulatory rulebooks worldwide, crucial supplier frameworks apply for AI owned and operated by, or outsourced to, a separate services provider. The crucial supplier is subject to additional monitoring by the outsourcing financial institution. However, financial services AI may increasingly be owned and operated in-house by the

¹³³ Andrew Tutt, 'An FDA for Algorithms' (2017) 69(1) *Administrative Law Review* 83, 111.

¹³⁴ See Dirk Broeders and Jermy Prenio, Financial Stability Institute ('FSI'), *Innovative Technology in Financial Supervision (Suptech) — The Experience of Early Users* (FSI Insights on Policy Implementation No 9, July 2018); Toronto Centre, *FinTech, RegTech and SupTech: What They Mean for Financial Supervision* (Report, August 2017).

¹³⁵ Enriques and Zetzsche (n 47).

¹³⁶ World Economic Forum (n 60).

¹³⁷ Enriques and Zetzsche (n 47).

financial intermediary's own staff. This raises questions around the adequacy of the AI legal framework.

One option for regulating in-house AI is the granting of limited legal personality to the algorithm itself, similar to a partial licence, paired with a self-executing 'kill switch' linked to minimum requirements as to the capital available for potential liability claims. If the capital is depleted, for example due to liabilities or regulatory sanctions, the algorithm will stop operating. The argument against such limited e-personhood are similar to those against authorising AI: the calculation of capital requires a clear delineation of risks created by the AI. If the limits of AI functions are vague, as with self-learning algorithms, regulatory capital will most likely be set too low or too high. Further, authorities have cheaper ways to restrict AI use, without a financial institution AI's own regulatory capital. These include reporting requirements for AI deployment as well as losses and damages resulting from such deployment, and responding to such reporting by issuing orders limiting, or prohibiting such AI applications as deemed appropriate.

3 *AI as a Key Function Holder?*

Can an AI serve as an executive or board member of the financial institution?¹³⁸ Here, legality and practicality differ.

In some jurisdictions, executive functions can be assigned to legal entities, or the law is silent on the entity status of executives. In those jurisdictions, it may be lawful to appoint an AI as a board member, if necessary, by embedding the AI in a special purpose vehicle (that is, a parent company subsidiary with a very limited business objective) as its sole activity. In other jurisdictions, these functions must be fulfilled by people.

Regarding practicality, an AI may function as a board member for certain routine tasks (for example, securitisation vehicles in a corporate group), and for procedural monitoring, but a human board majority may be required to ensure continuing operations when challenges exceed the AI's programmed limits.

Notwithstanding this, rules allowing AI to assume functions within a financial institution must respect the existing limits of AI, especially for compliance monitoring. AI alone is poorly adapted to handle compliance matters because it lacks ethical screening abilities, and because rules are incomplete on purpose. The law is full of vague terms such as 'fair', 'adequate', 'just', and 'reasonable'. These terms allow adjustment to an ever-changing world. Financial services are heavily regulated by rules that do not always operate in yes/no terms because their meaning depends on context. For this reason, an 'AI as compliance officer' could well lead to inaccurate monitoring, widespread misreporting, and mispricing of risks.¹³⁹

¹³⁸ Deep Knowledge Ventures, 'Deep Knowledge Venture's [sic] Appoints Intelligent Investment Analysis Software VITAL as Board Member — Hong Kong Venture Capital Fund Appoints Machine Intelligence as Board Member', *GlobeNewswire* (online, 13 May 2014) <<https://www.globenewswire.com/news-release/2014/05/13/635881/10081467/en/Deep-Knowledge-Venture-s-Appoints-Intelligent-Investment-Analysis-Software-VITAL-as-Board-Member.html>>.

¹³⁹ Enriques and Zetzsche (n 47) 74–5.

4 *The Fit-and-Proper Test for Core Personnel*

AI will likely influence regulatory practice in the fit-and-proper test for key function holders (that is, senior management or executives) and the board of directors, in two ways. First, some existing requirements may be redundant or need modification when AI is used. For instance, if AI is making decisions, a human executive's credentials may not require review.

Second, new requirements will reflect the greater reliance on AI, and some office holders may have new qualifications. EU authorities require executives of a financial intermediary to have at least three years of executive experience prior to appointment. This experience should demonstrate good standing, diligent handling of client matters and cooperation with the financial supervisory authority. However, AI experts may have accumulated their AI experience outside the financial sector, for example within a major e-commerce or software firm. Financial supervisors will need to modify some of their experience requirements as many have for licensing requirements for fintechs.

5 *Sanctioning AI*

Financial regulation typically imposes sanctions on an institution for its overall conduct and/or that of individual staff. To do so, regulators usually must prove negligence or ill intent of the institution and/or staff. When harm occurs, deficiencies in risk management systems may attract sanctions. With AI, these cases will be increasingly hard to make. Where AI fails and supervisors are incapable of establishing an AI's processes and limits with certainty, determining the culpability standard and burden of proof to be applied while retaining incentives to innovate will be very challenging. Potential sanctions may exercise little steering effect, even if sanctions are possible under the broad 'failure of risk management' rationale.¹⁴⁰

This brings us to the question of sanctioning AI. Withholding compensation, naming and shaming, and financial penalties have little meaning for AI. Similarly, director disqualification — the equivalent of a death penalty in the world of corporate management — as well as civil and criminal liability, have a limited steering effect for AI in its current form, other than perhaps being imposed upon currently unregulated outsourced technology companies or their regulated client financial institutions.

Hence, any sanctioning system needs reconsidered incentives for AI creation and deployment. AI-adapted regulation could possibly:

- (i) require blame-free remediation in which organisations are able to learn from failures and make improvements;
- (ii) encourage collaboration to promote early detection and the avoidance of unexpected AI failures; and/or

¹⁴⁰ Bamberger (n 22) 676.

- (iii) employ fit-for-purpose explainability with frameworks to decide ‘if’ explainability is a requirement on a risk- and impact-based assessment in any particular circumstance (thereby assisting organisations to prioritise their AI’s objectives) and ‘how’ explainability should be achieved.¹⁴¹

V Putting the Human in the Loop in Finance

While regulators expect financial institutions to deploy AI responsibly and develop and use new tools to safeguard the financial system, we have shown that, given the severe information asymmetry, data dependency and interdependency that arise with AI, external governance is not well-suited to ensuring the responsible use of AI in finance.

Given these black box challenges in AI for regulatory and supervisory authorities, measures focusing on personal responsibility requirements that put the human in the loop, should be central to regulating AI-enabled systems in finance.

Two approaches are gaining increasing currency. The first involves using technology (including AI) to monitor staff behaviour and identify issues before they arise (a form of regtech). As we have argued elsewhere, regtech is a logical consequence of fintech; fintech cannot work well without properly designed and implemented regtech.¹⁴²

The second approach is central to putting the human in the loop and will thus be expanded further here. An increasing range of regulatory systems strengthen the personal responsibility of designated senior managers — so-called ‘senior manager’, ‘manager-in-charge’, ‘key function holders’ or ‘personal responsibility’ systems. These frameworks seek to produce cultural change and an ethical environment in financial institutions through the personal responsibility of directors, management and, increasingly, individual managers.

We argue in this section that regulators should utilise and strengthen these external governance requirements in order to require human-in-the-loop systems for internal AI governance. External governance of AI risks and challenges should primarily be by mandating the quality and intensity of financial institutions’ internal governance. AI-adjusted personal responsibility frameworks are vital. In this section, to provide context we first lay out the fundamentals of personal responsibility frameworks in financial regulation. Then we analyse how these frameworks can be utilised for addressing AI-related black box issues.

Such personal responsibility frameworks should be supplemented to include explicit AI responsibility, including a non-waivable AI due diligence and explainability standard.

¹⁴¹ Accenture (n 7) 18; UK Finance and Microsoft (n 5) 10–13; World Economic Forum (n 60) 21.

¹⁴² Douglas W Arner, János Barberis and Ross P Buckley, ‘FinTech, RegTech and the Reconceptualisation of Financial Regulation’ (2017) 37(3) *Northwestern Journal of Law and Business* 371.

A *Personal Responsibility Frameworks in Finance*

Over the last ten years, most major financial jurisdictions have imposed, or are in the process of imposing, director and manager responsibility frameworks for financial regulation. Australia, along with the UK and Hong Kong, have implemented manager responsibility regimes. Singapore has proposed a regime with adoption currently delayed due to the COVID-19 epidemic.¹⁴³ The EU has developed a framework for internal governance and, to address information, communications and telecommunications risks in general, is going to adopt a Digital Operational Resilience Act ('DORA Proposal').¹⁴⁴ A similar manager responsibility approach has been proposed by the US Federal Reserve for 'Systemically Important Financial Institutions', but not yet adopted.¹⁴⁵

1 *Australia: Banking Executive Accountability Regime*

The Australian Prudential Regulation Authority ('APRA') administers the Banking Executive Accountability Regime ('BEAR'),¹⁴⁶ which came into effect on 1 July 2018 for large banks and 1 July 2019 for smaller banks (collectively, 'authorised deposit-taking institutions').¹⁴⁷ Authorised deposit-taking institutions must provide individual accountability statements to APRA that clearly outline individual responsibilities and provide an accountability map showing accountability allocation across an institution (based on size, risk profile, and complexity). 'Individual accountable persons' are accountable for their actual or effective responsibilities for the management or control of a significant or substantial part, or aspect of, an authorised deposit-taking institution's operations or an authorised deposit-taking institution group. Specifically, individual accountable persons have obligations to: act 'with honesty and integrity, and with due skill, care, and diligence'; 'deal with APRA in an open, constructive and cooperative way'; and take reasonable steps in conducting their responsibilities to prevent matters arising that would adversely affect the authorised deposit-taking institution's prudential standing or reputation.¹⁴⁸

¹⁴³ In April 2020, the Monetary Authority of Singapore announced that 'it will adjust selected regulatory requirements and supervisory programmes to enable financial institutions (FIs) to focus on dealing with issues related to the COVID-19 pandemic and supporting their customers during this difficult period': Monetary Authority of Singapore, 'MAS Takes Regulatory and Supervisory Measures to Help FIs Focus on Supporting Customers' (Media Release, 7 April 2020) [1]. The Authority noted that this includes deferring the Guidelines on Individual Accountability and Conduct and that 'FIs will be provided sufficient time for transition to the new dates when announced': at [15].

¹⁴⁴ See *Proposal for a Regulation of the European Parliament and of the Council on Digital Operational Resilience for the Financial Sector and Amending Regulations (EC) No 1060/2009, (EU) No 648/2012, (EU) No 600/2014 and (EU) No 909/2014*, COM/2020/595 final, 24 September 2020 ('DORA Proposal').

¹⁴⁵ See Federal Reserve System, 'Proposed Supervisory Guidance', 83(8) *Federal Register* 1351 (11 January 2018, Docket No OP-1594). The US Federal Reserve's proposal cover large banks, bank-like institutions, and non-bank Systemically Important Financial Institutions.

¹⁴⁶ Australian Prudential Regulation Authority ('APRA'), *Information Paper: Implementation of the Banking Executive Accountability Regime (BEAR)* (11 December 2020) 4.

¹⁴⁷ *Banking Act 1959* (Cth) pt IIAA.

¹⁴⁸ *Ibid* s 37C.

In response to recommendations of the Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry,¹⁴⁹ the Australian Government has proposed expanding BEAR into the Financial Accountability Regime ('FAR'),¹⁵⁰ with legislation proposed to be introduced in late 2020 to cover securities firms after public consultation. The underlying structure of FAR resembles BEAR, with several key differences:

- the Australian Securities and Investments Commission would join APRA in co-regulating FAR obligations;
- FAR expands regulatory scope to all APRA-regulated entities, not just authorised deposit-taking institutions; and
- regulators would have the power to define 'accountable person' (which, under BEAR, is defined in legislation) and to exempt entities from FAR obligations (which power, under BEAR, is with the Minister).¹⁵¹

Additionally, FAR imposes new obligations on accountable persons and introduces civil penalties for those in breach,¹⁵² thereby strengthening the focus on individual accountability.

2 United Kingdom: Senior Managers and Certification Regime

The UK's 'Senior Managers and Certification Regime' ('SMCR') evolved from the EU framework¹⁵³ and has been influential internationally. Regime compliance is subject to firms and individuals being authorised by the UK Prudential Regulation Authority ('PRA') and the FCA. Authorised firms must ensure that individuals who perform PRA-designated senior management functions are approved.¹⁵⁴ Authorisation will not be granted unless the PRA and FCA are satisfied that the person meets the requirements of the *Financial Services and Markets Act 2000* (UK).¹⁵⁵

The SMCR as established in 2016 applied to all individuals performing a 'Senior Management Function' at banks, building societies, credit unions, and PRA-designated investment firms. The Regime was expanded in 2018 to cover insurance firms, and again from December 2019, for FCA-regulated financial institutions, to apply to asset managers and designated activities of investment firms.¹⁵⁶

¹⁴⁹ *Banking Royal Commission Final Report* (n 84).

¹⁵⁰ Treasury (Cth), *Implementing Royal Commission Recommendations 3.9, 4.12, 6.6, 6.7 and 6.8: Financial Accountability Regime* (Proposal Paper, 22 January 2020) ('*Proposal Paper*'); Treasurer (Cth), 'Update on the Implementation of the Banking, Superannuation and Financial Services Royal Commission' (Media Release, 8 May 2020) <<https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/update-implementation-banking-superannuation-and#:~:text=The%20Morrison%20Government%20has%20today,significant%20impacts%20of%20the%20coronavirus>>.

¹⁵¹ Treasury (Cth), *Proposal Paper* (n 150) 14.

¹⁵² *Ibid* 6, 9, 11, 13.

¹⁵³ See below Part V(A)(5).

¹⁵⁴ *Financial Services and Markets Act 2000* (UK) s 59.

¹⁵⁵ 'Senior Managers Regime: Approvals', *Bank of England* (Web Page, 26 January 2021) <<https://www.bankofengland.co.uk/prudential-regulation/authorisations/senior-managers-regime-approvals>>.

¹⁵⁶ Barnabas Reynolds, Thomas Donegan, Simon Dodd and John Adams, Shearman & Sterling, 'The UK's Expanded Senior Managers and Certification Regime: Key Issues and Action Plan for Brokers, Advisors and Asset Managers', *Perspectives* (Blog Post, 8 July 2019) <<https://www.shearman.com/>>.

The SMCR is structured around: (1) a senior managers regime for individuals who require regulatory approval; (2) a certification regime for regulated firms to assess the fitness and propriety of employees carrying out a ‘significant harm’ function;¹⁵⁷ and (3) conduct rules that apply to most bank employees.¹⁵⁸

Senior managers are required to have a clear and succinct statement of responsibilities. These include regulator-prescribed responsibilities. Conduct rules for senior managers specify a ‘Duty of Responsibility’ that ensures the firm’s business is controlled effectively and they comply with the regulatory framework.¹⁵⁹ Senior managers must take reasonable steps to ensure that responsibility is delegated to an appropriate person, and that the delegated responsibility is effectively discharged.¹⁶⁰ A senior manager must disclose any information of which the PRA or FCA would reasonably expect notice.¹⁶¹ The FCA has stated the SMCR is not intended to subvert collective responsibility or collective decision-making.¹⁶²

Conduct rules encourage a healthy culture whereby all staff must act with integrity, due skill, care and diligence, openly cooperate with the PRA and FCA, pay due regard to the interests of customers and treat them fairly, and observe standards of market conduct. Firms are accountable for employee conduct and are required to notify the regulator of any breach of the conduct rules.¹⁶³

The scope of the current SMCR is slightly wider than the original 2016 Regime. Senior managers are responsible for the firm’s policies and procedures for countering financial crime risks: such as money laundering, sanctions, fraud, tax evasion and cybercrime; compliance with the client assets sourcebook where a firm has authority to hold client’s money or assets; and, for asset management firms, value for money assessments, independent director representation, and acting in investors’ best interests.¹⁶⁴ Furthermore, such responsibilities also apply to the board¹⁶⁵ (or to an ad-hoc tech committee)¹⁶⁶ where upskilling is often needed.

perspectives/2019/07/the-uks-expanded-senior-managers-and-certification-regime-key-issues-and-action-plan>.

¹⁵⁷ Financial Conduct Authority, *The Senior Managers and Certification Regime: Guide for FCA Solo-Regulated Firms* (July 2019) 10 <<https://www.fca.org.uk/publication/policy/guide-for-fca-solo-regulated-firms.pdf>> (‘*Senior Managers and Certification Regime Guide*’).

¹⁵⁸ Linklaters, ‘SMCR for Deposit Takers and PRA-Designated Investment Firms’ (Web Page) <<https://www.linklaters.com/en/insights/publications/smcr/smcr/smcr-for-deposit-takers-and-pra-designated-investment-firms>>.

¹⁵⁹ *Senior Managers and Certification Regime Guide* (n 157) 14.

¹⁶⁰ *Ibid.*

¹⁶¹ KPMG, *Individual Accountability: Global Regulatory Developments in Financial Services* (Report, July 2018) 4–5.

¹⁶² Allen & Overy, *The UK Senior Managers and Certification Regime: Themes, Trends and Challenges from the First Three Years* (Report, March 2019) 17.

¹⁶³ Patricia Volhard et al, Debevoise & Plimpton, ‘The UK’s Senior Managers and Certification Regime’ (Report, 18 February 2019).

¹⁶⁴ *Ibid.*

¹⁶⁵ Magnus Falk, Financial Conduct Authority, ‘Artificial Intelligence in the Boardroom’, *Insight* (online, 1 August 2019) <<https://www.fca.org.uk/insight/artificial-intelligence-boardroom>>.

¹⁶⁶ Although this would be the proper venue to discuss it, it seems that such committees (which are not even used by the so-called ‘GAFAM’ big tech five: Google, Apple, Facebook, Amazon and Microsoft) do perform a much more strategic function within the board and do not specifically address AI-related risks. See Maria Lillà Montagnani and Maria Lucia Passador, ‘AI Governance

3 *Hong Kong: Securities Firm Managers-in-Charge Regime*

For Hong Kong securities firms, since 2016 senior management are defined as directors, ‘responsible officers’ of a corporation, and ‘Managers-in-Charge’.¹⁶⁷ Licensed corporations must appoint a Manager-in-Charge as primarily responsible for: each core function; overall management oversight; key business lines; operational control and review; risk management; finance and accounting; IT; compliance; and anti-money laundering and combatting the financing of terrorism. For each core function, there should be at least one Manager-in-Charge responsible, although one can manage several core functions (depending on the size and scale of the corporation’s operations).

General Principle 9 of the *Code of Conduct for Persons Licensed or Registered with the Securities and Futures Commission* states that senior management shall ‘bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures’. A person’s actual and apparent authority shall be considered to determine responsibility and its degree.¹⁶⁸ The Board must approve and adopt a formal document clearly setting out roles, responsibilities, accountability, and the reporting lines of senior management.¹⁶⁹

Paragraph 14.1 of the Code of Conduct specifies that senior management should properly manage the risks associated with a firm’s business, including performing periodic evaluation of its risk processes, internal control procedures and risk policies; and understanding the extent of their own authority and responsibilities.¹⁷⁰ Senior management are ultimately responsible for the adequacy and effectiveness of the firm’s internal control systems.¹⁷¹ Managers-in-Charge should be aware of other codes and guidelines that impose responsibilities pursuant to the *Securities and Futures Ordinance* (Kong Kong) (cap 571).¹⁷²

4 *Singapore: Senior Manager Guidelines*

In September 2020, the Monetary Authority of Singapore issued *Guidelines on Individual Accountability and Conduct* that will be effective from 10 September 2021.¹⁷³ Senior managers will be responsible for the day-to-day operations of financial institutions in Singapore.¹⁷⁴ The Guidelines make senior managers

and Tech Committees: An Empirical Analysis in Europe and North America’ (Bocconi Legal Studies Research Paper No 3728946, 9 January 2021) 29–39 <<https://ssrn.com/abstract=3728946>>.

¹⁶⁷ Securities and Futures Commission, ‘Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management’ (Web Page, 16 December 2016) [5] <<https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC68>>.

¹⁶⁸ Ibid [1], [5], [7]–[9].

¹⁶⁹ Ibid [28].

¹⁷⁰ Ibid [14](b).

¹⁷¹ Ibid [14](c).

¹⁷² Ibid [14], [19].

¹⁷³ Monetary Authority of Singapore, *Guidelines on Individual Accountability and Conduct* (10 September 2020).

¹⁷⁴ Ibid 6 (definition of ‘senior managers’).

responsible for the management and conduct of ‘core management functions’, for the actions of their staff, and the conduct of the business.¹⁷⁵ Financial institutions should apply core-management-function definitions that reflect the actual responsibilities of a particular senior manager.¹⁷⁶ Responsibility is described as ‘principles-based’ and thus there is no list of mandatory responsibilities.¹⁷⁷ The Monetary Authority of Singapore states that the level of responsibility should reflect the senior manager’s roles vis-à-vis the financial institution’s Singaporean operations.¹⁷⁸ Senior managers are responsible regardless of their title or whether they are based overseas.¹⁷⁹

5 European Union

The EU joint internal governance guidelines were published in 2017 by the European Banking Authority and European Securities and Markets Authority to build upon the *Commission Delegated Regulation (EU) No 604/2014* criteria that identifies categories of staff whose professional activities have a material impact on a financial institution’s risk profile.¹⁸⁰ The joint internal governance guidelines aim to satisfy the *CRD IV* and *MiFID II* requirements and are made pursuant to *Directive 2013/36/EU* and *Directive 2014/65/EU*.¹⁸¹

The European Banking Authority and European Securities and Markets Authority internal governance guidelines, and European Insurance and Occupational Pensions Authority’s guidelines on systems of governance,¹⁸² apply to a variety of financial institutions under EU law. These guidelines govern the conduct of the management body and key function holders. ‘Key function holders’ refers to persons with significant influence over the direction of the institution who are not part of the management body.¹⁸³ The management body and key function holders must possess good repute, independence, honesty, integrity, knowledge, skills, and experience. Members of the management body must have sufficient time to perform their

¹⁷⁵ Ibid 7 [1.2(i)]. For a definition of core management functions in relation to senior management, see ibid 20–23 (Annex B).

¹⁷⁶ Ibid 7 [1.2(ii)].

¹⁷⁷ Ibid [4.1]–[4.2].

¹⁷⁸ Ibid [1.3].

¹⁷⁹ Ibid [1.2].

¹⁸⁰ See European Banking Authority (‘EBA’), *Final Report: Guidelines on Internal Governance under Directive 2013/36/EU* (Report No EBA/GL/2017/11, 26 September 2017) (‘EBA Guidelines EBA/GL/2017/11’); European Banking Authority and European Securities and Markets Authority (‘ESMA’), *Guidelines on the Assessment of the Suitability of Members of the Management Body and Key Function Holders* (Report No ESMA71-99-598 EBA/GL/2017/12, 21 March 2018) (‘EBA and ESMA Guidelines ESMA71-99-598 EBA/GL/2017/12’); European Banking Authority and European Securities and Markets Authority, *Final Report: Joint ESMA and EBA Guidelines on the Assessment of the Suitability of Members of the Management Body and Key Function Holders under Directive 2013/36/EU and Directive 2014/65/EU* (Report No EBA/GL/2017/12, 26 September 2017) (‘ESMA and EBA Joint Guidelines EBA/GL/2017/12’).

¹⁸¹ EBA Guidelines EBA/GL/2017/11 (n 180) 5–7. See also above nn 114, 116.

¹⁸² European Insurance and Occupational Pensions Authority, *Guidelines on System of Governance* (EIOPA-BoS-14/253 EN, January 2014) <https://www.eiopa.europa.eu/content/guidelines-system-governance_en>.

¹⁸³ Ibid [1.21].

functions including understanding the business of the institution, its main risks, and the implications of the business and risk strategy.¹⁸⁴

Responsibilities of the management body (in particular, the Chief Executive Officer and other key executives) include setting, approving, and overseeing implementation of the overall business strategy and the key legal and regulatory policies, overall risk strategy, internal governance and control, risk capital, liquidity targets, remuneration policy, key function holders' assessment policy, internal committees functionality, risk culture, corporate culture, conflict of interest policy, and the integrity of accounting and financial reporting systems.¹⁸⁵ The management body is also accountable for the implementation of the governance arrangements that ensure effective and prudential management of the institution, and promote market integrity and client interests.¹⁸⁶

Key function holders such as heads of internal control functions including risk management, compliance and audit functions have a crucial role in ensuring that the institution adheres to its risk strategy, complies with legal and regulatory requirements, and has robust governance arrangements.¹⁸⁷ A sound and consistent risk culture is a critical element of risk management. Key function holders should know and understand the extent of risk appetite and risk capacity for their role and contribute to internal communications regarding the institution's core values and staff expectations. They should promote an environment of open communication, welcoming challenges in decision-making, encouraging a broad range of views and the testing of current practices, stimulating a constructive critical attitude, and promoting an environment of open, constructive engagement throughout the entire organisation.¹⁸⁸ The proportionality principle applies to all governance arrangements, consistent with the institution's risk profile and business model.¹⁸⁹

The European Commission's DORA Proposal aims at addressing the digital operational resilience needs of all EU-regulated financial entities and fine-tunes the aforementioned principles with a view to ICT risks in general.¹⁹⁰ While not mentioning AI in particular, the DORA Proposal's definition of ICT risk is all-encompassing and includes AI-related malfunctions of any kind.¹⁹¹ While details of the Proposal exceed the scope of this article, its most important principle in the context of this article states that '[t]he management body of the financial entity shall define, approve, oversee and be accountable for the implementation of all arrangements related to the ICT risk management framework'.¹⁹²

¹⁸⁴ *EBA and ESMA Guidelines ESMA71-99-598 EBA/GL/2017/12* (n 180) 3 [6], 5–6 [15], 11 [26], 13 [37], 14 [39], 14 [41].

¹⁸⁵ *ESMA and EBA Joint Guidelines EBA/GL/2017/12* (n 180) 28–42 [41]–[93] (Title III).

¹⁸⁶ *EBA and ESMA Guidelines ESMA71-99-598 EBA/GL/2017/12* (n 180) 6, 11 [26], 13 [37], 14 [41], 31 [110].

¹⁸⁷ *Ibid* 11 [33].

¹⁸⁸ *EBA Guidelines EBA/GL/2017/11* (n 180) 34 [98].

¹⁸⁹ *EBA and ESMA Guidelines ESMA71-99-598 EBA/GL/2017/12* (n 180) 9 [20].

¹⁹⁰ DORA Proposal (n 144) Explanatory Memorandum.

¹⁹¹ *Ibid* art 3(4).

¹⁹² *Ibid* art 4(2).

6 *International Organization of Securities Commissions Consultation*

In June 2020, the Board of the International Organization of Securities Commissions ('IOSCO') published a consultation report relating to guidance on the use of AI and machine learning by market intermediaries and asset managers.¹⁹³ The very first measure of the *IOSCO AI Consultation Report* is that '[r]egulators should consider requiring firms to have designated senior management responsible for the oversight of the development, testing, deployment, monitoring and controls of AI and machine learning.'¹⁹⁴ If implemented at the national level, this guidance will help instil a personal responsibility framework for securities regulators across the world precisely along the lines of that for which we argue here for all financial institutions.

B *Addressing the Knowledge Gap*

The trend in financial services regulation is clear: ever-increasing personal responsibility for senior management and other individuals responsible for regulated activities within financial institutions. We argue here that such frameworks are instrumental in addressing AI-related risks.

Personal responsibility frameworks can underpin a system of addressing issues arising from AI in finance, in particular the three challenges of AI (information asymmetry, data dependency and interdependency).¹⁹⁵ Manager responsibility frameworks should be expanded to specifically incorporate responsibility for AI in regulated activities, thus mandating a human in the loop, especially for due diligence, fairness and explainability requirements. In many cases, this approach could be augmented by additional AI review committees. These can be highly effective in addressing black box issues and in providing a framework to address the four core financial risks relating to data, cybersecurity, systemic risk, and ethics.

1 *AI Due Diligence*

The first tool reinforcing and supporting manager responsibility is mandatory AI due diligence. Due diligence should include a full stocktaking of all characteristics of the AI. At a minimum, this must include the AI explainability standard further described in the next section. AI due diligence should be a requirement prior to AI procurement, adoption and deployment, while AI explainability is the standard to meet throughout the use of any AI to internal and external stakeholders.

¹⁹³ Board of the International Organization of Securities Commissions ('IOSCO'), *The Use of Artificial Intelligence and Machine Learning by Market Intermediaries and Asset Managers: Consultation Report* (Report CR02/2020, June 2020) <<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD658.pdf>> ('*IOSCO AI Consultation Report*').

¹⁹⁴ *Ibid* 2, 18.

¹⁹⁵ See above Part III(F).

To reflect data dependency, one part of AI due diligence is mapping the data sets used by the AI, including an analysis of dataset bias, data gaps and data quality.¹⁹⁶

AI due diligence is key to individual responsibility systems: individuals need to conduct sufficient due diligence in the exercise of their responsibilities to avoid liability for any failures, whether from internal governance systems, employees, third parties, or ICT systems.

2 *AI Explainability*

Explainability requirements are necessary minimum standards for humans in the loop — that is, demanding that AI functions, limits and risks can be explained *to someone*. Debates exist relating to the level of granularity required and to whom such explanations should be made (for example, a programmer/statistician, user, or regulator),¹⁹⁷ and the term ‘interpretability’ is sometimes used in the context of more technical explainability.

From a regulatory approach, this ‘someone’ could be an appropriate senior manager and/or a member of the executive board responsible for the AI (relying on the manager’s incentive to avoid sanctions) or an external institution, in particular regulators, supervisors and courts. From a consumer rights perspective, this ‘someone’ could be the ultimate user of the technology (as has been alluded to under the *GDPR*).¹⁹⁸

Based on this analysis, first, we encourage financial regulators to introduce explainability requirements for responsible managers, including documentation and governance requirements, with a clarification of the standards depending on a risk and impact assessment and to whom the explanation is required. Second, supervisory authorities should review compliance with explainability requirements. Manager responsibility systems will thus be buttressed by explainability systems, which in turn result from personal responsibility and accountability to regulators. As with their other decisions, individual senior managers must be able to explain and take responsibility for their own direct or indirect decisions about technology, the actions of their employees and contractors and, critically, the decisions of their AI systems at least to their regulators.

3 *AI Review Committees*

In addition to due diligence and explainability requirements to address the information asymmetry concerning AI’s functions and limits, financial regulators

¹⁹⁶ Brian W Tang, ‘The Chiron Imperative — A Framework of Six Human-in-the-Loop Paradigms to Create Wise and Just AI-Human Centaurs’ in Susanne Chishti, Sophia Adams Bhatti, Akber Datto, Drago Indjic (eds), *The LEGALTECH Book: The Legal Technology Handbook for Investors, Entrepreneurs and Fintech Visionaries* (Wiley, 2020) 38.

¹⁹⁷ Aleksandra Mojsilovic, ‘Introducing AI Explainability 360’, *IBM Research Blog* (Blog Post, 8 August 2019) <<https://www.ibm.com/blogs/research/2019/08/ai-explainability-360/>>; Tang (n 77) 243.

¹⁹⁸ *GDPR* (n 105).

should create independent AI review committees to provide cross-disciplinary and impartial expertise. This is an important practice emerging in some non-financial companies.¹⁹⁹ Some of these committees have been quite impactful, such as in Axon's management and board accepting the recommendation of its AI and Policing Ethics Board to impose a moratorium on the use of facial recognition in Axon's body cameras.²⁰⁰ The impact of other committees has been less,²⁰¹ or remains to be seen.²⁰² Regardless, these committees are designed to augment decision-making and should not detract from the ultimate responsibility vested in management and the board regarding AI governance.

C *Personal Responsibility in Financial Regulation: Challenges in Building Human-in-the-Loop Systems*

Several concerns relating to the personal responsibility model require consideration. These include: (1) inability to fully control AI using internal governance; (2) unwillingness to curtail highly profitable AI; (3) tacit collusion between AI systems; (4) over-deterrence of innovation; and (5) the differing attitudes to AI and technology in financial services.

1 *Inability to Fully Control AI Internally*

If AI cannot be controlled by external monitors, such as financial supervisors, it may be argued that AI cannot be monitored and controlled effectively by senior management not directly involved in AI data gathering, coding and operations.

Existing methods of internal control include: internal reporting; defining risk limits in terms of risk budgets; assigning budgets for code development and data pool acquisition; and setting adequate incentives through balanced compensation models. Personal responsibility/liability systems place the responsibility for regulated conduct areas upon specific individual senior managers. Thus, a senior manager who is directly responsible for regulatory breaches arising in their area of responsibility will have strong incentives to innovate and strengthen the existing governance tools to monitor and better understand their functional area, staff, third-party contractors and suppliers, and IT systems. A culture of due diligence and explainability should then evolve to address the black box problem. Where it does not, the individual and board will nonetheless remain responsible for any harm caused.

¹⁹⁹ Brian W Tang, 'Independent AI Ethics Committees and ESG Corporate Reporting on AI as Emerging Corporate and AI Governance Trends' in Susanne Chishti, Ivana Bartoletti, Anne Leslie and Shân M Millie (eds), *The AI Book: The Artificial Intelligence Handbook for Investors, Entrepreneurs and FinTech Visionaries* (Wiley, 2020) 180, 183.

²⁰⁰ Rick Smith, 'The Future of Face Matching at Axon and AI Ethics Board Report', *Axon* (Web Page, 27 June 2019) <<https://www.axon.com/news/ai-ethics-board-report>>.

²⁰¹ Parmy Olson, 'Google Quietly Disbanded Another AI Review Board Following Disagreements', *Wall Street Journal* (online, 16 April 2019) <<https://www.wsj.com/articles/google-quietly-disbanded-another-ai-review-board-following-disagreements-11555250401>>.

²⁰² Brent Harris, 'Establishing Structure and Governance for an Independent Oversight Board', *Facebook Newsroom* (Web Page, 17 September 2019) <<https://about.fb.com/news/2019/09/oversight-board-structure>>.

Naturally, the manager responsibility model requires those involved in AI development, procurement and deployment to be included within the net of responsibility. As argued in relation to techrisk, an individual should be designated as responsible for IT and technology systems.²⁰³

One concern often raised against a manager responsibility concept is where self-learning AI taps into unexpected or malicious data input, and produces unexpected correlations or unacceptable outcomes. However, as in the case of Microsoft's Tay, this can be countered by the proverbial mandatory 'AI off switch' depending on the risk and impact assessment and an appropriate contingency or business continuity plan. Such an 'AI kill switch' was expressly mentioned in an explanatory note to Measure 2 of the *IOSCO AI Consultation Report*, although not in the text of Measure 2 itself.²⁰⁴ The extent of this will certainly depend on the AI application, but the fact AI can impose risks on clients, the financial institution and the financial system is all the more reason to rigorously analyse and scrutinise AI use in finance.

2 *Unwillingness to Curtail Highly Profitable AI*

A common issue in financial institution governance is the unwillingness to curtail profitable, yet complex, conduct. We draw analogies with the 2008 Global Financial Crisis: even though senior managers found difficulty in understanding the true risk of tranching and structured finance as well as its allocation, they had little incentive to stop complex and opaque, but highly profitable, business models — especially as they benefited from the higher profitability through enhanced pay and reputation. This argument is especially relevant in light of the recent growth of less regulated tech companies that offer new financial services and products.

This manifestation of agency risk is perennial in corporate and financial governance. While our proposal does not change management's incentives from the standpoint of profitmaking, the implementation of personal responsibility impacts directly through individual responsibility for failures, thus incentivising individual and managerial due diligence and efforts to ensure sustainability. AI review committees add another level of oversight and input, and another avenue through which explainability can be sought (in addition to managers with individual responsibility for AI activities and overall board responsibility).

3 *Tacit Collusion between AI Systems*

The profitability of tacit collusion among AI systems poses particular challenges. Accordingly, competition authorities are increasingly focused on this issue.²⁰⁵

The WEF has suggested this be mitigated by:

²⁰³ Buckley et al (n 72) 61.

²⁰⁴ *IOSCO AI Consultation Report* (n 193) 19–20.

²⁰⁵ Bundeskartellamt and Autorité de la Concurrence, *Algorithms and Competition* (Report, November 2019); UK Competition and Markets Authority, *Pricing Algorithms: Economic Working Paper on the Use of Algorithms to Facilitate Collusion and Personalised Pricing* (October 2018).

- (i) restricting AI-enabled systems communication with their environments to ‘explicitly justifiable business purposes’;²⁰⁶
- (ii) ensuring their AI-enabled systems’ decisions are explainable by ‘valid, legal business reasons’;²⁰⁷ and
- (iii) requiring humans to oversee decisions made by AI-enabled systems.²⁰⁸

These are good suggestions, but may not always be sufficient to fully mitigate this substantial risk, in particular when collusion is highly profitable. In the end, this comes down to the unwillingness dimension discussed above in Part V(C)(2): personal responsibility requirements address these, particularly when supplemented by review committee, due diligence and explainability requirements that all come with enhanced documentation and potentially severe liability and director and managerial disqualification resulting from lack of oversight.

4 *Over-Deterrence of Innovation*

At the same time, manager responsibility may be too much of a good thing. If the regulatory burden excessively deters good managers from being involved in AI-based financial services, we may find a reduction in innovation in finance and corollary reductions in efficiency, access to justice and combatting of financial crime, and/or leadership by less thoughtful and reflective people serving as senior managers for financial services firms. Well-intentioned global regulation may also lead to unintended consequences that disadvantage financial institutions, fintechs and technology companies from emerging economies seeking to deploy AI.²⁰⁹ Regulators must respond to this concern with proportional ‘carrots’ to incentivise and recognise good actors as well as ‘sticks’ for irresponsible conduct.²¹⁰ Personal responsibility liability systems should also include continuing education frameworks.

Individual responsibility could lead to decreased diligence in monitoring fellow key function holders. Conversely, collective responsibility could increase monitoring among key function holders, but lead to over-deterrence. This debate is underscored by the Australian Westpac bank scandal — a potent example of the potential magnitude of techrisk.²¹¹ The bank had developed its own software to implement and govern remittances, and a relatively innocuous looking piece of software allegedly permitted 23 million anti-money laundering breaches.²¹² The

²⁰⁶ World Economic Forum (n 60) 118.

²⁰⁷ Ibid.

²⁰⁸ Ibid.

²⁰⁹ Fintech Association of Hong Kong and LITE Lab@HKU, ‘Joint Response to IOSCO Consultation on “The Use of Artificial Intelligence and Machine Learning By Market Intermediaries and Asset Managers”’ (23 October 2020) <https://ftahk.org/system/files/2020-10/FTAHK%20LITELabHKU%20IOSCO%20AI%20Consultation_October%2023.pdf>.

²¹⁰ Brian W Tang, ‘Promoting Capital Markets Professionalism: An Emerging Asian Model’ in Ross P Buckley, Emiliós Avgouleas and Douglas W Arner (eds), *Reconceptualising Global Finance and its Regulation* (Cambridge, 2016) 357, 389.

²¹¹ Buckley et al (n 72) 40–1.

²¹² See above n 80 and accompanying text.

breaches attracted a massive financial penalty and arguably even more reputational damage for the bank.²¹³

To avoid or limit over-deterrence of innovation, a compromise would include defining some collective core duties, while also imposing individual responsibility. This should apply to both board and corporate responsibility.

Regulators usually require finance experience as a precondition for licensing a financial entity. Technology start-up founders often have little experience in running a regulated firm. If regulators require this expertise of all key function holders in a start-up, innovation will be severely impaired. One obvious response is for regulators to require sufficient expertise and experience from the fintech start-up's board and key executives as a group. Therefore, some board members and executives can contribute the IT/AI expertise,²¹⁴ while others contribute experience in running regulated financial services firms. Gradually, all board members and executives should be able to meet the standards for seasoned financial intermediaries.

For personal responsibility in given areas, specific area-related expertise is required as one aspect of the fit-and-proper test. While it may make sense in a fintech start-up to take a balanced and proportionate approach to board and key executive requirements as a group, specifically mandated individual responsibility requirements, expertise and experience requirements would remain necessary in the licensing process.

5 *Differing Attitudes to AI and Technology in Financial Services*

Our final, and perhaps most important, recommendation goes to the cultural attitude of many in financial services towards AI and technology in general. There is much talk about the trust crisis in our modern world of fake news and low institutional credibility. But we do not need to trust AI more in financial services (or in medicinal care or criminal sentencing or other applications). We need AI to demonstrate its trustworthiness.

²¹³ Paul Smith, 'Westpac's Tech Mess Could Happen to Anyone', *Australian Financial Review* (online, 6 December 2019) <<https://www.afr.com/technology/westpac-s-tech-mess-could-happen-to-anyone-20191204-p53gqq>>; Stephen Bartholomeusz, 'Mission Impossible? Westpac Panel Highlights Directors' Dilemma', *The Sydney Morning Herald* (online, 4 June 2020) <<https://www.smh.com.au/business/banking-and-finance/mission-impossible-westpac-panel-highlights-directors-dilemma-20200604-p54zfp.html>>; James Frost and James Eysers, 'Westpac's Risk Culture Deemed "Immature and Reactive"', *Australian Financial Review* (online, 4 June 2020) <<https://www.afr.com/companies/financial-services/westpac-scandal-sloppy-not-a-conspiracy-20200604-p54zbpq>>.

²¹⁴ Montagnani and Passador (n 166) 9 (including n 35), 40–41. Such skill may effectively contribute to the proper selection of the perfect 'black box' (more correctly, AI tool) for that specific company, and become as essential as a legal or economic background among directors now often is. More specifically, as a consequence, 'boards will incorporate these features and will be able to independently equip themselves with the most suitable composition to fully understand those mechanisms and, specifically, to choose the most suitable AI system for their specific company, thereby ensuring the utmost accountability of AI systems employed for predictive goals': at 42.

Topol, in his authoritative review of medical AI, states that '[t]he state of AI hype has far exceeded the state of AI science, especially when it pertains to validation and readiness for implementation in patient care'.²¹⁵

Spiegelhalter's recent article illuminates these issues succinctly and we recommend it highly.²¹⁶ In his words:

It seems reasonable that, when confronted by an algorithm, we should expect trustworthy claims both:

1. *about* the system—what the developers say it can do, and how it has been evaluated, and
2. *by* the system—what it says about a specific case.²¹⁷

Spiegelhalter suggests anyone seeking to purchase or use an AI system should ask these questions about it:

1. Is it any good when tried in new parts of the real world?
2. Would something simpler, and more transparent and robust, be just as good?
3. Could I explain how it works (in general) to anyone who is interested?
4. Could I explain to an individual how it reached its conclusion in their particular case?
5. Does it know when it is on shaky ground, and can it acknowledge uncertainty?
6. Do people use it appropriately, with the right level of skepticism?
7. Does it actually help in practice?²¹⁸

These questions strongly appeal for their directness and simplicity. We have seen senior finance professionals, including in some major Australian banks, unwilling to insist on what their organisation really needs in its AI, and accept instead assurances or explanations from AI developers that they would not accept from other service suppliers. The reason seems to be the apprehension or lack of understanding many senior people have about AI and technology generally. In one of the most regulated of all industries, financial services, these attitudes are inappropriate. Spiegelhalter's seven questions provide a highly useful checklist in this regard. What is needed at the most senior levels of major banks, and within their in-house legal departments, is a cultural shift. Instead of the hesitancy and apprehension that often characterises current approaches to AI and technology more generally, these tools need to be approached with confidence, humility and the understanding that they can and must be held to perform at the required standards, and can be built to do so, if the procuring institution insists.

²¹⁵ Eric J Topol, 'High-Performance Medicine: The Convergence of Human and Artificial Intelligence' (2019) 25(1) *Nature Medicine* 44, 51.

²¹⁶ David Spiegelhalter, 'Should We Trust Algorithms?' (2020) 2(1) *Harvard Data Science Review* <<https://hdr.mitpress.mit.edu/pub/56lnenzj/release/1>>.

²¹⁷ *Ibid* [2 (Trust and Trust Worthiness)] (emphasis in original).

²¹⁸ *Ibid* [5 (Conclusions)].

VI Conclusion

The financial services sector globally is one of the leaders in AI use and development. However, AI comes with numerous technical, ethical and legal challenges that can undermine the objectives of financial regulation with respect to data, cybersecurity, systemic risk and ethics — in particular, relating to black box issues.

As shown, traditional financial supervision focused on external governance is unlikely to sufficiently address the risks created by AI, due to: (1) enhanced information asymmetry; (2) data dependency; and (3) interdependency. Accordingly, even where supervisors have exceptional resources and expertise, supervising the use of AI in finance by traditional means is extremely challenging.

To address this weakness, we suggest that internal governance of financial institutions be strengthened to impose personal responsibility requirements to put a human in the loop. This approach is based on existing frameworks of managerial responsibility that evolved in the aftermath of the 2008 Global Financial Crisis and of a seemingly continuing stream of ethically questionable behaviour across the world in finance. These frameworks should be cognisant of and consistent with broader data privacy and human-in-the-loop approaches beyond finance.²¹⁹ From a financial supervisor's perspective, internal governance can be strengthened largely through a renewed focus on senior managements' (or key function holders') personal responsibilities and accountability for regulated areas and activities, as designated for regulatory purposes. These key function holder rules — particularly if enhanced by specific AI due diligence and explainability requirements — will assist core staff of financial services firms to ensure that any AI is performing in ways consistent with the senior managers' personal responsibilities. The key function holders or managers-in-charge are responsible for themselves, their area of supervision, their staff, their third-party contractors, and their technology, including AI.

This direct personal responsibility encourages due diligence in investigating new technologies, their uses and impact, and on requiring fairness and explainability as part of any AI system, with attendant dire personal consequences for failure. For a financial services professional with direct responsibility, demonstrating appropriate due diligence and explainability will be key to a personal defence in the event of a regulatory action. This approach will also prove helpful to address the other data, cybersecurity, systemic risk, and ethical issues relating to AI in finance, particularly when combined with new AI review committees that can augment the decision-making and collective responsibility of senior management and the board.²²⁰

Importantly, this approach — while a natural evolution in the context of financial regulation — also has great potential for addressing AI concerns in any

²¹⁹ Tang (n 196).

²²⁰ Also within the board of directors, sound AI governance should be fostered and encouraged. Montagnani and Passador propose, at an operational level, enhancing board characteristics to this end, and, at a systemic level, avoiding the neglect of the ethical implications of using AI systems: Montagnani and Passador (n 166) 40–43. Creating an ad hoc committee (a tech committee) and assigning it tech-related functions, or specifically providing other board committees (mainly the audit or the risk management committees) with such tasks, might help in this regard.

other regulated industry facing black box issues arising from AI. While this does not necessarily address the macro issues emerging as a result of the Fourth Industrial Revolution, it will at least ensure that humans are central to the evolution of AI in already regulated industries. As it seems inevitable that AI will play a growing role in our lives and world it is imperative that we put humans in the loop in this human-machine relationship.²²¹

²²¹ Tang (n 196).

Vicarious Liability, Entrepreneurship and the Concept of Employment at Common Law


Pauline Bomball*

Abstract

The concept of employment at common law serves as a gateway to a wide range of statutory labour rights in Australia. Despite its significance in labour law and its frequent invocation before the courts, the concept remains the subject of significant contestation. A major point of disagreement concerns the notion of entrepreneurship. In some cases, judges have stated that entrepreneurship should be determinative of the inquiry as to whether a worker is an employee or an independent contractor. In other cases, entrepreneurship has been treated as simply one factor to be weighed against many others in the multifactorial test for employment status. This article explores the issue from a theoretical and a doctrinal perspective. It draws upon theories and case law on the doctrine of vicarious liability for guidance on the test for employment status. It argues that the proper approach is to treat entrepreneurship as the organising principle for the inquiry into whether a worker is an employee or an independent contractor. It contends that the adoption of such an approach would bring a greater degree of conceptual and analytical coherence to the complex task of distinguishing employees from independent contractors.

I Introduction

The ‘entrepreneur’ has attracted increased interest in recent times. The rise of the gig economy has drawn attention to the notion of entrepreneurship and its concomitant suite of characteristics, including innovation, flexibility, autonomy and profit-making.¹ Those who perform work in the gig economy are often branded as self-employed entrepreneurs by the organisations that hire them.² Yet, some workers

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¹ For a comprehensive analysis of gig economy work in Australia, see Paula McDonald, Penny Williams, Andrew Stewart, Robyn Mayes and Damian Oliver, *Digital Platform Work in Australia: Prevalence, Nature and Impact* (Report, November 2019).

² ‘Platforms suggested to the Inquiry that self-employment is a hallmark of their systems.’: Natalie James, *Report of the Inquiry into the Victorian On-Demand Workforce* (Report, June 2020) 112 [777]. Stewart and Stanford have referred to the ‘common assumption that gig economy workers are self-employed or operating as independent contractors’: Andrew Stewart and Jim Stanford,

in the gig economy do not exhibit the characteristics of entrepreneurs.³ Instead, they resemble employees who are subordinate to and dependent upon the organisations that engage them.⁴ The emergence of the gig economy has drawn into sharp focus an important, and unresolved, debate about the notion of entrepreneurship and its relevance to the legal determination of employment status. This article makes a contribution to the resolution of that debate.

Employment status in Australian law is important for a range of reasons.⁵ It is a crucial element of the doctrine of vicarious liability. An employer is vicariously liable for the torts committed by an employee in the course of his or her employment, whereas a principal cannot be held vicariously liable for the tortious conduct of an independent contractor.⁶ Employment status also marks out the boundaries of labour law's protection.⁷ This is because many labour statutes in Australia, including the *Fair Work Act 2009* (Cth), generally confer rights and protections upon employees only.⁸ Workers who are not employees, such as independent contractors, usually fall outside labour law's regime of protection.

In Australia, courts apply a multifactorial test to determine whether a worker is an employee or an independent contractor. This test, which the High Court of Australia enunciated in *Stevens v Brodribb Sawmilling Co Pty Ltd*⁹ and subsequently affirmed in *Hollis v Vabu Pty Ltd*,¹⁰ requires a court to examine and balance a range of indicia,¹¹ including:

- the nature and extent of control that the hiring party exercises over the worker;¹²
- the existence or otherwise of a right on the part of the worker to delegate his or her work to a third party;
- whether the worker assumes the risk of loss or has an opportunity for profit;
- whether the hiring party supplies the equipment and tools required to perform the work;

'Regulating Work in the Gig Economy: What are the Options?' (2017) 28(3) *Economic and Labour Relations Review* 420, 426.

³ See, eg, Valerio De Stefano, 'The Rise of the "Just-in-Time Workforce": On-Demand Work, Crowdfund, and Labor Protection in the "Gig-Economy"' (2016) 37(3) *Comparative Labor Law and Policy Journal* 471, 491–3.

⁴ *Ibid.*

⁵ Carolyn Sappideen, Paul O'Grady and Joellen Riley, *Mackenzie's Law of Employment* (Thomson Reuters, 8th ed, 2016) 20–1; Andrew Stewart, Anthony Forsyth, Mark Irving, Richard Johnstone and Shae McCrystal, *Creighton and Stewart's Labour Law* (Federation Press, 6th ed, 2016) 194–7.

⁶ *Sweeney v Boylan Nominees Pty Ltd* (2006) 226 CLR 161, 167 (Gleeson CJ, Gummow, Hayne, Heydon and Crennan JJ) ('*Sweeney*').

⁷ Rosemary Owens, Joellen Riley and Jill Murray, *The Law of Work* (Oxford University Press, 2nd ed, 2011) 152–3.

⁸ See, eg, *Fair Work Act 2009* (Cth) pts 2–2–2–4.

⁹ *Stevens v Brodribb Sawmilling Co Pty Ltd* (1986) 160 CLR 16 ('*Brodribb*').

¹⁰ *Hollis v Vabu Pty Ltd* (2001) 207 CLR 21 ('*Hollis*').

¹¹ Mark Irving, *The Contract of Employment* (LexisNexis Butterworths, 2nd ed, 2019) ch 2; Stewart et al (n 5) 204–13; Sappideen, O'Grady and Riley (n 5) 33–53.

¹² The term 'hiring party' or 'hirer' is used in this article to refer to the entity that engages the worker to perform work: Andrew Stewart, 'Redefining Employment? Meeting the Challenge of Contract and Agency Labour' (2002) 15(1) *Australian Journal of Labour Law* 235, 235 n 2.

- whether the hiring party makes arrangements on behalf of the worker in relation to matters such as insurance, superannuation and taxation; and
- whether the worker is integrated into the hiring party's organisation.

In affirming this test, the majority in *Hollis* referred with approval¹³ to the following statement of Windeyer J in *Marshall v Whittaker's Building Supply Co*:

[T]he distinction between [an employee] and an independent contractor is ... rooted fundamentally in the difference between a person who serves his employer in his, the employer's, business, and a person who carries on a trade or business of his own.¹⁴

In subsequent cases, this reference to carrying on a business of one's own has been encapsulated in the notion of entrepreneurship.¹⁵

There are currently diverging judicial approaches to the notion of entrepreneurship in Australian cases concerning the distinction between employees and independent contractors.¹⁶ In some cases, entrepreneurship is regarded as a separate legal test.¹⁷ According to this approach, an employee is someone who is not an entrepreneur.¹⁸ The court is to determine whether the worker in question is carrying on a business of his or her own.¹⁹ If the question is answered in the negative, then the worker is not an entrepreneur, and is likely to be an employee.²⁰ In other cases, judges have noted that this approach is erroneous, on the basis that focusing attention on whether the worker is an entrepreneur diverts a court's attention from the true inquiry, which is whether the worker is an employee.²¹

In some cases, judges have stated that an approach that treats entrepreneurship as determinative is inconsistent with the nature of the multifactorial test for employment status.²² That test involves a weighing up and balancing of

¹³ *Hollis* (n 10) 39 [40] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ).

¹⁴ *Marshall v Whittaker's Building Supply Co* (1963) 109 CLR 210, 217.

¹⁵ See, eg, *On Call Interpreters and Translators Agency Pty Ltd v Federal Commissioner of Taxation (No 3)* (2011) 214 FCR 82, 122–3 [207] ('*On Call Interpreters*'); *Fair Work Ombudsman v Quest South Perth Holdings Pty Ltd* (2015) 228 FCR 346, 389–92 ('*Quest*').

¹⁶ Stewart et al (n 5) 211–2; Andrew Stewart and Shae McCrystal, 'Labour Regulation and the Great Divide: Does the Gig Economy Require a New Category of Worker?' (2019) 32(1) *Australian Journal of Labour Law* 4, 8.

¹⁷ See, eg, *On Call Interpreters* (n 15); *Quest* (n 15).

¹⁸ *On Call Interpreters* (n 15) 123–7; *Quest* (n 15) 389–92.

¹⁹ *On Call Interpreters* (n 15) 123–7; *Quest* (n 15) 389–92.

²⁰ *On Call Interpreters* (n 15) 123–7; *Quest* (n 15) 389–92.

²¹ See, eg, *Tattsbet Ltd v Morrow* (2015) 233 FCR 46, 61 [61] ('*Tattsbet*'); *Fair Work Ombudsman v Ecosway Pty Ltd* [2016] FCA 296, [78] ('*Ecosway*'); *Jamsek v ZG Operations Australia Pty Ltd* (2020) 297 IR 210, 216 [8] (Perram J), 245–6 [181] (Anderson J) ('*Jamsek*'); *Dental Corporation Pty Ltd v Moffet* (2020) 297 IR 183, 199–200 [68] (Perram and Anderson JJ) ('*Moffet*'); *Eastern Van Services Pty Ltd v Victorian WorkCover Authority* (2020) 296 IR 391, 399–400 [35] ('*Eastern Van*').

²² See, eg, *Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd* [2019] FCA 1806, [153] ('*Personnel Contracting Trial*'): '[I]t is inconsistent with a multifactorial assessment to say that the absence of one factor (or the presence of it, for that matter), should for practical purposes dictate a result.' See also *Jensen v Cultural Infusion (Int) Pty Ltd* [2020] FCA 358, [89] ('*Jensen*').

multiple factors to form an overall impression of the character of the relationship.²³ Courts are to assess the ‘totality of the relationship’.²⁴ The elevation of one of the factors (entrepreneurship) above others is, it is said, incompatible with that injunction.²⁵ A third approach involves treating the notion of entrepreneurship as the organising principle that informs the court’s assessment of the indicia in the multifactorial test.²⁶

There is yet to be a sustained scholarly analysis of the proper role or function of the notion of entrepreneurship in the inquiry as to employment status. In providing that analysis, this article takes as its starting point two related propositions about the ‘common law concept of employment’.²⁷ The first proposition is that this concept is anchored in the doctrine of vicarious liability.²⁸ The second proposition is that when a statute, such as the *Fair Work Act 2009* (Cth), refers to the common law concept of employment, the statute is referring to this concept as understood in the law of vicarious liability.²⁹ Acceptance of these two propositions carries with it the consequence that the rationales underlying the doctrine of vicarious liability are relevant to the exposition of the common law concept of employment.³⁰ This approach is supported by the majority’s reasoning in *Hollis*. In that case, the majority observed that the common law concept of employment is shaped by ‘various matters which are expressive of the fundamental concerns underlying the doctrine of vicarious liability’.³¹ Some cases concerning the concept of employment involve a claim by a worker to certain protections and entitlements under labour statutes that operate by reference to this common law concept.³² Other cases involve claims of vicarious liability by third parties against organisations for injuries suffered due to torts committed by workers performing work for those organisations.³³ In both types of cases, the applicable conception of employment that is applied is that anchored in the concerns of vicarious liability.

²³ *Hall (Inspector of Taxes) v Lorimer* [1992] 1 WLR 939, 944 (‘*Lorimer*’); *Roy Morgan Research Pty Ltd v Federal Commissioner of Taxation* (2010) 184 FCR 448, 460 [31]–[32].

²⁴ See, eg, *Brodribb* (n 9) 29 (Mason J); *Hollis* (n 10) 33 [24], 41 [44] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ).

²⁵ See, eg, *Personnel Contracting Trial* (n 22) [153]; *Jensen* (n 22) [89].

²⁶ *Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd* (2020) 381 ALR 457, 461–3 [13]–[21] (Allsop CJ) (‘*Personnel Contracting*’).

²⁷ *ACE Insurance Ltd v Trifunovski* (2011) 200 FCR 532, 543 (‘*Trifunovski Trial*’); Pauline Bomball, ‘Statutory Norms and Common Law Concepts in the Characterisation of Contracts for the Performance of Work’ (2019) 42(2) *Melbourne University Law Review* 370, 373.

²⁸ *Trifunovski Trial* (n 27) 542–3. See also *Personnel Contracting* (n 26) 503–4 [176]–[179] (Lee J), referring to the submission of Counsel for the appellants (M Irving QC); Bomball (n 27) 377–9; Irving (n 11) 58.

²⁹ *Trifunovski Trial* (n 27) 542–3; *C v Commonwealth* (2015) 234 FCR 81, 87 [34]; *Personnel Contracting* (n 26) 475 [64] (Lee J). See also *Personnel Contracting* (n 26) 503–4 [176]–[179], referring to the submission of Counsel for the appellants (M Irving QC); *Jamsek* (n 21) 215 [3] (Perram J); Bomball (n 27) 379–82; Irving (n 11) 58.

³⁰ See *Personnel Contracting* (n 26) 503–4 [176]–[179], referring to the submission of Counsel for the appellants (M Irving QC); Bomball (n 27) 379; Irving (n 11) 58.

³¹ *Hollis* (n 10) 41 (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ). See also Bomball (n 27) 379; Irving (n 11) 58–9.

³² See, eg, *ACE Insurance Ltd v Trifunovski* (2013) 209 FCR 146 (‘*Trifunovski*’); *Jamsek* (n 21).

³³ See, eg, *Hollis* (n 10); *Sweeney* (n 6).

It remains unclear how the rationales underlying the doctrine of vicarious liability may bear upon the multifactorial test for employment status. The matter was left open in *Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd*,³⁴ a recent decision of the Full Court of the Federal Court of Australia that involved claims made pursuant to the *Fair Work Act 2009* (Cth). In that case, Lee J referred to the proposition that two key rationales underpinning vicarious liability, enterprise risk and agency, favour the view that entrepreneurship should be the central focus of the test for employment status.³⁵ Lee J, with whom Allsop CJ and Jagot J agreed, observed that such considerations were ‘beyond the scope of this judgment’.³⁶ This article analyses the proposition in detail and uses this analysis to illuminate the proper approach to the notion of entrepreneurship in cases concerning employment status. In so doing, it examines four principal theoretical justifications for vicarious liability: enterprise risk, deterrence, just compensation and loss distribution, and agency.³⁷ After engaging with the justifications at a theoretical level, the article examines key decisions of the High Court of Australia on vicarious liability to evaluate the extent to which the Court has embraced these justifications.³⁸

It is important to make some observations at the outset about the orientation of this article. While this article considers the doctrine of vicarious liability, it does so as part of a broader analysis of the concept of employment. It does not provide a comprehensive account of the law of vicarious liability. Furthermore, it does not critique the justifications for vicarious liability or catalogue those justifications.³⁹ This article is, in essence, a labour law article that engages with the theory and cases on vicarious liability only to the extent that these assist in resolving questions regarding employment status. It should also be noted that the article focuses on the multifactorial test for distinguishing employees and independent contractors. In order for a worker to be categorised as an employee, it must be established that there is a contract in existence between the worker and the hirer,⁴⁰ and that the contract has the character of a contract of employment.⁴¹ The two issues are distinct.⁴² This

³⁴ *Personnel Contracting* (n 26) 503–4 [177]–[179], 506 [189].

³⁵ *Ibid* 504 [178]–[179], referring to the submission of Counsel for the appellants (M Irving QC).

³⁶ *Ibid* 506 [189].

³⁷ For an examination and critique of the theoretical justifications, see Harold J Laski, ‘The Basis of Vicarious Liability’ (1916) 26(2) *Yale Law Journal* 105; T Baty, *Vicarious Liability* (Clarendon Press, 1916); Guido Calabresi, ‘Some Thoughts on Risk Distribution and the Law of Torts’ (1961) 70(4) *Yale Law Journal* 499; P S Atiyah, *Vicarious Liability in the Law of Torts* (Butterworths, 1967); Glanville Williams, ‘Vicarious Liability and the Master’s Indemnity’ (1957) 20(3) *Modern Law Review* 220 (‘Vicarious Liability I’); Glanville Williams, ‘Vicarious Liability and the Master’s Indemnity’ (1957) 20(5) *Modern Law Review* 437 (‘Vicarious Liability II’); JW Neyers, ‘A Theory of Vicarious Liability’ (2005) 43(2) *Alberta Law Review* 287; Douglas Brodie, *Enterprise Liability and the Common Law* (Cambridge University Press, 2010); Paula Giliker, *Vicarious Liability in Tort: A Comparative Perspective* (Cambridge University Press, 2010); Anthony Gray, *Vicarious Liability: Critique and Reform* (Hart Publishing, 2018).

³⁸ *Hollis* (n 10); *Sweeney* (n 6); *New South Wales v Lepore* (2003) 212 CLR 511 (‘*Lepore*’); *Prince Alfred College Inc v ADC* (2016) 258 CLR 134 (‘*Prince Alfred College*’).

³⁹ See above at n 37.

⁴⁰ Stewart et al (n 5) 204.

⁴¹ *Ibid*.

⁴² *Ibid*, citing *Ermogenous v Greek Orthodox Community of SA Inc* (2002) 209 CLR 95.

article is concerned with the latter issue regarding characterisation of the work contract; it does not address the former issue.

The arguments in this article are developed as follows. Part II critically analyses divergent judicial approaches to the notion of entrepreneurship in the case law on employment status. It argues that three different approaches are discernible, which it terms ‘entrepreneurship as a separate test’, ‘entrepreneurship as the organising principle’ and ‘entrepreneurship as a single factor’. The article argues that the first approach, entrepreneurship as a separate test, is not supported by decisions of the High Court on employment status. Accordingly, the question that remains for consideration is whether entrepreneurship is to be treated as the organising principle or as a single factor to be weighed against others in the multifactorial test. In searching for an answer to this question, Part III considers theoretical justifications for the doctrine of vicarious liability, and then examines the extent to which the High Court has embraced these justifications.

Having identified the key rationales underpinning vicarious liability, Part IV argues that these rationales demonstrate that the distinction between employees and independent contractors rests, in essence, on the basis that the former are working in the service of another while the latter are carrying on a business of their own.⁴³ Accordingly, the article argues that the proper approach to the multifactorial test for employment status is the one that treats entrepreneurship as the organising principle around which the indicia are assessed.⁴⁴ Such an approach would, by aligning the concept of employment with the relevant rationales, bring a degree of conceptual coherence to the exercise of distinguishing employees from independent contractors. Part IV of the article also engages with the view, expressed in some cases,⁴⁵ that the elevation of one factor above others is inconsistent with the nature of the multifactorial test. It suggests, with respect, that an alternative view, and the view that should be favoured, is that adoption of an organising principle would bring a degree of analytical coherence to the application of a test involving multiple factors that pull in different directions.⁴⁶

The ideas advanced in this article have important practical ramifications for workers. An example from the gig economy is illustrative. In *Gupta v Portier Pacific Pty Ltd*,⁴⁷ the Full Bench of the Fair Work Commission rejected an Uber Eats driver’s unfair dismissal claim on the basis that she was not an employee and thereby ineligible to bring a claim under the relevant provisions of the *Fair Work Act 2009* (Cth).⁴⁸ The Commission concluded that she was not running a business of her own,⁴⁹ but nevertheless held that she was not employed by Uber.⁵⁰ Had the Commission regarded entrepreneurship as the organising principle in its application

⁴³ See *Personnel Contracting* (n 26) 503–4 [177]–[179] (Lee J), referring to the submission of Counsel for the appellants (M Irving QC).

⁴⁴ Ibid 461 [13] (Allsop CJ).

⁴⁵ See, eg, *Personnel Contracting Trial* (n 22) [153]; *Jensen* (n 22) [89].

⁴⁶ *Personnel Contracting* (n 26) 461 [13] (Allsop CJ); Ian Neil and David Chin, *The Modern Contract of Employment* (Lawbook, 2nd ed, 2017) 22.

⁴⁷ *Gupta v Portier Pacific Pty Ltd* (2020) 296 IR 246 (‘*Gupta*’).

⁴⁸ Ibid 276 [70], [72] (President Ross and Vice President Hatcher).

⁴⁹ Ibid 275–6 [68], [71]–[72] (President Ross and Vice President Hatcher).

⁵⁰ Ibid 276 [70], [72] (President Ross and Vice President Hatcher).

of the multifactorial test for employment status, it is possible that it would have reached the opposing conclusion.

Cases such as *Gupta* have, along with other matters, prompted the authors of the *Report of the Inquiry into the Victorian On-Demand Workforce* to recommend that the Commonwealth Parliament amend the *Fair Work Act 2009* (Cth) so as to include a statutory test for employment that identifies as employees those workers who are not carrying on a business of their own.⁵¹ There is, with respect, great force in this recommendation. Unless and until such a recommendation is adopted by the Parliament, however, the courts must continue to apply the common law concept of employment, and it is that concept that forms the subject of this article.

II Three Competing Approaches to Entrepreneurship in the Legal Determination of Employment Status

This part of the article examines the case law dealing with the distinction between employees and independent contractors. Disagreement as to the role and function of entrepreneurship in the multifactorial inquiry turns primarily upon diverging approaches to the statement of Windeyer J in *Marshall* that was identified in the introduction to this article.⁵² In *Brodrigg*, Wilson and Dawson JJ referred to Windeyer J's statement as the 'ultimate question',⁵³ but it is important to note that their Honours did not regard the statement as a separate legal test. Their Honours noted that Windeyer J 'was really posing the ultimate question in a different way rather than offering a definition which could be applied for the purpose of providing an answer'.⁵⁴

While the majority in *Hollis* referred with approval to Windeyer J's statement,⁵⁵ their Honours did not express a view as to its treatment in *Brodrigg* and did not provide explicit guidance on how, if at all, Windeyer J's statement was to be incorporated into the multifactorial test for employment status. Nevertheless, a holistic reading of the judgment in *Hollis* indicates that Windeyer J's statement in *Marshall* informed the majority's analysis of the various indicia.⁵⁶ For example, the majority observed that the bicycle couriers in *Hollis*, whom they concluded were employees, 'were not running their own business or enterprise'.⁵⁷ The majority in *Hollis* did not treat Windeyer J's statement as a separate legal test.

Recently, members of the Federal Court of Australia have adopted competing approaches to Windeyer J's statement. Parts II(A)–(D) below traverse the case law to demonstrate the existence of these approaches.

⁵¹ James (n 2) 192.

⁵² See above n 14 and accompanying text.

⁵³ *Brodrigg* (n 9) 35.

⁵⁴ *Ibid.*

⁵⁵ *Hollis* (n 10) 39 [40] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ). See also above n 14 and accompanying text.

⁵⁶ *Ibid* 39–45 (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ).

⁵⁷ *Ibid* 41 [47] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ).

A *Entrepreneurship as a Separate Test*

In *On Call Interpreters and Translators Agency Pty Ltd v Commissioner of Taxation (No 3)*,⁵⁸ Bromberg J referred to Windeyer J's statement in *Marshall* and observed that it supplies 'a focal point around which relevant indicia can be examined'.⁵⁹ In the course of his Honour's reasons, however, Bromberg J appeared to go further. Instead of treating the notion of entrepreneurship as a focal point for the application of the indicia, his Honour developed a separate test of entrepreneurship. The test that Bromberg J articulated for determining whether a worker is an independent contractor was framed in the following manner:

Viewed as a 'practical matter':

- (i) is the person performing the work an entrepreneur who owns and operates a business; and,
- (ii) in performing the work, is that person working in and for that person's business as a representative of that business and not of the business receiving the work?

If the answer to that question is yes, in the performance of that particular work, the person is likely to be an independent contractor. If no, then the person is likely to be an employee.⁶⁰

Bromberg J stated that the indicia traditionally considered in the application of the multifactorial test were relevant at the second stage of the analysis.⁶¹ According to this approach, then, the court first asks whether the worker is carrying on a business of his or her own, and the considerations relevant to the multifactorial test come into play after the court has determined the answer to that antecedent question. Furthermore, the various indicia are relevant not to determining whether the worker is carrying on a business, but rather to determining whether the work is being performed for the worker's business, as opposed to the business of the person or entity that has engaged the worker.⁶²

In *Fair Work Ombudsman v Quest South Perth Holdings Pty Ltd*,⁶³ a decision of the Full Court of the Federal Court, North and Bromberg JJ explicitly endorsed Bromberg J's approach in *On Call Interpreters*. Importantly, North and Bromberg JJ stated that '[w]here the hallmarks of a business are absent, it will be a short step to the conclusion that the worker is an employee.'⁶⁴ In this regard, their Honours referred to Lander J's observation in *ACE Insurance Ltd v Trifunovski* that '[i]f the

⁵⁸ *On Call Interpreters* (n 15).

⁵⁹ *Ibid* 122 [207].

⁶⁰ *Ibid* 123 [208].

⁶¹ *Ibid* 125–7 [218]–[220]. See also *Quest* (n 15) 392 [186] (North and Bromberg JJ) (citations omitted): [T]he second question does not need to be answered in this case, but where relevant that question will need to be assessed in the context of the totality of the relationship. A range of indicia identified in the authorities may need to be examined in an exercise which is not to be performed mechanically because different significance may attach to the same indicators in different cases.

⁶² *On Call Interpreters* (n 15) 125–7 [218]–[220]; *Quest* (n 15) 392 [186] (North and Bromberg JJ).

⁶³ *Quest* (n 15).

⁶⁴ *Ibid* 391 [184].

respondents were not conducting their own business then logically it followed that they must have been working in the appellant's business.'⁶⁵

It might be argued, with respect, that the approach expounded in *On Call Interpreters* and endorsed in *Quest* is not supported by the reasoning in *Brodribb*.⁶⁶ Moreover, it is not supported by the majority's judgment in *Hollis*, where the ultimate question of whether the worker was carrying on a business of his or her own was answered by reference to the multifactorial analysis.⁶⁷ In other cases, which will be considered in Part II(B) below, the notion of entrepreneurship is accorded central importance, but assigned a different function. Instead of functioning as a separate test, entrepreneurship is treated as the organising principle around which the indicia in the multifactorial test are assessed.

B Entrepreneurship as the Organising Principle

In *Personnel Contracting*, Allsop CJ identified a need for there to be 'principles or organising conceptions that inform the relevant binary distinction'⁶⁸ between employees and independent contractors. In identifying those principles or organising conceptions, Allsop CJ referred to Windeyer J's statement in *Marshall*.⁶⁹ In elucidating the nature of the judicial exercise involved in determining the character of a contract for the performance of work,⁷⁰ Allsop CJ referred to the reasoning of Mummery J in *Hall (Inspector of Taxes) v Lorimer*.⁷¹ Mummery J had, in turn, referred to the judgment of Cooke J in *Market Investigations Ltd v Minister for Social Security*,⁷² where it was posited that the ultimate question in cases involving employment status was whether the worker was carrying on a business of his or her own. In answering that ultimate question, Mummery J observed that '[i]n order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person's work activity.'⁷³

This approach to the multifactorial test treats entrepreneurship as an organising principle. The various indicia are examined and balanced to determine whether the worker is in business on his or her own account. A similar approach can be discerned from the judgment of Buchanan J in *Trifunovski*.⁷⁴ Buchanan J, with whom Lander and Robertson JJ agreed, had regard to Windeyer J's statement in *Marshall*,⁷⁵ but did not treat it as a separate legal test. Instead, Buchanan J used it to inform his Honour's analysis of the various indicia in the multifactorial test.⁷⁶

⁶⁵ *Trifunovski* (n 32) 149 [15].

⁶⁶ See *Personnel Contracting* (n 26) 503 [176] (Lee J), referring to the submission of Counsel for the appellants (M Irving QC).

⁶⁷ *Hollis* (n 10) 41–5 [46]–[57]. See also Neil and Chin (n 46) 8–9; *Personnel Contracting* (n 26) 503 [176] (Lee J), referring to the submission of Counsel for the appellants (M Irving QC).

⁶⁸ *Personnel Contracting* (n 26) 461 [13].

⁶⁹ *Ibid* quoting *Marshall* (n 14) 217.

⁷⁰ *Personnel Contracting* (n 26) 462 [18].

⁷¹ *Lorimer* (n 23) 944.

⁷² *Market Investigations Ltd v Minister for Social Security* [1969] 2 QB 173, 184–5.

⁷³ *Lorimer* (n 23) 944.

⁷⁴ *Trifunovski* (n 32).

⁷⁵ *Ibid* 170 [93] (Buchanan J; Lander J agreeing at 148 [2]; Robertson J agreeing at 190 [172]).

⁷⁶ *Ibid* 182–6 [126]–[149].

C *Entrepreneurship as a Single Factor*

The third approach, which accords no particular significance to the notion of entrepreneurship, is illustrated by Jessup J's judgment in *Tattsbet Ltd v Morrow*.⁷⁷ Jessup J stated that to inquire whether the worker is an entrepreneur is 'to deflect attention from the central question, whether the person concerned is an employee or not'.⁷⁸ His Honour emphasised that '[t]he question is not whether the person is an entrepreneur: it is whether he or she is an employee.'⁷⁹ This approach treats entrepreneurship as simply one factor to be balanced against the others in the multifactorial test. Subsequently, in *Fair Work Ombudsman v Ecosway Pty Ltd*,⁸⁰ White J adopted Jessup J's approach in *Tattsbet*.⁸¹ The Victorian Court of Appeal also adopted this approach in *Eastern Van Services Pty Ltd v Victorian WorkCover Authority*.⁸²

In *Personnel Contracting*, Lee J observed that a focus on entrepreneurship 'might, in some cases, have the potential to detract attention from the central question'.⁸³ Nevertheless, his Honour stated that this 'is not to say that the reasoning of North and Bromberg JJ in ... *Quest* [is] not of real assistance.'⁸⁴ Lee J noted that to ask, as their Honours did, whether the worker is carrying on his or her own business 'is likely to be a useful way of approaching the broader inquiry in many cases'.⁸⁵ Ultimately, Lee J observed that 'the weight to be afforded to whether the worker is conducting a business on their own account is to be assessed in the light of the *whole* picture and will, of course, vary on a case by case basis'.⁸⁶

In *Jamsek v ZG Operations Australia Pty Ltd*, a decision of the Full Court of the Federal Court of Australia, Perram J stated that '[n]o doubt understanding whose business is being conducted is a valuable aid to comprehension but it is not the central inquiry and an answer to it, one way or the other, is not necessarily decisive'.⁸⁷ In the same case, Anderson J observed that 'the appropriate question is not whether the person is conducting their own business; the question is whether the person is an employee'.⁸⁸ In *Dental Corporation Pty Ltd v Moffet*, another decision of the Full Federal Court, Perram and Anderson JJ, with whom Wigney J agreed, stated that 'the central question to be answered is whether the person is employed'.⁸⁹

⁷⁷ *Tattsbet* (n 21).

⁷⁸ *Ibid* 61 [61].

⁷⁹ *Ibid*. White J agreed with Jessup J: at 80 [140]. Allsop CJ declined to comment on this issue, noting that it was 'unnecessary' to determine whether the test enunciated in *On Call Interpreters* (n 15) and adopted in *Quest* (n 15) is 'likely to be generally determinative': at 49 [3]. *Tattsbet* (n 21) was handed down before *Personnel Contracting* (n 26) and Allsop CJ made his views clear in the subsequent decision: see above Part II(B).

⁸⁰ *Ecosway* (n 21).

⁸¹ *Ibid* [78].

⁸² *Eastern Van* (n 21) 399–400 [30]–[36].

⁸³ *Personnel Contracting* (n 26) 484 [96].

⁸⁴ *Ibid*.

⁸⁵ *Ibid*.

⁸⁶ *Ibid* (emphasis in original).

⁸⁷ *Jamsek* (n 21) 216 [8].

⁸⁸ *Ibid* 245–6 [181].

⁸⁹ *Moffet* (n 21) 199 [68].

and '[c]onsiderations of who is conducting what business and for whom does the goodwill inure are but aids to that analysis.'⁹⁰

D Summary of the Competing Approaches to Entrepreneurship

Part II has examined diverging approaches to the notion of entrepreneurship in cases concerning employment status. It identified three competing approaches: entrepreneurship as a separate test; entrepreneurship as the organising principle; and entrepreneurship as a single factor. It argued that the first approach appears to be inconsistent with High Court authorities on the multifactorial test. The issue that remains unresolved is which of the latter two approaches is the proper approach. In answering that question, it is instructive to consider the justifications or rationales underlying the doctrine of vicarious liability. These justifications are explored in Part III below.

III Justifications for the Doctrine of Vicarious Liability

The common law concept of employment has its basis in the law of vicarious liability.⁹¹ Generally, a person who has suffered harm as a result of a worker's wrongful act must surmount two hurdles in order to establish vicarious liability on the part of the organisation that engaged that worker.⁹² First, it must be established that the worker was an employee of the organisation (as opposed to an independent contractor).⁹³ Second, it must be shown that the wrongful act occurred in that employee's course of employment.⁹⁴ The common law concept of employment arises at the first stage of the analysis. In *Hollis*, the majority stated that the common law concept of employment is shaped by the 'concerns'⁹⁵ or 'considerations'⁹⁶ that underpin the doctrine of vicarious liability. Accordingly, in giving content to that concept, it is instructive to have regard to the rationales underlying vicarious liability.

Before discussing those rationales, two contextualising matters should be noted. First, the nature, scope and contours of the doctrine of vicarious liability are the subject of significant contestation in the courts⁹⁷ and within the literature.⁹⁸ As discussed below in Part III(B), the High Court of Australia is yet to articulate a unified view on vicarious liability,⁹⁹ and the approach that it adopts at present departs

⁹⁰ Ibid.

⁹¹ See above nn 27–33 and accompanying text.

⁹² For an overview of the law of vicarious liability in Australia, see Harold Luntz, David Hambly, Kylie Burns, Joachim Dietrich, Neil Foster, Genevieve Grant and Sirko Harder, *Torts: Cases and Commentary* (LexisNexis, 8th ed, 2017) ch 17.

⁹³ See, eg, *Hollis* (n 10); *Sweeney* (n 6).

⁹⁴ See, eg, *Lepore* (n 38); *Prince Alfred College* (n 38).

⁹⁵ *Hollis* (n 10) 41 [45] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ).

⁹⁶ Ibid 38 [36] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ).

⁹⁷ See discussion below at Part III(B).

⁹⁸ See above n 37 and discussion and sources cited below in Part III(A).

⁹⁹ *Prince Alfred College* (n 38) 148–50 [38]–[47]. See also Paula Giliker, 'Analysing Institutional Liability for Child Sexual Abuse in England and Wales and Australia: Vicarious Liability, Non-Delegable Duties and Statutory Intervention' (2018) 77(3) *Cambridge Law Journal* 506.

from the approaches adopted by courts in other common law jurisdictions, including the United Kingdom¹⁰⁰ and Canada.¹⁰¹ This article is concerned with the proper approach to determining employment status in the Australian context. Accordingly, the focus will be on decisions of the High Court of Australia rather than upon those from overseas. Decisions from other jurisdictions will be discussed only to the extent necessary to illuminate the reasoning in the Australian cases.

The second contextualising point concerns the fact that the High Court has drawn a distinction between the rationales or justifications for the doctrine of vicarious liability on the one hand, and the legal principles or ‘criterion of liability’¹⁰² that guide the imposition of vicarious liability on the other.¹⁰³ This article considers the underlying rationales or justifications for vicarious liability. It does not seek to discern the legal principles or tests for the imposition of vicarious liability. Furthermore, this article is concerned with the rationales underpinning vicarious liability only to the extent that they provide guidance on the function of the notion of entrepreneurship in the legal test for employment status.

Before examining the relevant High Court authorities, this article considers the theoretical justifications for vicarious liability as elucidated in the scholarly literature. This discussion is useful in situating the observations of the High Court as to those rationales. It is particularly important because the High Court has not provided comprehensive guidance on the relevant justifications.¹⁰⁴ The theoretical discussion provides an overarching framework through which to analyse more specific statements made at various times by different members of the High Court.

A Theoretical Justifications

Four key theoretical justifications for vicarious liability are enterprise risk, deterrence, just compensation and loss distribution, and agency.

1 Enterprise Risk

According to the enterprise risk theory,¹⁰⁵ the running of an enterprise or business inevitably involves the introduction of certain risks into the community, or an enhancement of certain existing risks. The employer derives benefits from running such an enterprise and should, therefore, bear the concomitant costs and burdens.¹⁰⁶

¹⁰⁰ See, eg, *Lister v Hesley Hall Limited* [2002] 1 AC 215; *Various Claimants v Catholic Child Welfare Society* [2013] 2 AC 1; *Cox v Ministry of Justice* [2016] AC 660; *Mohamud v Wm Morrison Supermarkets plc* [2016] AC 677.

¹⁰¹ See, eg, *Bazley v Curry* [1999] 2 SCR 534 (‘Bazley’); *Jacobi v Griffiths* [1999] 2 SCR 570; *John Doe v Bennett* [2004] 1 SCR 436; *EB v Order of the Oblates of Mary Immaculate in the Province of British Columbia* [2005] 3 SCR 45.

¹⁰² *Hollis* (n 10) 38 [36] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ).

¹⁰³ *Ibid.*

¹⁰⁴ *Prince Alfred College* (n 38) 148–50 [38]–[47].

¹⁰⁵ Calabresi (n 37); Simon Deakin, ‘“Enterprise-Risk”: The Juridical Nature of the Firm Revisited’ (2003) 32(2) *Industrial Law Journal* 97; Douglas Brodie, ‘Enterprise Liability: Justifying Vicarious Liability’ (2007) 27(3) *Oxford Journal of Legal Studies* 493; Brodie (n 37).

¹⁰⁶ Calabresi (n 37) 500–15; Brodie (n 37) 9.

When a risk associated with conducting the business materialises and causes harm to a third party, it is fair for the law to impose upon the employer the costs associated with the materialisation of that risk.¹⁰⁷ One risk associated with running a business is the risk that an employee may engage in negligent conduct or intentional wrongdoing in the course of his or her employment. Some scholars have explained the enterprise risk theory by reference to economic theories.¹⁰⁸ The enterprise risk approach facilitates the internalisation of the costs of conducting a business.¹⁰⁹ Imposing liability on the employer means that this particular cost of running the enterprise is accurately captured; failing to capture it would mean that the true costs of running the enterprise are understated, leading to overproduction and a suboptimal allocation of resources.¹¹⁰

2 *Deterrence*

The deterrence theory posits that it is the employers (that is, the persons or entities running the businesses) who are in the best position to implement systems and processes within their workplaces that mitigate the risk of harm.¹¹¹ It is the employers who have control over their systems and processes. If employers are made to bear the burden of any harm arising from the conduct of their businesses, then this will provide them with an incentive to put in place measures to reduce the risk of harm.¹¹² There are a range of possible measures that can be adopted, including those pertaining to the selection, training, supervision and discipline of employees. According to this theory, then, the imposition of vicarious liability is justified because of its deterrent effect.

It should be acknowledged that this theory is not based on the view that vicarious liability is imposed because there are flaws within an employer's work systems that equate to negligence on the part of the employer.¹¹³ Vicarious liability is imposed in the absence of fault on the part of the employer.¹¹⁴ The theory is simply based upon the idea that if employers are made to bear the costs associated with the risks arising from their businesses, then they will be incentivised to take precautionary measures to mitigate those risks.

¹⁰⁷ Calabresi (n 37) 500–1; Brodie (n 37) 9.

¹⁰⁸ Calabresi (n 37) 500–15.

¹⁰⁹ *Ibid.*

¹¹⁰ *Ibid.*

¹¹¹ Giliker (n 37) 241–3.

¹¹² *Ibid.*

¹¹³ *Hollis* (n 10) 43 [53] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ), quoting *Bazley* (n 101) 554–5:

Fixing the employer with responsibility for the employee's wrongful act, even where the employer is not negligent, may have a deterrent effect. ... Beyond the narrow band of employer conduct that attracts direct liability in negligence lies a vast area where imaginative and efficient administration and supervision can reduce the risk that the employer has introduced into the community. Holding the employer vicariously liable for the wrongs of its employee may encourage the employer to take such steps, and hence, reduce the risk of future harm.

¹¹⁴ *Prince Alfred College* (n 38) 148 [39] (French CJ, Kiefel, Bell, Keane and Nettle JJ): 'Vicarious liability is imposed despite the employer not itself being at fault.'

3 *Just Compensation and Loss Distribution*

There are generally three relevant parties to a case involving a claim of vicarious liability: the employer, the employee and the third party who has suffered harm as a result of the wrongful act of the employee. According to the just compensation theory, the innocent victim of harm should not have to shoulder the burden of the loss suffered. The law should facilitate compensation for the victim by imposing liability upon the party most able to bear the burden.¹¹⁵ The employer has ‘deep pockets’¹¹⁶ and is thereby in the best position to compensate the plaintiff. The employer also has the ability to spread the losses.¹¹⁷ This rationale was encapsulated in Williams’ observation that ‘[h]owever distasteful the theory may be, we have to admit that vicarious liability owes its explanation, if not its justification, to the search for a solvent defendant.’¹¹⁸

4 *Agency*

Another proposed theoretical justification for vicarious liability has its basis in the concept of agency, broadly conceived to refer to the situation where one party is acting on behalf of another.¹¹⁹ According to this theory, the imposition of vicarious liability upon the employer is justified because the employee is acting on the employer’s behalf. If harm occurs while the employee is acting on the employer’s behalf (that is, in the course of that employee’s employment) then it is fair for the employer to bear the cost.

Part III(A) has discussed four key theoretical justifications for the doctrine of vicarious liability. Part III(B) below explores several leading High Court authorities on vicarious liability to determine the extent to which members of the Court have embraced these justifications.

B *Justifications Advanced in the Case Law*

The High Court of Australia is yet to provide definitive guidance on the justifications for the doctrine of vicarious liability. As the majority recognised in *Hollis*, ‘[a] fully satisfactory rationale for the imposition of vicarious liability in the employment relationship has been slow to appear in the case law.’¹²⁰ In the High Court’s most

¹¹⁵ Williams, ‘Vicarious Liability I’ (n 37) 232.

¹¹⁶ Baty (n 37) 154.

¹¹⁷ Williams, ‘Vicarious Liability II’ (n 37) 440–3; Calabresi (n 37) 517–27.

¹¹⁸ Williams, ‘Vicarious Liability I’ (n 37) 232.

¹¹⁹ Oliver Wendell Holmes Jr, ‘Agency’ (1891) 4(8) *Harvard Law Review* 345; Oliver Wendell Holmes Jr, ‘Agency II’ (1891) 5(1) *Harvard Law Review* 1; Gray (n 37); Anthony Gray, ‘Liability of Educational Providers to Victims of Abuse: A Comparison and Critique’ (2017) 39(2) *Sydney Law Review* 167 (‘Liability of Educational Providers to Victims of Abuse’).

¹²⁰ *Hollis* (n 10) 37 [35] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ). Similarly, in *Sweeney*, the majority acknowledged that there is an absence of ‘any clear or stable principle which may be understood as underpinning the development of this area of the law’: *Sweeney* (n 6) 166–7 [11] (Gleeson CJ, Gummow, Hayne, Heydon and Crennan JJ).

recent decision on vicarious liability, *Prince Alfred College Inc v ADC*,¹²¹ the plurality stated that ‘common law courts have struggled to identify a coherent basis’ for imposing vicarious liability.¹²² Instead of seeking to identify the rationales that underpin the doctrine of vicarious liability, the plurality in *Prince Alfred College* adopted an incremental approach to the development of the doctrine, discerning particular features in previous cases that had favoured the imposition of liability.¹²³ The plurality eschewed the rationales and principles of vicarious liability adopted by ultimate appellate courts in Canada and the United Kingdom, although the features in those cases that favoured liability were of significance in the plurality’s reasoning.¹²⁴ Parts III(B)(1)–(3) below draw upon the Canadian decisions because they shed light upon the reasoning in the Australian cases.

1 *Enterprise Risk*

One of the most influential judicial expositions of the enterprise risk rationale is located in the judgment of the Supreme Court of Canada in *Bazley v Curry*.¹²⁵ In delivering the Court’s judgment, McLachlin J made the following observation:

Underlying the cases holding employers vicariously liable for the unauthorized acts of employees is the idea that employers may justly be held liable where the act falls within the ambit of the risk that the employer’s enterprise creates or exacerbates.¹²⁶

In *Hollis*, the majority appeared to endorse the enterprise risk theory as one rationale underpinning the doctrine of vicarious liability.¹²⁷ Their Honours referred to McLachlin J’s judgment in *Bazley*¹²⁸ and stated that

[i]n general, under contemporary Australian conditions, the conduct by the defendant of an enterprise in which persons are identified as representing that enterprise should carry an obligation to third persons to bear the cost of injury or damage to them which may fairly be said to be characteristic of the conduct of that enterprise.¹²⁹

Subsequently, in *New South Wales v Lepore*,¹³⁰ several members of the High Court also considered the enterprise risk theory. In analysing *Lepore*, it is important to acknowledge that the judges in this case adopted differing views on vicarious

¹²¹ *Prince Alfred College* (n 38).

¹²² *Ibid* 148 [39] (French CJ, Kiefel, Bell, Keane and Nettle JJ).

¹²³ *Ibid* 150 [46]–[47].

¹²⁴ *Ibid* 153–60 [57]–[83]. As Gageler and Gordon JJ observed in the same case (at 172 [130]), the approach adopted by the plurality does not adopt or endorse the generally applicable ‘tests’ for vicarious liability for intentional wrongdoing developed in the United Kingdom or Canada (or the policy underlying those tests), although it does draw heavily on various factors identified in cases involving child sexual abuse in those jurisdictions.

¹²⁵ *Bazley* (n 101).

¹²⁶ *Ibid* 557 [37].

¹²⁷ *Hollis* (n 10).

¹²⁸ *Ibid* 39 [41], citing *Bazley* (n 101) 552–5.

¹²⁹ *Hollis* (n 10) 40 [42] (Gleeson CJ, Gaudron, Gummow, Kirby and Hayne JJ).

¹³⁰ *Lepore* (n 38).

liability.¹³¹ Gleeson CJ drew a distinction between the rationales underlying the doctrine on the one hand, and the criterion of liability or principles that determine liability on the other.¹³² His Honour stated that '[a]s a test for determining whether conduct is in the course of employment, as distinct from an explanation of the willingness of the law to impose vicarious liability, [enterprise risk reasoning] has not been taken up in Australia'.¹³³ His Honour did not, however, eschew enterprise risk reasoning altogether. Gleeson CJ approached the course of employment test by reference to the question of whether there was a sufficiently close connection between the employment and the employee's wrongdoing.¹³⁴ His Honour stated that

in most cases, the considerations that would justify a conclusion as to whether an enterprise materially increases the risk of an employee's offending would also bear upon an examination of the nature of the employee's responsibilities, which are regarded as central in Australia.¹³⁵

In a joint judgment in *Lepore*, Gummow and Hayne JJ expressed reservations about the enterprise risk theory adopted in *Bazley*. Their Honours observed that '[c]reation and enhancement of risk ... may distract attention from what meaning should be given to course of employment'.¹³⁶ In the same case, Kirby J stated that the enterprise risk theory articulated in *Bazley* was 'persuasive'.¹³⁷ More recently, the plurality in *Prince Alfred College* observed that 'the risk-allocation aspect of the theory is based largely on considerations of policy, in particular that an employer should be liable for a risk that its business enterprise has created or enhanced',¹³⁸ and that '[s]uch policy considerations have found no real support in Australia or the United Kingdom'.¹³⁹

The reasoning in *Prince Alfred College* might, on one reading, support an approach that is similar to that based on the enterprise risk theory.¹⁴⁰ The plurality in that case developed an approach that distinguished between the concepts of 'opportunity' and 'occasion' to guide the analysis of whether the employee's wrongful act occurred in the course of his or her employment.¹⁴¹ According to the plurality, the fact that the employment provided the mere opportunity for the employee's wrongful act would not be sufficient to render the act one that occurred within the course of employment.¹⁴² On the other hand, if the employment provided the 'occasion' for the commission of the wrong, then that would be sufficient to

¹³¹ As the plurality observed in *Prince Alfred College* (n 38) 158 [75], '[i]t is well known that different approaches were taken to the question of vicarious liability in *New South Wales v Lepore*.' See also Jane Wangmann, 'Liability for Institutional Child Sexual Assault: Where Does Lepore Leave Australia?' (2004) 28(1) *Melbourne University Law Review* 169.

¹³² *Lepore* (n 38) 543–4 [65].

¹³³ *Ibid* 543 [65].

¹³⁴ *Ibid* 543–4 [65].

¹³⁵ *Ibid* 544 [65].

¹³⁶ *Ibid* 586 [214].

¹³⁷ *Ibid* 613 [303].

¹³⁸ *Prince Alfred College* (n 38) 153 [59].

¹³⁹ *Ibid*.

¹⁴⁰ Gray, 'Liability of Educational Providers to Victims of Abuse' (n 119) 186–7.

¹⁴¹ *Prince Alfred College* (n 38) 159–61 [80]–[85].

¹⁴² *Ibid* 159 [80].

ground the conclusion that the wrong was committed in the course of employment.¹⁴³ The plurality in *Prince Alfred College* stated that

it is possible for a criminal offence to be an act for which the apparent performance of employment provides the occasion. Conversely, the fact that employment affords an opportunity for the commission of a wrongful act is not of itself a sufficient reason to attract vicarious liability.¹⁴⁴

It has been suggested that the reference to employment providing the ‘occasion’ for the commission of the wrong is similar to the notion of enterprise risk, based as it is on the idea that the conduct of the enterprise gives rise to certain risks of harm.¹⁴⁵

2 Deterrence

In *Hollis*, the majority referred explicitly to the deterrence theory in reaching their conclusion that a bicycle courier was an employee, as opposed to an independent contractor.¹⁴⁶ The bicycle courier had negligently injured a member of the public while performing his courier duties. Along with a range of other factors, the majority observed that the company that engaged the bicycle courier knew of the risks that were posed to the public by the way its bicycle couriers carried out their duties.¹⁴⁷ Quoting from McLachlin J’s exposition of the deterrence theory in *Bazley*, the majority observed that one rationale for imposing vicarious liability was that it would incentivise employers to put in place precautionary measures to mitigate risks of harm.¹⁴⁸

In *Lepore*, Gummow and Hayne JJ were unpersuaded by the deterrence theory.¹⁴⁹ Their Honours’ observations were made in the context of a case involving an employee’s intentional criminal act. Their Honours stated that ‘[i]f the criminal law will not deter the wrongdoer there seems little deterrent value in holding the employer of the offender liable in damages for the assault committed.’¹⁵⁰ In the same case, Kirby J also acknowledged the shortcomings of the deterrence theory.¹⁵¹ His Honour noted that deterrence was ‘neither the main nor only factor’¹⁵² underpinning vicarious liability, and that it should instead ‘be taken together with the risk analysis ... and with a candid acknowledgment that vicarious liability is a loss distribution device’.¹⁵³

¹⁴³ Ibid 159–60 [80]–[81]. See also Desmond Ryan, ‘From Opportunity to Occasion: Vicarious Liability in the High Court of Australia’ (2017) 76(1) *Cambridge Law Journal* 14; James Goudkamp and James Plunkett, ‘Vicarious Liability in Australia: On the Move?’ (2017) 17(1) *Oxford University Commonwealth Law Journal* 162.

¹⁴⁴ *Prince Alfred College* (n 38) 159 [80] (French CJ, Kiefel, Bell, Keane and Nettle JJ).

¹⁴⁵ Gray, ‘Liability of Educational Providers to Victims of Abuse’ (n 119) 186–7.

¹⁴⁶ *Hollis* (n 10) 39 [41], 43 [53].

¹⁴⁷ Ibid 43 [53].

¹⁴⁸ Ibid, quoting *Bazley* (n 101) 554–5.

¹⁴⁹ *Lepore* (n 38) 587–8 [217]–[219].

¹⁵⁰ Ibid 587 [219].

¹⁵¹ Ibid 613–14 [305]–[306].

¹⁵² Ibid 614 [306].

¹⁵³ Ibid.

3 *Just Compensation and Loss Distribution*

As noted in the immediately preceding discussion, Kirby J accepted loss distribution as a rationale for vicarious liability in *Lepore*. His Honour observed that “[f]air and efficient” compensation is concerned with the search for a solvent defendant whom it is just and reasonable to burden with the legal liability for damages.¹⁵⁴ His Honour drew a connection between the just compensation rationale and the enterprise risk theory, observing that “[t]he basis upon which the Canadian Supreme Court concluded that a party can be justly burdened is through the application of an “enterprise risk” analysis.”¹⁵⁵ Gummow and Hayne JJ referred to the deep pockets justification in *Lepore* without expressly endorsing it. Their Honours noted that the justification

finds other, less pejorative, expression as a ‘principle of loss-distribution’ or as the need to provide a ‘just and practical remedy’ for harm suffered as a result of wrongs committed in the course of the conduct of the defendant’s enterprise.¹⁵⁶

4 *Agency*

In *Colonial Mutual Life Assurance Society Ltd v Producers and Citizens Co-operative Assurance Co of Australia Ltd*,¹⁵⁷ Dixon J observed that

[t]he rule which imposes liability upon a master for the wrongs of his servant committed in the course of his employment is commonly regarded as part of the law of agency: indeed, in our case-law the terms principal and agent are employed more often than not although the matter in hand arises upon the relation of master and servant.¹⁵⁸

In addition, Gummow and Hayne JJ’s judgment in *Lepore* draws on the language of agency,¹⁵⁹ with their Honours making the following statement by reference to Dixon J’s judgment in *Deatons Pty Ltd v Flew*:

[T]here are two elements revealed by what his Honour said that are important for present purposes. First, vicarious liability may exist if the wrongful act is done in *intended pursuit* of the employer’s interests or in *intended performance* of the contract of employment. Secondly, vicarious liability may be imposed where the wrongful act is done in *ostensible pursuit* of the employer’s business or in the *apparent execution of authority* which the employer holds out the employee as having.¹⁶⁰

¹⁵⁴ Ibid 612 [303].

¹⁵⁵ Ibid.

¹⁵⁶ Ibid 581 [197] (citations omitted).

¹⁵⁷ *Colonial Mutual Life Assurance Society Ltd v Producers and Citizens Co-operative Assurance Co of Australia Ltd* (1931) 46 CLR 41 (*‘Colonial Mutual Life Assurance’*). For a comprehensive discussion of the judicial statements that identify agency as the basis for vicarious liability, see Gray (n 37) 159–88; Gray, ‘Liability of Educational Providers to Victims of Abuse’ (n 119) 190–7.

¹⁵⁸ *Colonial Mutual Life Assurance* (n 157) 49.

¹⁵⁹ Gray, ‘Liability of Educational Providers to Victims of Abuse’ (n 119) 191 n 172.

¹⁶⁰ *Lepore* (n 38) 591–2 [231] (emphasis in original) discussing *Deatons Pty Ltd v Flew* (1949) 79 CLR 370. For a comprehensive analysis of Gummow and Hayne JJ’s approach in *Lepore*, see Christine Beuermann, *Reconceptualising Strict Liability for the Tort of Another* (Hart Publishing, 2019);

In *Lepore*, Gaudron J put forward the proposition that the doctrine of vicarious liability has its basis in the law of agency. Her Honour stated:

To the extent that vicarious liability is imposed on employers by reason that an employee has either done something that the employer has authorised or has done something in the course of his or her employment, it is referable to the general law of principal and agent.¹⁶¹

IV The Proper Approach: Entrepreneurship as the Organising Principle

A Conceptual Coherence

In the introduction to this article, it was noted that the Full Federal Court in *Personnel Contracting* had recently left open an important proposition about the concept of employment at common law. The relevant proposition was that two of the rationales underpinning vicarious liability, enterprise risk and agency, favour the view that entrepreneurship should be treated as the organising principle for the inquiry as to employment status.¹⁶² The basis for this proposition was that these rationales are not engaged when the worker is carrying on a business of his or her own. The rationales support the view that the distinction between employees and independent contractors is rooted in the distinction between working in the service of another and carrying on a business of one's own.¹⁶³

The theoretical and doctrinal analysis of the rationales for vicarious liability presented in Part III above provides a basis for evaluating the proposition. It is the contention of this article that the proposition is, with respect, correct. In substantiating this contention, it is instructive to consider the enterprise risk, deterrence, just compensation and loss distribution, and agency justifications for vicarious liability.

The enterprise risk theory focuses on the risks that are introduced into the community as a result of the conduct of the employer's enterprise. The relevant concerns are not enlivened when the worker is carrying on a business of his or her own. Calabresi has observed that the exception carved out for independent contractors from the law of vicarious liability is 'clearly justified' by reference to theories of risk distribution.¹⁶⁴ Even if the broader approach to enterprise risk adopted in the Canadian cases does not ultimately find favour in Australia, a narrower approach that is consistent with notions of enterprise risk is discernible

Christine Beuermann, 'Conferred Authority Strict Liability and Institutional Child Sexual Abuse' (2015) 37(1) *Sydney Law Review* 113.

¹⁶¹ *Lepore* (n 38) 554 [108].

¹⁶² See *Personnel Contracting* (n 26) 504 [178]–[179] (Lee J), 506 [189], referring to the submission of Counsel for the appellants (M Irving QC).

¹⁶³ *Ibid* 504 [178]–[179], referring to the submission of Counsel for the appellants (M Irving QC). See also Stewart (n 12) 261.

¹⁶⁴ Calabresi (n 37) 547.

from the judgments in *Sweeney v Boylan Nominees Pty Ltd*¹⁶⁵ and *Lepore*.¹⁶⁶ The majority in *Sweeney*¹⁶⁷ and Gummow and Hayne JJ in *Lepore*¹⁶⁸ regarded as significant Pollock's explanation of the basis of vicarious liability.¹⁶⁹ In *Sweeney*, the majority stated:

Pollock identified the element common to cases of vicarious liability as being that 'a man has for his own convenience brought about or maintained some state of things which in the ordinary course of nature may work mischief to his neighbours'. Pollock further concluded that where an employer conducted a business, and for that purpose employed staff, the employer brought about a state of things in which, if care was not taken, mischief would be done. But the liability to be imposed on the employer was liability for the way in which the business (that is, the employer's business) was conducted. Conduct of the business and the employee's actions in the course of employment in that business were the only state of things which the employer created and for which the employer would be responsible.¹⁷⁰

The focus of this narrower version of the enterprise risk theory remains on the conduct of the employer's business. In *Lepore*, Gummow and Hayne JJ made several important observations about Pollock's justification. Their Honours stated:

Conducting any enterprise carries with it a variety of risks. The paradigm kind of risk of which Pollock spoke was the risk that an employee, setting out on the employer's business, carried out a task carelessly and injured a third party. ... The risk, for the occurrence of which the employer was to be held liable, was, therefore, the risk of injury caused by an employee in pursuing the employer's venture.¹⁷¹

It appears that the explanation given by Pollock of the basis for imposing vicarious liability is very similar to the enterprise risk theory propounded in *Bazley*. Gummow and Hayne JJ stated:

Where the analysis made in *Bazley* departs from the proposition identified by Pollock is that the risks to be considered are not confined to those risks which attend the *furtherance* of the venture but include the risks of conduct that is directly antithetical to those aims.¹⁷²

The preceding observations shed light upon the connection between the enterprise risk theory and the notion of entrepreneurship, and on the relevance of the notion of entrepreneurship to the inquiry as to employment status. These observations demonstrate that the focus of the enterprise risk theory, either broadly or narrowly conceived, is on the business conducted by the employer and the venture of the employer. The concerns are not engaged when the worker is conducting a business of his or her own. The significance of the worker conducting his or her own business was addressed explicitly in *Sweeney*, with the majority stating that the

¹⁶⁵ *Sweeney* (n 6).

¹⁶⁶ *Lepore* (n 38).

¹⁶⁷ *Sweeney* (n 6) 170–1 [21]–[23] (Gleeson CJ, Gummow, Hayne, Heydon and Crennan JJ).

¹⁶⁸ *Lepore* (n 38) 588 [220]–[221].

¹⁶⁹ Frederick Pollock, *Essays in Jurisprudence and Ethics* (Macmillan and Co, 1882).

¹⁷⁰ *Sweeney* (n 6) 170–1 [23] (Gleeson CJ, Gummow, Hayne, Heydon and Crennan JJ) (emphasis omitted) (citations omitted). See also *Lepore* (n 38) 582 [200]–[202] (Gummow and Hayne JJ).

¹⁷¹ *Lepore* (n 38) 588 [221] (emphasis in original).

¹⁷² *Ibid* 588 [222] (emphasis in original).

worker, who was held to be an independent contractor, 'did what he did not as an employee of the respondent but as a principal pursuing his own business or as an employee of his own company pursuing its business'.¹⁷³

The version of the just compensation and loss distribution theories that has the most promising foundation in the Australian case law is the one that links just compensation and loss distribution with the enterprise risk theory. As explained above,¹⁷⁴ Kirby J made this connection in *Lepore*, observing that it is fair to impose the burden of losses suffered on the party who has introduced into the community, through the conduct of an enterprise, the relevant risk that led to the losses.¹⁷⁵ The connection between loss distribution and enterprise risk is also noted in the literature on theories of vicarious liability.¹⁷⁶ On this basis, the reasoning in the immediately preceding paragraph, which addressed the relationship between the enterprise risk theory and the notion of entrepreneurship, applies equally to the rationales of just compensation and loss distribution.

Pollock's exposition of vicarious liability also assists in the articulation of the connection between the deterrence theory and the notion of entrepreneurship. In *Lepore*, Gummow and Hayne JJ referred to Pollock's view that one justification for vicarious liability is that employers should be incentivised to select employees, and to create and administer work systems, with due care, even if this means that in particular cases the imposition of liability causes 'some individual hardship'.¹⁷⁷ Pollock adopted a different view in relation to contractors, noting that 'the use of care in choosing a contractor who is likely to be careful is too remote a benefit to the community to be enforced by indiscriminate penalties'.¹⁷⁸ Gummow and Hayne JJ observed that 'the deterrent effect of holding an employer responsible for the negligence of employees'¹⁷⁹ was thus one reason underlying the principle that an employer is vicariously liable for the torts of an employee, but a principal is not vicariously liable for the torts of an independent contractor.¹⁸⁰ The deterrence justification is not engaged when the worker is conducting a business of his or her own.

Finally, the agency theory also supports the view that the notion of entrepreneurship should be the ultimate inquiry in cases concerning employment status. According to the agency theory, the imposition of vicarious liability is justified on the basis that the employee is the employer's agent; the employee is acting on behalf of the employer in the conduct of that employer's business.¹⁸¹ The relevant concerns are not enlivened when the worker is conducting his or her own business.¹⁸²

¹⁷³ *Sweeney* (n 6) 173 [33] (Gleeson CJ, Gummow, Hayne, Heydon and Crennan JJ).

¹⁷⁴ See above Pt III(B)(3).

¹⁷⁵ *Lepore* (n 38) 612–13 [303].

¹⁷⁶ See, eg, Brodie (n 37) 14, citing C Robert Morris Jr, 'Enterprise Liability and the Actuarial Process: The Insignificance of Foresight' (1961) 70(4) *Yale Law Journal* 554, 584.

¹⁷⁷ *Lepore* (n 38) 581 [198], quoting Pollock (n 169) 130.

¹⁷⁸ *Ibid.*

¹⁷⁹ *Lepore* (n 38) 581 [198].

¹⁸⁰ *Ibid.*

¹⁸¹ See above Part III(A)(4) and Part III(B)(4).

¹⁸² See *Personnel Contracting* (n 26) 504 [178] (Lee J), referring to the submission of Counsel for the appellants (M Irving QC).

The four principal rationales examined above demonstrate that the distinction between employees and independent contractors rests, in essence, upon the basis that the former are working in the service of another, while the latter are carrying on a business of their own.¹⁸³ Accordingly, in marking out the boundary between these two categories, the legal test for employment status should adopt, as its ultimate inquiry, the question of whether the worker is carrying on a business of his or her own.¹⁸⁴ The notion of entrepreneurship should provide an overarching framework by reference to which the various indicia in the multifactorial test are assessed. Such an approach aligns the concept of employment with the rationales underlying the body of law in which it is anchored, thereby bringing a degree of conceptual coherence to the exercise of distinguishing employees from independent contractors.

B *Analytical Coherence*

Some judges have observed that the elevation of entrepreneurship above other factors is inconsistent with the nature of the multifactorial test.¹⁸⁵ The test requires an evaluation and balancing of various indicia, none of which are determinative.¹⁸⁶ One advantage of the approach that treats entrepreneurship as the organising principle for the application of the test is that it provides courts with an overarching framework by which to assess a multitude of factors that pull in different directions. In *Ellis v Wallsend District Hospital*, Samuels JA of the New South Wales Court of Appeal, with whom Meagher JA agreed, expressed the following reservations about the multifactorial approach expounded in *Brodribb*:

The problem is that this approach, tending as it does to define the relationship only in terms of its elements, does not provide any external test or requirement by which the materiality of the elements may be assessed. The assertion that a working relationship between A and B will constitute one of employment, provided that it manifests the elements of such a relationship, may be unhelpful unless those elements are certain in number, character, quality and importance, in which case their presence in the prescribed measure will establish the character of the relationship.¹⁸⁷

The adoption of entrepreneurship as the organising principle mitigates some of these concerns. Support for this proposition may be derived from Allsop CJ's judgment in *Personnel Contracting*.¹⁸⁸ His Honour observed that there needs to be 'organising conceptions that inform the relevant binary distinction in order that the task is not one to determine a legal category of meaningless reference'.¹⁸⁹ Treating

¹⁸³ Ibid 504 [178]–[179], referring to the submission of Counsel for the appellants (M Irving QC).

¹⁸⁴ Ibid.

¹⁸⁵ See, eg, *Personnel Contracting Trial* (n 22) [153]; *Jensen* (n 22) [89].

¹⁸⁶ The one exception is the requirement of personal service. Employment requires the provision of personal service. If a worker has an unqualified right to delegate his or her work to another party, then that will almost invariably lead to the conclusion that the worker is an independent contractor: *Australian Mutual Provident Society v Chaplin* (1978) 18 ALR 385, 391; *Brodribb* (n 9) 38.

¹⁸⁷ *Ellis v Wallsend District Hospital* (1989) 17 NSWLR 553, 597. See also Neil and Chin (n 46) 16–17.

¹⁸⁸ *Personnel Contracting* (n 26) 461 [13].

¹⁸⁹ Ibid referring to Julius Stone, *The Province and Function of Law* (Harvard University Press, rev ed, 1950) 171.

entrepreneurship as the organising principle around which the indicia are assessed may bring some degree of analytical coherence to the task.¹⁹⁰

V Conclusion

The many and varied ways in which work relationships are structured in the modern economy¹⁹¹ have brought to the fore existing uncertainties surrounding the multifactorial test for employment status. This article has addressed one of those uncertainties: namely, the role and function of the notion of entrepreneurship in the application of that test. It has critically examined the cases and discerned three competing approaches to entrepreneurship: entrepreneurship as a separate test; entrepreneurship as the organising principle; and entrepreneurship as a single factor. It has argued that the proper approach is to treat entrepreneurship as the organising principle that informs the assessment of the indicia in the multifactorial test.

In advocating for the adoption of this approach, this article has drawn upon theoretical justifications underpinning the doctrine of vicarious liability, as well as the case law on this doctrine. The common law concept of employment is anchored in the law of vicarious liability. The rationales underpinning the doctrine of vicarious liability demonstrate that the distinction between employees and independent contractors rests, in essence, on the basis that employees work in the service of another, while independent contractors carry on their own businesses. The common law concept of employment marks out the boundary between those who are running their own businesses ('entrepreneurs') and those who are not. The determination of whether a worker is an employee or an independent contractor is a complex exercise that has long vexed the judiciary.¹⁹² Delineating the contours of the concept of employment by reference to the rationales underpinning vicarious liability may bring a greater degree of conceptual and analytical coherence to that exercise.

¹⁹⁰ *Personnel Contracting* (n 26) 461 [13]. See also Neil and Chin (n 46) 22.

¹⁹¹ See generally Richard Johnstone, Shae McCrystal, Igor Nossar, Michael Quinlan, Michael Rawling and Joellen Riley, *Beyond Employment: The Legal Regulation of Work Relationships* (Federation Press, 2012).

¹⁹² See, eg, Hugh Collins, 'Independent Contractors and the Challenge of Vertical Disintegration to Employment Protection Laws' (1990) 10(3) *Oxford Journal of Legal Studies* 353; Joellen Riley, 'The Definition of the Contract of Employment and its Differentiation from Other Contracts and Other Work Relations' in Mark Freedland, Alan Bogg, David Cabrelli, Hugh Collins, Nicola Countouris, ACL Davies, Simon Deakin and Jeremias Prassi (eds), *The Contract of Employment* (Oxford University Press, 2016) 321; Simon Deakin, 'Decoding Employment Status' (2020) 31(2) *King's Law Journal* 180.

Before the High Court

The Limits of Fairness and Fact-Finding in Judicial Review: *MZAPC v Minister for Immigration and Border Protection*

Serena May*

Abstract

The appeal to the High Court of Australia in *MZAPC v Minister for Immigration and Border Protection* raises important questions about how, and why, applicants for judicial review of administrative decisions must prove that a legal error was material, in the sense that it deprived them of the possibility of a different outcome. The current approach to proving materiality invites a review court to engage with a decision on its merits so as to determine whether an applicant has discharged this onus of proof. This column argues that approach fails adequately to vindicate legal limits on public powers, and, as such, is both a source of injustice and incorrect at a level of principle.

I Introduction

Materiality has long been used by review courts as a tool of analysis in administrative law, both in the identification of jurisdictional errors and in the exercise of the court's discretion to grant relief. Recently, it has attracted renewed interest in light of the High Court of Australia's ruling that an error *must* be material to be jurisdictional in nature.¹ Yet, how is materiality to be proved, and by whom? More importantly, does the proof of materiality promote or undermine the protection of individuals from unfair exercises of public power?

These questions arise in a novel form in *MZAPC v Minister for Immigration and Border Protection*,² which now comes before the High Court of Australia.³ The decision concerns the review by the then Refugee Review Tribunal under pt 7 of the

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¹ *Minister for Immigration v SZMTA* (2019) 264 CLR 421 ('SZMTA'), 444 [44] (Bell, Gageler and Keane JJ), applying the principle in *Hossain v Minister for Immigration and Border Protection* (2018) 264 CLR 123, 134–5 [29]–[31] (Kiefel CJ, Gageler and Keane JJ). Contrast the dissenting view in *SZMTA* at 455–60 [81]–[95] (Nettle and Gordon JJ).

² *MZAPC v Minister for Immigration and Border Protection* [2019] FCA 2024, [20] ('MZAPC (FCA)').

³ High Court of Australia, Case No M77/2020 ('MZAPC').

Migration Act 1958 (Cth) (*'Migration Act'*) of the Minister for Immigration and Border Protection's refusal to grant a protection visa. During its review, the Tribunal failed to disclose to the applicant that the Minister asserted a form of public interest immunity in certain materials given to the Tribunal. These materials were potentially adverse to the applicant, and, on the applicant's submissions on appeal, were capable of contributing to the Tribunal's findings regarding the applicant's credibility. Nevertheless, the Federal Court of Australia held that the appellant had failed to prove that the Tribunal's reasoning was affected by the adverse materials; thus, any unfairness that resulted from the Tribunal's failure to disclose the public interest immunity claim did not involve a jurisdictional error.

In the appeal from *MZAPC (FCA)*, the High Court must authoritatively decide how an applicant is to establish the materiality of a breach of procedural fairness, where the breach relates to a failure to disclose materials adverse to the applicant. In doing so, the High Court will be required to clarify aspects of its recent judgment in *Minister for Immigration v SZMTA*. In *SZMTA*, the Court held that a breach of procedural fairness due to non-disclosure of an invalid public interest immunity claim was immaterial to the outcome of the decision.⁴ This column argues that the High Court should use this opportunity to reframe the applicant's burden of proof with respect to materiality. Given the recent significance of materiality as a precondition to jurisdictional error, it is vital that the method of establishing materiality is principled. This appeal vividly demonstrates that the current approach is far from principled, for it undermines the statutory scheme to afford participation rights to applicants in the decision-making process and thereby fails to achieve any purported aim of practical justice.

II The Statutory Framework and Facts

Under pt 7 of the *Migration Act*, an applicant is entitled to review of a decision of a delegate of the Minister to refuse or cancel a protection visa.⁵ Upon the lodgement of a valid application for review,⁶ the Administrative Appeals Tribunal (previously the Refugee Review Tribunal) must review the decision.⁷ Section 418 of the *Migration Act* imposes a procedural obligation upon the Secretary of the Department to provide all documents that are relevant to the review to the Registrar for the purpose of giving the documents to the Tribunal. The Tribunal is then obliged to consider the merits of the decision under review in light of evidence provided to it by the Secretary, in addition to evidence the Tribunal obtains for itself.⁸ In addition, the applicant is entitled under s 423 to give the Tribunal a written statement and written arguments in relation to the decision under review.

Section 438 of the *Migration Act* imposes a further procedural duty upon the Secretary to notify the Tribunal if the Minister determines that the section applies in relation to a document provided for the Tribunal's consideration. Section 438 is

⁴ *SZMTA* (n 1) 445–6 [45]–[50] (Bell, Gageler and Keane JJ).

⁵ *Migration Act 1958* (Cth) s 411(1)(c)–(d) (*'Migration Act'*).

⁶ *Ibid* s 412.

⁷ *Ibid* s 414(1).

⁸ *Ibid* s 424(1).

enlivened by one of two preconditions: first, under s 438(1)(a), if the Minister certifies that disclosure of any matter contained in the document would be contrary to the public interest; and second, under s 438(1)(b), if the document was given to the Minister in confidence. Upon notification that s 438 applies, the Tribunal has a discretion under s 438(3)(a) to have regard to the document for the purpose of exercising its powers and an additional discretion under s 438(b) to disclose to the applicant any matter in the document. Section 422B(2) of the *Migration Act* further provides that s 438 is an exhaustive statement of the requirements of the natural justice hearing rule in relation to the matters with which s 438 deals.

Significantly, s 438 of the *Migration Act* gives rise to procedural *discretions*, rather than mandatory duties. Nevertheless, the High Court in *SZMTA* and several Federal Court judgments have recognised the ‘obvious unfairness’ caused by a Tribunal’s failure to positively exercise or decline to exercise its discretion under s 438.⁹ The plurality in *SZMTA* explained this unfairness in the following terms:

The very fact of notification ... changes the context in which the entitlement of the applicant under s 423 ... falls to be exercised.

The entitlement under s 423 extends to allowing the applicant to present a legal or factual argument in writing either to contest the assertion of the Secretary that s 438 applies to a document or information, or to argue for a favourable exercise of one or both of the discretions conferred by s 438(3). This entitlement, at least in those specific applications, is capable of meaningful exercise only if the applicant is aware of the fact of a notification having been given to the Tribunal.¹⁰

The appeal from *MZAPC (FCA)* arose in relation to an application to the Tribunal for review of the decision of a delegate of the Minister to refuse a protection visa. Prior to the lodgement of that application, a delegate of the Minister had notified the Tribunal that s 438 applied to certain materials that had been given to the Tribunal. The contents of the materials included a Victorian Police court outcomes report in relation to the applicant, which showed that the applicant had been convicted of a number of driving-related offences, and one offence of ‘State false name’.¹¹ Upon the Tribunal’s affirmation of the delegate’s decision to refuse the protection visa, the applicant sought judicial review of the Tribunal’s decision before the Federal Circuit Court of Australia,¹² which dismissed the application for reasons that are not relevant to this appeal.

Subsequently, the applicant appealed to the Federal Court of Australia, on the sole ground that the failure by the Tribunal to disclose the s 438 notification was procedurally unfair. The applicant further submitted that it could be inferred from the Tribunal’s adverse credibility findings against the applicant that the Tribunal had taken the s 438 notification information into account, and on that basis the Tribunal’s

⁹ *MZAOL v Minister for Immigration and Border Protection* [2019] FCAFC 68, [74] (Bromberg, Farrel and Davies JJ) (*MZAOL*). See also *MZAFZ v Minister for Immigration and Border Protection* (2016) 243 FCR 1, 12–13 [49]–[53] (Beach J); *Minister for Immigration and Border Protection v Singh* (2016) 244 FCR 305, 317 [51]–[52] (The Court).

¹⁰ *SZMTA* (n 1) 441 [30]–[31] (Bell, Gageler and Keane JJ).

¹¹ *MZAPC (FCA)* (n 2) [20].

¹² *MZAPC v Minister for Immigration* [2016] FCCA 1414.

decision was affected by jurisdictional error.¹³ The Minister, as first respondent to the appeal, conceded that the Tribunal's failure to disclose the s 438 notification constituted a denial of procedural fairness of the kind identified in *SZMTA*.¹⁴ Nevertheless, the Minister relied upon *SZMTA* to submit that the error was immaterial to the outcome of the decision because the information was irrelevant or alternatively because the Tribunal could be presumed to not have taken the s 438 information into account.¹⁵ The Federal Court, constituted by Mortimer J alone, accepted the Minister's submission, holding that the denial of procedural fairness was immaterial and as such did not provide grounds for review.¹⁶

III The Decision and Issues on Appeal

In *MZAPC (FCA)*, Mortimer J held that where there is an admitted non-disclosure of a s 438 notification, and the information subject to the notification is adverse to the applicant, the applicant must follow a two-step process to establish materiality by proving: first, that the Tribunal had regard to the s 438 information; and second, that 'the outcome of the review could have realistically been different' if the notification had been disclosed to the applicant.¹⁷ Mortimer J considered that this two-step process was required on the approach of the majority of the High Court in *SZMTA*, read with the full Federal Court decision in *MZAOL v Minister for Immigration and Border Protection*.¹⁸ Her Honour ultimately concluded that the applicant had failed to discharge that burden of proof, due to the absence of any indication that the Tribunal's assessment was affected by the court outcomes report.¹⁹

Three key issues are to be determined by the High Court in the appeal from *MZAPC (FCA)*. The first issue is whether Mortimer J correctly stated the approach to proving materiality required by *SZMTA*. The answer to this question raises a second key issue: whether the approach in *SZMTA* is correct at a level of principle. The third issue on appeal is whether the approach in *SZMTA* was correctly applied by Mortimer J to the facts of the case. This column focuses exclusively on the first two issues, in order to argue for a more cogent approach to matters of proof in the assessment of materiality.

In *SZMTA*, the majority comprising of Bell, Gageler and Keane JJ held that an assessment of materiality is 'an ordinary question of fact in respect of which the applicant bears the onus of proof'.²⁰ This assessment 'is to be determined by inferences',²¹ drawn from expectations as to 'the course of the regular administration of the Act'.²² From this statement of principles, the majority extrapolated the following presumption: 'the Tribunal can be expected in the ordinary course to treat

¹³ *MZAPC (FCA)* (n 2) [17]–[22].

¹⁴ *Ibid* [30].

¹⁵ *Ibid* [31]–[32].

¹⁶ *Ibid* [58]–[59].

¹⁷ *Ibid* [50].

¹⁸ *Ibid* [50]–[51].

¹⁹ *Ibid* [58].

²⁰ *SZMTA* (n 1) 445 [46].

²¹ *Ibid* 445 [46].

²² *Ibid* 445 [47].

a notification by the Secretary that [s 438] applies as a sufficient basis for accepting' that s 438 applies to the information, in which case the Tribunal can further be expected to leave that information 'out of account in reaching its decision'.²³ The majority conceded that the presumption could be displaced by 'some contrary indication in the statement of the Tribunal's reasons for decision or elsewhere in the evidence'.²⁴ However, in absence of any such indication, the presumption that the Tribunal paid no attention to the s 438 information in reaching its decision applied.

Contrary to the appellant's submissions in *MZAPC*,²⁵ it is difficult to read the majority's analysis in *SZMTA* as anything else but the clear statement of a presumption that applies in absence of evidence to the contrary. The presumption is critical to the majority's reasons in *SZMTA*, as it justified their Honour's finding that evidence of the s 438 information is relevant and admissible. The High Court in *SZMTA* has shown a clear intention to take into account the Tribunal's treatment of information in order to assess whether the outcome of the decision could have been different.²⁶ Since it is sufficiently clear that the majority created a presumption of general application and placed the onus of proof upon the applicant, then logically it follows that the applicant must overcome or disprove this presumption to show that the decision could realistically have been different.

The *SZMTA* majority's development of the law is not unprecedented. As noted by Daly, review courts have long recognised that the applicant must demonstrate a causal link between error and result to make their case for judicial review.²⁷ What is novel in the majority's approach is that proof of materiality requires proof of how the Tribunal in fact acted as well as whether the decision could realistically have been different. Contrary to the appellant's submission in *MZAPC*, there is little doubt that both aspects are required to make out a material error on the authority of *SZMTA*, and there is no indication that the applicant must prove any lesser standard. Mortimer J's statement in *MZAPC (FCA)* of the principles in *SZMTA* is correct.

IV The (Il)logic of the *SZMTA* Presumption

This column contends that the *SZMTA* presumption is flawed and ought to be reframed by the High Court for the following three reasons. First, the inferences drawn by the plurality are arguably inconsistent with the Tribunal's power to determine whether the notifications were validly made. Given that it is open to the Tribunal to form and act on its own view as to whether s 438 of the *Migration Act* applies to the documents, it is arguably likely that the Tribunal would not have disregarded the documents, but rather would have reviewed them for compliance with s 438. Thus, the likelihood that the Tribunal followed a procedure contrary to law is at least as strong as the probability that the Tribunal accepted the s 438

²³ Ibid 445 [47].

²⁴ Ibid.

²⁵ *MZAPC*, 'Appellant's Submissions', Submission in *MZAPC v Minister for Immigration and Border Protection*, Case No M77/2020, 5 October 2020, 10–11 [25]–[28] ('Appellant's Submissions').

²⁶ *SZMTA* (n 1) 449–50 [63], 451–2 [70] (Bell, Gageler and Keane JJ).

²⁷ Paul Daly, 'A Typology of Materiality' (2019) 26 *Australian Journal of Administrative Law* 134.

notification at face value. Correspondingly, the distinction drawn in the Minister's submissions between the present case and *Applicant VEAL of 2002 v Minister for Immigration and Multicultural and Indigenous Affairs*²⁸ does not hold true; simply because the Tribunal had 'no power'²⁹ to have regard to the notification without exercising a positive discretion to do so does not mean that the Tribunal did, in fact, ignore the information subject to the notification.³⁰

Further, the explanation given by the Full Federal Court in *MZAOL* does little to dispel this criticism. In that case, the Court inferred that the Tribunal would appreciate that it could not have regard to the s 438 information without affirmatively exercising its discretion, and would only have regard to the information without disclosing it to the applicant with good reason.³¹ Yet, as argued convincingly in the appellant's written submissions in *MZAPC*, it is illogical to assume that the Tribunal would appreciate the unfairness of having regard to the s 438 information without exercising a positive discretion or notifying the applicant, when it has failed to appreciate the unfairness of its failure to disclose the fact of notification.³²

Second, the *SZMTA* presumption is flawed because the imposition of the burden of proof upon the applicant when combined with the operation of the presumption is inconsistent with the requirements of procedural fairness. As Nettle and Gordon JJ jointly explained in *SZMTA*, requiring the applicant to prove that the breach of a duty of fairness is material undermines the applicant's entitlement to know 'the playing field' or the statutory framework, which was held to be unfair by all members of the High Court in that decision.³³ In such circumstances, the very principle that statutory powers are exercised in accordance with statutory terms is 'put in doubt'.³⁴ This is not to suggest that the possibility of non-jurisdictional error is contrary to the rule of law;³⁵ rather, where the error consists of a failure to notify the applicant of a change to the statutory landscape, it is inappropriate to require the applicant to assess the materiality of the terms of the statute. The nature and implications of the type of unfairness that arose in both *SZMTA* and *MZAPC (FCA)* will be further considered below in Section V.

²⁸ *Applicant VEAL of 2002 v Minister for Immigration and Multicultural and Indigenous Affairs* (2005) 225 CLR 88.

²⁹ Minister for Immigration and Border Protection, 'Submissions of the First Respondent', Submission in *MZAPC v Minister for Immigration and Border Protection*, Case No M77/2020, 30 October 2020, 13 [35].

³⁰ *Ibid* 10–11 [28]; 12–13 [34]–[35].

³¹ *MZAOL* (n 9) [75] (Bromberg, Farrell and Davies JJ).

³² *Appellant's Submissions* (n 25) 14–15 [35]–[36]; *MZAPC*, 'Appellant's Submissions in Reply', Submission in *MZAPC v Minister for Immigration and Border Protection*, Case No M77/2020, 19 November 2020, 6–7 [14].

³³ *SZMTA* (n 1) 459–60 [93] (Nettle and Gordon JJ).

³⁴ *Ibid* 459 [93].

³⁵ The joint judgment made broader arguments with respect to parliamentary intention that have been rightly criticised by Burton Crawford as 'a step too far', particularly as the discretion to refuse relief, the very approach advocated by Nettle and Gordon JJ, is also vulnerable to these same criticisms: see Lisa Burton Crawford, 'Immaterial Errors, Jurisdictional Errors and the Presumptive Limits of Executive Power' (2019) 30(4) *Public Law Review* 281, 297.

Third, by developing a presumption that the applicant must disprove, the plurality in *SZMTA* also shifted the balance of curial assessment subtly towards refusal of relief. This is particularly the case where the presumption applies to adverse information. As noted by Mortimer J in *MZAPC (FCA)*, the effect of the burden of proof upon the operation of the presumption is to ‘make it difficult’ for the applicant, as without a clear statement in the Tribunal’s reasons, there is little possibility the applicant can prove how the Tribunal treated the adverse material.³⁶ Furthermore, this tendency is contrary to the previous stringent approach, whereby the refusal to grant relief for legal error was rare. Arguably, the majority’s articulation of the presumption corresponds to their reasons for creating a fact-finding role for the courts, which will be discussed in Section VI.

V Reconceptualising Fairness through a Statutory Lens

The type of unfairness that arose in *SZMTA* and subsequently *MZAPC (FCA)* was the failure to be notified of an event that alters the procedural context,³⁷ or ‘playing field’,³⁸ of the Tribunal’s review. In *SZMTA*, the High Court found that a notification issued under s 438 of the *Migration Act* constrained the Tribunal’s ability to give weight to relevant documents given by the Secretary of the Department. Consequently, the failure to disclose the notification to the applicants necessarily gave rise to a lost opportunity for the applicants to advance their cases, for under s 423 of the *Migration Act*, the applicant is entitled to contest the Secretary’s notification that s 438 applied to the documents, or to argue that the Tribunal should exercise one of the discretions available under s 438(3).³⁹ The High Court thus held that a notification under s 438 created an obligation of procedural fairness to disclose the fact of notification to the applicant.⁴⁰

This presentation of fairness differs in an important respect from the more conventional presentation of fairness in earlier High Court decisions. In the cases *Re Refugee Review Tribunal; Ex parte Aala*⁴¹, *Re Minister for Immigration and Multicultural Indigenous Affairs; Ex parte Lam*⁴² and *Minister for Immigration and Border Protection v WZARH*,⁴³ the administrative decision-maker gave the applicants a statement of intention with respect to how the review would be conducted. The procedure indicated by the statement was not an express statutory requirement, although it foreshadowed a line of inquiry that the applicants then relied upon. The question that arose for the Court in each case was whether the failure of the decision-maker to abide by the statement of intention was unfair.⁴⁴

³⁶ *MZAPC (FCA)* (n 2) [49].

³⁷ *SZMTA* (n 1) 440–41 [29] (Bell, Gageler and Keane JJ).

³⁸ *Ibid* 466 [115] (Nettle and Gordon JJ).

³⁹ *Ibid* 441 [30]–[31] (Bell, Gageler and Keane JJ).

⁴⁰ *Ibid* 440 [27] (Bell, Gageler and Keane JJ). 454 [78] (Nettle and Gordon JJ).

⁴¹ *Re Refugee Review Tribunal; Ex parte Aala* (2000) 204 CLR 82 (‘*Aala*’).

⁴² *Re Minister for Immigration and Multicultural Indigenous Affairs; Ex parte Lam* (2003) 214 CLR 1 (‘*Lam*’).

⁴³ *Minister for Immigration and Border Protection v WZARH* (2015) 256 CLR 326 (‘*WZARH*’).

⁴⁴ *Lam* (n 42) 9 [24]–[25] (Gleeson CJ); *WZARH* (n 43) 340 [47] (Kiefel, Bell and Keane JJ).

In the nearly 20 years that have elapsed between *Aala* and *SZMTA*, there has been an incremental reorientation of the High Court's conceptualisation of administrative law. It is argued by administrative law scholars that the courts have sought to legitimise judicial review by grounding the courts' review in statutory interpretation.⁴⁵ This is not to say that the courts dispensed with legal norms entirely, however the focus of judicial review shifted in emphasis towards the statutory text and purpose. An important case that demonstrates this shift is *Saeed v Minister for Immigration and Citizenship*, in which the High Court found that a duty of procedural fairness could be implied from a strictly textual analysis of the statute, focusing upon the interrelation of the provisions to ascertain the purpose of each individual provision.⁴⁶

While the outcomes of the traditional earlier cases differed, it is argued that the principles that underpinned those decisions were the same; the Court held that a finding of unfairness was contingent upon the existence of practical injustice, understood as the loss of an opportunity to make submissions. By contrast, the unfairness in *SZMTA* and *MZAPC (FCA)* arose from the applicant's lack of knowledge that a statutory mechanism had been enforced, which prevented the applicant from taking opportunities to respond afforded by the *Migration Act*.

Yet, although the High Court used the language of statutory interpretation to describe the duty of fairness owed to the applicant in *SZMTA*, the majority's analysis of materiality ultimately had the effect of undermining the statutory scheme itself — an ironic outcome for an ostensible statutory approach to jurisdictional error. The contradiction inherent in the majority's approach in *SZMTA* is best illustrated by contrast with the High Court decision in *Kioa v West*.⁴⁷ In that decision, a majority of the Court found that the Tribunal had breached its obligations of procedural fairness by failing to disclose its receipt of adverse information to the applicant, and that this breach was sufficient to establish jurisdictional error, regardless of whether the Tribunal took the information into account.⁴⁸ Indeed, Wilson J acknowledged in obiter dicta that 'it is difficult to see how even an emphatic reversal of the imputation contained in [the adverse material] could affect the result'.⁴⁹ Nevertheless, his Honour considered that to deny relief for a breach of the natural rules of justice would frustrate the purposes of the relevant legislation in that case, and be tantamount to condoning such a breach.⁵⁰ A comparison between *SZMTA* and *Kioa* clearly demonstrates the significance of the High Court's departure from its previous stringent stance. Not only has the High Court thrown doubt upon the primacy of statutory rules and duties, it now requires applicants to prove the materiality of the statutory breach in question.

⁴⁵ Will Bateman and Leighton McDonald, 'The Normative Structure of Australian Administrative Law' (2017) 45(2) *Federal Law Review* 153.

⁴⁶ *Saeed v Minister for Immigration and Citizenship* (2010) 241 CLR 252, 267 [41]–[42] (French CJ, Gummow, Hayne, Crennan and Kiefel JJ).

⁴⁷ *Kioa v West* (1985) 159 CLR 550 ('*Kioa*').

⁴⁸ *Ibid* 629 (Brennan J). See also 588 (Mason J), 603 (Wilson J), 633 (Deane J).

⁴⁹ *Ibid* 603 (Wilson J).

⁵⁰ *Ibid*.

VI Implications for the Courts' Fact-Finding Role

The High Court's resolution of the issues discussed above will have broader implications than these particularised facts might suggest, as the Court's formulation of fairness and materiality has formed the basis for the development of a potentially controversial fact-finding role for the courts. As discussed previously, the centrality of materiality to the courts' exercise of discretion to refuse relief is not a new development in judicial review.⁵¹ It is also accepted that consideration of materiality requires an enquiry as to the statutory and factual context presented by the case.⁵² However, *SZMTA* was the first High Court decision to provide guidance for fact-finding in order to determine the materiality of legal errors in judicial review.

The issue of whether fact-finding should be permitted is contentious because it disrupts the constitutional limits of judicial review. Traditionally, courts do not make determinations as to the weight or persuasive force of evidence, in order to avoid impinging upon the Tribunal's role to determine the merits of a decision. Rather, courts are required to consider the legality of a decision, understood as the decision-maker's compliance with statute and administrative law principles. Arguably, the effect of *SZMTA* has been to extend the limits of the Court's supervisory jurisdiction to allow for judicial review of what has traditionally been viewed as the merits of a decision.

The correlation drawn between the legal norms that inform the content of procedural fairness and the justification for fact-finding was further analysed in the plurality's judgment in *SZMTA*. The plurality quoted the unanimous High Court judgment in *Stead v State Government Insurance Commission* to emphasise that it is 'no easy task' to make a finding that 'a denial of natural justice could have had no bearing on the outcome' of the decision.⁵³ Yet this caution was immediately qualified by the plurality's insistence that the task 'is not impossible', supported by reference to the controversial judgment of McHugh J in *Aala*.⁵⁴ The citations of *Stead* and *Aala* are difficult to reconcile. *Stead* outlines a stringent, cautious approach to the courts' use of discretion to refuse relief, whereas the approach taken by McHugh J in *Aala* was arguably broader, stating that courts should refuse relief only when 'confident' that the outcome was unaffected by a breach of fairness.⁵⁵ In his analysis, McHugh J allowed himself to compare the strength of the evidence before the Tribunal to determine whether the breach of fairness affected the outcome.⁵⁶ The fact that McHugh J was the sole dissenting judge in *Aala*, with the rest of the High Court finding that the unfairness of the legal error attracted the Court's jurisdiction to grant relief, further emphasises the greater breadth of McHugh J's approach. The

⁵¹ See, eg, *WZARH* (n 43) 341–2 [56]–[57] (Gageler and Gordon JJ). See also Harry Aniulis, 'Materiality: Marking the Metes and Bounds of Jurisdictional Error?' (2020) 27(2) *Australian Journal of Administrative Law* 88, 95, 102.

⁵² Mark Aronson, Matthew Groves and Greg Weeks, *Judicial Review of Administrative Action and Government Liability* (Lawbook, 6th ed, 2017) 484–9 [7.380].

⁵³ *SZMTA* (n 1) 264 [48]–[49] (Bell, Gageler and Keane JJ) quoting *Stead v State Government Insurance Commission* (1986) 161 CLR 141, 145–6 ('*Stead*').

⁵⁴ *SZMTA* (n 1) 264 [49] (Bell, Gageler and Keane JJ) citing *Aala* (n 41) 122 [104], 128 [122] (McHugh J).

⁵⁵ *Aala* (n 41) 122 [104] (McHugh J).

⁵⁶ *Ibid* 128 [122] (McHugh J).

plurality's reasons in *SZMTA* thus indicate a willingness to adopt a broader view of practical injustice and consequently a wider basis upon which to review documents for materiality than that allowed by previous High Courts.

In *SZMTA*, the High Court entered into a debate that until recently had been mostly limited to extra-judicial writing. Gageler, prior to his appointment to the High Court, considered that '[k]eeping administrative decision-makers within the express limits of ... statute ... is as uncontroversial as it is mechanical'.⁵⁷ He nonetheless questioned whether the implications drawn from statute by the courts, for example that of materiality or fairness, were 'truly value-free'.⁵⁸ Chief Justice French similarly demonstrated an awareness that judicial review required a kind of analysis that came dangerously close to the function of the decision-maker, by creating a taxonomy of 'factual merits review' and 'legal merits review'.⁵⁹ Justice Robertson proposed a modified classification of judicial review as 'consideration of the merits but not a decision on the merits',⁶⁰ to support his contention that the courts' discretion is not outside scope where it is sufficiently connected to a statutory framework.⁶¹

A common thread between these extra-judicial statements is the necessity of statutory interpretation in the legitimisation of judicial review. By contrast, the Court in *SZMTA* extended its supervisory jurisdiction by reference to legal norms. Although the Court used the language of statutory interpretation, the underlying basis for fact-finding and the Court's refusal to grant relief lay in the Court's focus upon practical justice. Moreover, while it is true that the High Court has always, to some extent, sought to give effect to practical justice through judicial review, the basis articulated by the plurality in *SZMTA* is subtly broader than the more stringent approach of earlier High Court decisions.

Arguably, the weaknesses exposed in the *SZMTA* approach by *MZAPC (FCA)* further undermine this rationale for the courts' review of s 438 material. The effect of the majority's view of jurisdictional error, as applied in *MZAPC (FCA)*, is to create a legal framework that is weighted against applicants. If the terms of the materiality enquiry are subtly shifted towards refusal of relief, then the courts' review of s 438 information and its effect upon Tribunal decisions will be correspondingly predisposed to some extent against finding that the documents could have made a difference to the outcome of the decision. This puts in jeopardy the fundamental aim of judicial review: to protect applicants from implied and express breaches of legislative requirements, in order to preserve certainty and equality before the law.

⁵⁷ Stephen Gageler, 'Impact of Migration on the Development of Australian Administrative Law' (2010) 17(2) *Australian Journal of Administrative Law* 92, 104.

⁵⁸ *Ibid* 105.

⁵⁹ Chief Justice RS French AC, 'Administrative Law in Australia: Themes and Values Revisited' in Matthew Groves (ed), *Modern Administrative Law in Australia: Concepts and Context* (Cambridge University Press, 2014) 24, 34.

⁶⁰ Justice Alan Robertson, 'What is "Substantive" Judicial Review? Does It Intrude on Merits Review in Administrative Decision-Making?' (2016) 85 *AIAL Forum* 24, 30.

⁶¹ *Ibid* 30, 37.

VII Conclusion

Before the High Court reached its decision in *SZMTA*, commentators on judicial review noted that the purposes of fairness and jurisdictional error were unclear,⁶² lacking a unifying conceptual framework.⁶³ *SZMTA* has gone some way to showing how functional concerns can be accommodated within a statutory or formalist paradigm, although commentators continue to criticise the lack of coherence in the High Court's approach.⁶⁴ The appeal from *MZAPC (FCA)* builds upon these cases by questioning whether and how evidence before a Tribunal can be relevant to the courts' exercise of discretion.

This column has sought to demonstrate that the *SZMTA* approach to establishing the materiality of procedural unfairness in migration merits review decisions is wrong in principle and should be reconsidered in the upcoming appeal in *MZAPC*. There are significant difficulties in the present approach, which requires review applicants to overcome a presumption that a decision-maker who has failed to afford procedural fairness, has nonetheless acted in a way that neutralises the procedural unfairness. This presumption operates to compound the injustice of the procedural unfairness, undermines the statutory scheme, and skews the court's fact-finding on materiality towards the merits of the decision. In *MZAPC*, the High Court must develop more cogent legal principles to guide evaluation of materiality, especially if this concept is to continue to operate as a precondition to jurisdictional error.

⁶² Matthew Groves, 'The Unfolding Purpose of Fairness' (2017) 45(4) *Federal Law Review* 653, 667.

⁶³ Matthew Alderton, 'When Jurisdictional Errors Are Not Remedied: Refusal of Constitutional Relief on Discretionary Grounds' (2015) 23(1) *Australian Journal of Administrative Law* 15, 24.

⁶⁴ Burton Crawford (n 35) 282.

Review Essay

Understanding Proportionality Analysis

Proportionality in Australian Constitutional Law
by Shipra Chordia (2020), The Federation Press,
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Abstract

The use of proportionality reasoning to determine whether there has been an actionable breach of constitutional rights is spreading around the globe. Except in assessing the constitutional validity of legislation claimed to infringe the implied freedom of political communication, it has not taken root in Australia. If, as claimed in its favour, proportionality reasoning can promote transparency and accountability, should it be more widely adopted in this country; or is it in all respects an exotic jurisprudential pest? By explaining the concept, its legal history, and the staged reasoning of structured proportionality, *Proportionality in Australian Constitutional Law* by Shipra Chordia provides context and clarity for those engaged in the debate. Dr Chordia supports the role of proportionality reasoning in cases dealing with the implied freedom, but recognises and confronts the objections that have been raised. Her book raises important issues for the ongoing development of Australian constitutional law.

I Introduction

In 2015, Vicki C Jackson of Harvard wrote a paper entitled ‘Constitutional Law in an Age of Proportionality’.¹ She addressed ways in which a tool for jurisprudential analysis which was being adopted in legal systems across the western world might inform constitutional analysis in the United States (‘US’). On 7 October 2015, the High Court of Australia delivered judgment in *McCloy v New South Wales*,² a case involving the implied freedom of political communication, in which a majority of the Court (French CJ, Kiefel, Bell and Keane JJ) expressly adopted a form of proportionality analysis³ to determine the validity of the impugned statute. The new

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¹ Vicki C Jackson, ‘Constitutional Law in an Age of Proportionality’ (2015) 124(8) *Yale Law Journal* 3094. Professor Jackson is Laurence H Tribe Professor of Constitutional Law at Harvard Law School.

² *McCloy v New South Wales* (2015) 257 CLR 178 (‘*McCloy*’).

³ *Ibid* 195–6 [3]–[4].

book by Shipra Chordia, *Proportionality in Australian Constitutional Law*,⁴ is undoubtedly timely. Further, as Sir Anthony Mason says of the book in the Foreword, '[i]t is the product of wide-ranging research and scholarship, aided by a clear understanding and explanation of the complex issues which arise.'⁵

As Chordia recognises,⁶ the adoption of 'structured proportionality' in *McCloy* involved a departure from the principles by which the High Court reviewed legislation that might infringe the implied freedom of political communication in *Lange v Australian Broadcasting Corporation*.⁷ Only two years before *McCloy*, in *Unions NSW v New South Wales*,⁸ the Court had applied the approach adopted in *Lange*, as had other cases over the intervening years. That *McCloy* involved a change in course by four members of the Court, suggested a degree of doctrinal instability. Although the plurality noted that *Lange* 'pointed clearly in the direction of proportionality analysis',⁹ their Honours did not suggest that the adoption of structured proportionality was driven by precedent. The sense of instability was not diminished by the express rejection of proportionality reasoning by Gageler J,¹⁰ its non-adoption by Nettle J,¹¹ and the rejection of 'uncritical use of proportionality from other legal contexts' by Gordon J.¹²

Cognisant of the division of views in the High Court, both in *McCloy* and in later cases, Chordia sets out to demonstrate the source of proportionality analysis, its nature and history, and the benefits it may provide by way of transparency and predictability, at least when determining whether legislation infringes the implied freedom of political communication. Chordia's analysis is careful, methodical, and well-expressed, essential qualities in addressing the fundamental tensions that have given rise to strongly disparate judicial views on this topic and a growing library of academic commentary.

II Proportionality Analysis Explained

Chordia identifies the criteria for invoking proportionality analysis as follows:

1. When a challenge to an impugned statutory provision is brought on the basis of the implied freedom, and a burden on the implied freedom is identified, there exists a conflict of interests.
2. Each interest in conflict has a constitutional source. The implied freedom, on one hand, is derived from the text and structure of the Constitution, and therefore operates as a constitutional limit. On the other hand, the enactment of legislation – when carried out in sufficient

⁴ Shipra Chordia, *Proportionality in Australian Constitutional Law* (Federation Press, 2020). Dr Shipra Chordia is, as the book notes, in practice at the NSW Bar, and has a PhD in Constitutional Law from the University of New South Wales. The manuscript was awarded the 2019 Holt Prize.

⁵ Sir Anthony Mason, 'Foreword' in Chordia (n 4) v.

⁶ Chordia (n 4) 159–62.

⁷ *Lange v Australian Broadcasting Corporation* (1997) 189 CLR 520 ('*Lange*').

⁸ *Unions NSW v New South Wales* (2013) 252 CLR 530.

⁹ *McCloy* (n 2) 214 [70] (French CJ, Kiefel, Bell and Keane JJ).

¹⁰ *Ibid* 234 [140]ff.

¹¹ *Ibid* 259 [222].

¹² *Ibid* 288 [339]. See generally 287–9 [336]–[339].

connection with a head of power in s 51 of the Constitution – is an exercise of constitutionally conferred, albeit limited, power.

3. The implied freedom does not operate absolutely to override other rights, interests or obligations embodied in statutory provisions.
4. The implied freedom – contingent as it is on the more amorphous concept of representative and responsible government – cannot be defined in the abstract.¹³

The cumulative effect of these four criteria is to require a balancing exercise in order to determine the validity of the statutory provision.

The doctrinal tool for balancing the conflicting interests, known as ‘structured proportionality’, is summarised by Chordia as involving three questions, to be addressed in order:

- (i) Is there a rational connection between the law under judicial review and the purpose that it seeks to achieve? This stage is commonly referred to as *suitability testing*. At times, it is preceded by a threshold question: is the law aimed at the achievement of a proper purpose or legitimate end? This is commonly referred to as the *proper purpose or legitimate ends* test.
- (ii) Are the means used to achieve the law’s purpose or end necessary in the sense that there is no available alternative that is capable of achieving the same purpose with less restrictive effect on a competing right or interest? This stage is commonly referred to as *necessity testing*.
- (iii) Does the importance of the law’s purpose justify its intrusion into a competing right or interest? This is commonly referred to as the *strict proportionality or strict balancing* stage.¹⁴

The antecedent or threshold question identified in (i) should not be glossed over. In Australia, it will involve a determination that the law in question falls within a relevant head of legislative power under, usually, s 51 of the *Australian Constitution*. Answering that question may involve two separate steps, namely: determining the scope of the constitutional head of power, an exercise known as ‘characterisation’;¹⁵ and construing the statutory provision under review. Because we seek to construe legislation to uphold validity, questions of constitutionality can be intertwined with questions of statutory construction; how structured proportionality analysis fits within that framework is itself an important issue.

The preliminary question aside, each of the three structured proportionality questions, taken in order, requires the court either to make an evaluative judgment, or to supervise legislative judgments made by the Parliament. As Chordia correctly observes,¹⁶ Australian judges express degrees of discomfort with the former exercise. For example, the second step in the proportionality analysis accepted in *McCloy* asks whether the purpose of the impugned legislation could have been

¹³ Chordia (n 4) 171.

¹⁴ Ibid 3 (emphasis in original).

¹⁵ See, eg, James Stellios, *Zines’s The High Court and the Constitution* (Federation Press, 6th ed, 2015) chs 2–3.

¹⁶ Chordia (n 4) 8–9.

pursued by reasonably practicable alternative means having a less restrictive effect on the protected freedom. The scope of that inquiry was limited in *McCloy* by accepting that ‘necessity’ would be satisfied if there were ‘no obvious and compelling’ alternative involving less restrictive means available.¹⁷

III Objections to Proportionality Analysis

Chordia devotes Chapter 4 to a consideration of the charge that proportionality analysis ‘invites the judiciary to exceed its institutional role, both in terms of its legitimacy and its competency’.¹⁸ Her analysis of the interrelationship between principles of judicial restraint and structured proportionality is both powerful and nuanced. However, she is not sympathetic to what she describes as ‘restrictive institutional approaches’,¹⁹ stating:

However, structured proportionality does not assume a starting position on the scale of deference and restraint. As we have seen, it adopts a neutral starting position from which deference can either be ratcheted up or dialled down. Structured proportionality thus requires a theory that can respond more contextually to both factors that may suggest the need for increased judicial restraint and factors that may suggest the need for a more interventionist role on the part of the judiciary.²⁰

It is by no means clear that this conclusion is the only one consistent with acceptance of proportionality analysis. Arguably, it gives support to criticisms of proportionality reasoning raised by Gageler J in *McCloy* and discussed below.²¹ This passage also raises a fundamental issue as to the role of the courts in the constitutional structure of the Australian Federation: this too will be addressed below.

A related objection to the introduction of proportionality analysis into Australian constitutional review of legislation was articulated by Gleeson CJ in 2007 in a voting rights case, *Roach v Electoral Commissioner*.²² *Roach* involved a successful challenge to a Commonwealth law disentitling any person who is ‘serving a sentence of imprisonment’ from voting.²³ Laws preventing voting by prisoners had been challenged in Canada in *Sauvé v Canada (Chief Electoral Officer)*,²⁴ and in the United Kingdom in the European Court of Human Rights, in *Hirst v United Kingdom (No 2)*.²⁵ The *Canadian Charter of Rights and Freedoms* relied on in *Sauvé* conferred a right to vote, but contained an express limitation by reference to ‘such reasonable limits prescribed by law as can be demonstrably justified in a free and democratic society’.²⁶ The *European Convention on Human Rights* adopts a similar

¹⁷ *McCloy* (n 2) 195 [2], 211 [58], 217 [81]–[82] (French CJ, Kiefel, Bell and Keane JJ).

¹⁸ Chordia (n 4) 63.

¹⁹ *Ibid* 75–7.

²⁰ *Ibid* 77.

²¹ See below nn 59–63 and accompanying text.

²² *Roach v Electoral Commissioner* (2007) 233 CLR 162 (Gleeson CJ writing separately; Gummow, Kirby and Crennan JJ writing together; Hayne and Heydon JJ dissenting) (*‘Roach’*).

²³ *Ibid* 185 [38].

²⁴ *Sauvé v Canada (Chief Electoral Officer)* [2002] 3 SCR 519 (*‘Sauvé’*).

²⁵ *Hirst v United Kingdom (No 2)* (2005) 42 EHRR 41 (*‘Hirst’*).

²⁶ *Canada Act 1982* (UK) c 11, sch B pt I s 1 (*‘Canadian Charter of Rights and Freedoms’*).

structure, conferring rights, subject to justifiable limitations.²⁷ Speaking of the Canadian Charter, Gleeson CJ in *Roach* stated:

This qualification requires both a rational connection between a constitutionally valid objective and the limitation in question, and also minimum impairment to the guaranteed right. It is this minimum impairment aspect of proportionality that necessitates close attention to the constitutional context in which that term is used.²⁸

With respect to the decision of the European Court of Human Rights in *Hirst*, Gleeson CJ noted:

The majority accepted that the United Kingdom law pursued the legitimate aim of enhancing civic responsibility and respect for the rule of law by depriving those who had breached the basic rules of society of the right to have a say in the way such rules were made for the duration of their sentence. However, they concluded that the measure was arbitrary in applying to all prisoners, and lacked proportionality (which in this context also required not only a rational connection between means and ends but also the use of means that were no more than necessary to accomplish the objective), even allowing for the margin of appreciation to be extended to the legislature.²⁹

The Chief Justice continued:

There is a danger that uncritical translation of the concept of proportionality from the legal context of cases such as *Sauvé* or *Hirst* to the Australian context could lead to the application in this country of a constitutionally inappropriate standard of judicial review of legislative action. Human rights instruments which declare in general terms a right, such as a right to vote, and then permit legislation in derogation of that right, but only in the case of a legitimate objective pursued by means that are no more than necessary to accomplish that objective, and give a court the power to decide whether a certain derogation is permissible, confer a wider power of judicial review than that ordinarily applied under our *Constitution*. They create a relationship between legislative and judicial power significantly different from that reflected in the *Australian Constitution* ...³⁰

A further case involving voting rights arose shortly after the decision in *McCloy*. In 2016, in *Murphy v Electoral Commissioner*,³¹ the Court considered a challenge to statutory provisions requiring the closure of the electoral roll on the seventh day after the issue of a writ for an election. It was contended that the early closure disenfranchised persons who might otherwise have obtained enrolment prior to polling day. The plaintiffs expressly relied upon the form of proportionality reasoning adopted by the joint judgment in *McCloy*.³² The law was said to exclude a class of adult citizens from participating in a federal election in circumstances

²⁷ *Convention for the Protection of Human Rights and Fundamental Freedoms*, opened for signature 4 November 1950, ETS No 5 (entered into force 3 September 1953) art 18.

²⁸ *Roach* (n 22) 177–8 [15] citing *Mulholland v Australian Electoral Commission* (2004) 220 CLR 181, 197–9 [33]–[38]; *Sauvé* (n 24) 534–5 [7].

²⁹ *Roach* (n 22) 178 [16] citing *de Freitas v Permanent Secretary of Ministry of Agriculture, Fisheries, Lands and Housing* [1999] 1 AC 69, 80.

³⁰ *Roach* (n 22) 178–9 [17].

³¹ *Murphy v Electoral Commissioner* (2016) 261 CLR 28 (*‘Murphy’*).

³² See *ibid* 33 (C J Tran) (during argument).

where, as state laws to similar effect demonstrated, enrolment up to and including polling day was a practical alternative that had no such limiting effect on participation in the choice of representatives at the election.³³ The challenge was unanimously rejected.

French CJ and Bell J accepted the potential availability of proportionality reasoning, noting that its adoption in *McCloy* 'did not reflect the birth of some exotic jurisprudential pest destructive of the delicate ecology of Australian public law'.³⁴ However, their Honours held such an approach not to be appropriate in dealing with what were said to be obvious and compelling legislative alternatives:

These arguments invited the Court to undertake an hypothetical exercise of improved legislative design by showing how such alternatives could work. In so doing, they invited the Court to depart from the borderlands of the judicial power and enter into the realm of the legislature. The *McCloy* analysis was inapposite in this case.³⁵

Referring to the alternative schemes used in state electoral systems, French CJ and Bell J stated:

The existence of such possibilities does not support a characterisation of the design limits of the existing Act as a 'burden' upon the realisation of the constitutional mandate of popular choice. The impugned provisions do not become invalid because it is possible to identify alternative measures that may extend opportunities for enrolment. That would allow a court to pull the constitutional rug from under a valid legislative scheme upon the court's judgment of the feasibility of alternative arrangements.³⁶

By contrast, Kiefel J held:

The aim of any testing for proportionality is to ascertain the rationality and reasonableness of a legislative restriction in a circumstance where it is recognised that there are limits to legislative power. Proportionality analysis does not involve determining policy or fiscal choices, which are the province of the Parliament. Thus the test of whether there are alternative, less restrictive means available for achieving a statutory object, which assumes some importance in this case, requires that the alternative measure be otherwise identical in its effects to the legislative measures which have been chosen. It will not be equal in every respect if it requires not insignificant government funding.³⁷

Keane J found that there was no burden on the constitutional mandate that representatives should be 'chosen by the people'; 'rather, their case was no more than a complaint that better arrangements might be made to fulfil the mandate'.³⁸

³³ Ibid. See also at 63 [71] (Kiefel J).

³⁴ Ibid 52 [37].

³⁵ Ibid 53 [39].

³⁶ Ibid 55 [42].

³⁷ Ibid 61–2 [65] citing *McCloy* (n 2) 213 [68]; Aharon Barak, *Proportionality: Constitutional Rights and their Limitations* (Cambridge University Press, 2012) 324–5.

³⁸ *Murphy* (n 31) 88 [181].

Chordia deals with *Murphy* as a case in which there was no burden on constitutional rights.³⁹ However, on one view there was self-evidently a burden (a prohibition) on the exercise by one group of the very suffrage for which freedom of political speech is essential. Only Kiefel J applied proportionality analysis, and did so without expressly identifying the precise nature and extent of the burden.⁴⁰ There were six separate judgments in *Murphy* prepared by the same seven judges who sat in *McCloy*, suggesting that, in seeking to rely upon the proportionality analysis adopted in *McCloy*, counsel for the plaintiffs may have misjudged their court. Gageler J, who had expressed ‘reservations’ about proportionality analysis in *McCloy*,⁴¹ referred to the plaintiffs’ attempt ‘to shoehorn their argument within it’,⁴² and further stated:

Under the guise of inviting the Court to assess the rationality of the timing of the cut-off, to examine the availability of less restrictive alternative means of achieving its purpose, and to weigh the adequacy of its balance, the plaintiffs would have had the Court engage in a process of electoral reform. Through the application of an abstracted top-down analysis, they would have had the Court compel the Parliament to maximise the franchise by redesigning the legislative scheme to adopt what the plaintiffs put forward currently to be best electoral practice.⁴³

In a series of further cases involving the implied freedom of political communication, structured proportionality reasoning was applied in joint judgments of Kiefel CJ, Bell and Keane JJ, with separate judgments of Nettle J and Edelman J.⁴⁴ However, in a contemporaneous but separate publication, Chordia has described the 2019 decision in *Unions NSW v New South Wales*⁴⁵ as revealing that the High Court ‘is even further along in its path to retreating from an express acknowledgment of the value of structured proportionality analysis in this context’.⁴⁶

It is appropriate to return to the reasoning of the two members of the *McCloy* Court who rejected proportionality reasoning. Gordon J took the more conventional approach, seeing no reason to depart from the second test in *Lange* (as restated in *Coleman v Power*⁴⁷); namely, that the legislation must be ‘reasonably appropriate and adapted to serve a legitimate end’.⁴⁸ Her Honour continued:

But the two questions call for judgment. However expressed, identifying the relevant objects or ends of an impugned law and considering where those objects or ends can be classed as ‘legitimate’ is, and must be, a question for

³⁹ Chordia (n 4) 191–3.

⁴⁰ *Murphy* (n 31) 60 [60]–[61]; *ibid* 192 n 268.

⁴¹ *McCloy* (n 2) 235 [141].

⁴² *Murphy* (n 31) 72 [101].

⁴³ *Ibid* 73–4 [109].

⁴⁴ *Brown v Tasmania* (2017) 261 CLR 328 (‘Brown’); *Unions NSW v New South Wales* (2019) 264 CLR 595 (‘*Unions NSW* (2019)’); *Clubb v Edwards* (2019) 267 CLR 171; *Comcare v Banerji* (2019) 93 ALJR 900.

⁴⁵ *Unions NSW* (2019) (n 44).

⁴⁶ Shipra Chordia, ‘Proportionality and the New Postwar Juridical Paradigm: A Challenge to Australian Exceptionalism?’ in Matthew Groves, Janina Boughey and Dan Meagher (eds), *The Legal Protection of Rights in Australia* (Hart Publishing, 2019) 365.

⁴⁷ *Coleman v Power* (2004) 220 CLR 1, 50–51 [93], [95]–[96] (McHugh J).

⁴⁸ *McCloy* (n 2) 281–2 [309].

judgment. And considering whether that impugned law advances those legitimate objects or ends in a manner compatible with the maintenance of the constitutionally prescribed system of representative and responsible government also is, and must be, a question for judgment.⁴⁹

Gordon J further said that:

The method or structure of reasoning to which the plurality refers does not yield in this case an answer any different from that reached by the accepted modes of reasoning. It does not avoid the judgments that the two questions require and, as always, it is necessary to explain how and why those judgments are formed.⁵⁰

As Chordia observes, there is no avoiding the need for a balancing exercise.⁵¹ However, Chordia's statement that 'there is an inescapable disjuncture between Gordon J's apparent disavowing of a need to balance and the way in which her Honour's analysis actually proceeded in the cases'⁵² may place too much weight on the distinction between the rejection of balancing and the acceptance of an evaluative judgment. In another passage, Gordon J echoed the dismissal by McHugh J in *Coleman v Power* of the criticism by Adrienne Stone that the tests adopted in *Lange* involved 'an "ad hoc balancing" process without criteria or rules for measuring the value of the means (the burden of the provision) against the value of the end (the legitimate purpose)'.⁵³ Gordon J continued in *McCloy*:

Because there are no criteria or rules by which a 'balance' can be struck between means and ends, the question is not one of balance or *value* judgment but rather whether the impugned law *impermissibly* impairs or tends to impair the maintenance of the constitutionally prescribed system of representative and responsible government having regard not only to the *end* but also to the *means* adopted in achieving that *end*.⁵⁴

To the extent that this analysis reflected that of McHugh J in *Coleman v Power*,⁵⁵ there is much to be said for Chordia's refusal to accept the response as other than a confirmation of the criticism that no criteria or standards have been established.⁵⁶ There is undoubtedly an evaluative judgment to be made; the question ultimately is whether structured proportionality provides a better basis for that exercise and its expression.

Chordia takes some care in addressing the objections raised by Gageler J in *McCloy* and *Brown v Tasmania*.⁵⁷ Dealing first with *McCloy*, Chordia treads carefully, describing his analysis as 'calibrated scrutiny'.⁵⁸ Gageler J raised two

⁴⁹ Ibid.

⁵⁰ Ibid 282 [311].

⁵¹ Chordia (n 4) 176–7.

⁵² Ibid 177.

⁵³ *Coleman v Power* (n 47) 46 [83] citing Adrienne Stone, 'The Limits of Constitutional Text and Structure: Standards of Review and the Freedom of Political Communication' (1999) 23(3) *Melbourne University Law Review* 668.

⁵⁴ *McCloy* (n 2) 287–8 [336] (emphasis in original).

⁵⁵ *Coleman v Power* (n 47) 49–50 [91].

⁵⁶ Chordia (n 4) 176–7.

⁵⁷ *McCloy* (n 2); *Brown* (n 44).

⁵⁸ Chordia (n 4) 177–9; *McCloy* (n 2) 238 [150].

principled objections to what he identified as ‘a particular and prescriptive form of proportionality analysis’.⁵⁹ His Honour’s objections were as follows:

First, I am not convinced that one size fits all. In particular, I am not convinced that standardised criteria, expressed in unqualified terms of ‘suitability’ and ‘necessity’, are appropriate to be applied to every law which imposes a legal or practical restriction on political communication irrespective of the subject matter of the law and no matter how large or small, focused or incidental, that restriction on political communication might be.

...

Secondly, I am not convinced that to require a law which burdens political communication to be ‘adequate in its balance’ is to adopt a criterion of validity which is sufficiently focused adequately to reflect the reasons for the implication of the constitutional freedom and adequately to capture considerations relevant to the making of a judicial determination as to whether or not the implied freedom has been infringed.⁶⁰

Gageler J concluded with a reformulation of the second step in the *Lange* analysis as requiring a finding

that such restriction as each [impugned provision] imposes on political communication is imposed in pursuit of an end which is appropriately characterised within our system of representative and responsible government as compelling; and that the imposition of the restriction in pursuit of that compelling end can be seen on close scrutiny to be a reasonable necessity.⁶¹

His Honour continued:

In the application of that standard, much turns on identification of the precise nature and degree of the restriction which each of the impugned provisions imposes on political communication. Much also turns on the identification and characterisation of the end each is designed to achieve.⁶²

Chordia identifies the basis of the scrutiny required as reflecting the need to ensure that representative institutions are protected against the risks of abuse arising from majoritarian characteristics of the institutions, reflecting the approach of the US scholar John Hart Ely.⁶³ In the US, she notes, Ely’s theory has been criticised as ‘underinclusive’.⁶⁴ However, it is not entirely clear that this was a legitimate criticism with respect to cases specific to the implied freedom of political communication, nor that, if otherwise warranted, it was applicable to the approach of Gageler J.

In *Brown*, after a minor reformulation of the *Lange* test, Gageler J addressed proportionality analysis with specific reference to its history:

Though it originated within a civil law tradition, three-staged testing for proportionality ... has been found by some courts applying the methodology

⁵⁹ *McCloy* (n 2) 234 [140].

⁶⁰ *Ibid* 235 [142], 236 [145].

⁶¹ *Ibid* 239 [155].

⁶² *Ibid* 239 [156].

⁶³ Chordia (n 4) 180.

⁶⁴ *Ibid* 77, 181.

of the common law to be useful when undertaking constitutionally or statutorily mandated rights adjudication. The structure it imposes is not tailored to the constitutional freedom of political communication, which is not concerned with rights, and which exists solely as the result of a structural implication concerned not with attempting to improve on outcomes of the political process but with maintaining the integrity of the system which produces those outcomes. The first stage – ‘suitability’ ... – can be quite perfunctory if confined to an inquiry into ‘rationality’. The second – ‘necessity’ ... – is too prescriptive, and can be quite mechanical if confined to an inquiry into ‘less restrictive means’. The third stage – ‘adequacy of balance’ ... – even if the description of it as involving a court making a ‘value judgment’ conveys no more than that the judgment the court is required to make can turn on difficult questions of fact and degree, is too open-ended, providing no guidance as to how the incommensurables to be balanced are to be weighted or as to how the adequacy of their balance is to be gauged.⁶⁵

As to Gageler J’s first point (on the origins of proportionality analysis methodology), a great benefit of Chordia’s book is that it explains the background to the development of proportionality analysis in a way that allows one to assess whether its origin in a civil law jurisdiction (Germany), and its adoption of three-staged testing, renders it inappropriate as a method for reviewing legislation for constitutional validity in Australia. Like French CJ and Bell J in *Murphy*, Chordia has little sympathy for such a view. Further, to note that the methodology has been found ‘useful’ by common law courts implies acceptance that it is not inherently inconsistent with common law adjudication. Chordia deals with the circumstances in which it has been adopted in Canada and the UK.⁶⁶ Although it is said to have been adopted with respect to ‘rights adjudication’ (whether under a constitution or statute), there is some irony in the fact that it has not been adopted in the US, which has a constitution mandating rights in absolute terms to which limitations have been implied by the courts. (That ‘modern constitutions’ subject rights to express limitations that the courts must adjudicate is of limited importance.)⁶⁷

Gageler J’s second point (as to the structure imposed by three-stage proportionality testing) relies on the distinction between individual rights and a structural implication such as the protection of political speech. The distinction may be accepted, but its sufficiency as an objection to proportionality analysis remains in issue. Chordia states that the German Federal Constitutional Court, in considering the validity of legislation, has treated individual rights as drawn from, and as aspects of, ‘broader public goods and societal interests ... [and thus] has ensured that these rights are properly viewed as reflecting wider “principles” (or values) rather than as operating as more specific “rules” divorced from those values’.⁶⁸ There is a sense in which all human rights are a reflection of public values underpinning the political structure, of which the implied freedom of political communication is one.

⁶⁵ *Brown* (n 44) 376–7 [160] quoting *McCloy* (n 2) [2], [74]–[75] and citing *Re Wakim; Ex parte McNally* (1999) 198 CLR 511, 588 [149]; Frederick Schauer, ‘Proportionality and the Question of Weight’ in Grant Huscroft, Bradley W Miller and Grégoire Webber (eds), *Proportionality and the Rule of Law: Rights, Justification, Reasoning* (Cambridge University Press, 2014) 173, 177–8, 180.

⁶⁶ Chordia (n 4) 24–7.

⁶⁷ Iddo Porat, ‘Mapping the American Debate over Balancing’ in Huscroft, Miller and Webber (n 65) ch 17, 398.

⁶⁸ Chordia (n 4) 55.

Recognition as an individual human right is no more than a statement as to a potential mechanism of enforcement. The Australian emphasis on the implied freedom as a structural implication reflects the principle that limits on legislative power must be found in the written *Constitution*. The effect of applying the principle to invalidate a law is to protect an otherwise prohibited activity.

Gageler J's specific complaints refer to the 'perfunctory' nature of the first test, the argument that the second is 'too prescriptive' and can be 'quite mechanical', while the third step is said merely to establish that a judgment is required and is 'too open-ended'.⁶⁹ On one view, these characterisations understate the difficulties with proportionality analysis. The substantial objection to the second step is that it requires the identification of other less restrictive mechanisms for pursuing the legitimate purpose, which are more compatible with the constitutionally protected value and which are reasonably practicable. There is a significant literature with respect to the third step, which is said to involve weighing 'incommensurables'.⁷⁰ These objections, including Schauer's analysis referred to by Gageler J,⁷¹ are considered by Chordia.⁷²

There is another aspect of the history that may explain, in part, the antipathy to proportionality in Australia. Chordia records that structured proportionality reasoning was developed in the German Constitutional Court in order to deal with limitations on both legislative and executive power.⁷³ As explained by Cohen-Eliya and Porat, the German approach developed with a focus on judicial review of administrative action.⁷⁴ By contrast, the US developed its approach to review of legislation, based on its Bill of Rights,⁷⁵ before it developed a comprehensive and coherent set of administrative law principles.

In Australia, there has been resistance to proportionality reasoning in review of administrative action, based on its potential to loosen the constraints on review by reworking (or replacing) principles of manifest unreasonableness. The chronology in the Australian case law may be significant in this respect. In 2013, the High Court delivered judgment in three cases where reference was made to proportionality reasoning, namely *Monis v The Queen*⁷⁶ (freedom of communication by postal services); *Attorney-General (South Australia) v Adelaide City Corporation*⁷⁷ (validity of by-laws limiting free speech); and *Minister for Immigration and Citizenship v Li*⁷⁸ (review of administrative decision-making). The possibility of proportionality analysis was adverted to in *Li* by French CJ⁷⁹ and in

⁶⁹ See above n 64 and accompanying text.

⁷⁰ See above n 64 and accompanying text. See also Timothy Endicott, 'Proportionality and Incommensurability' in Huscroft, Miller and Webber (n 65) ch 14.

⁷¹ See above n 64 and accompanying text.

⁷² Chordia (n 4) 177–81.

⁷³ Ibid.

⁷⁴ Moshe Cohen-Eliya and Iddo Porat, 'The Administrative Origins of Constitutional Rights and Global Constitutionalism' in Vicki C Jackson and Mark Tushnet (eds), *Proportionality: New Frontiers, New Challenges* (Cambridge University Press, 2017) ch 5.

⁷⁵ *United States Constitution* amends I–X.

⁷⁶ *Monis v The Queen* (2013) 249 CLR 92, 153 [144] (Hayne J).

⁷⁷ *A-G (SA) v Adelaide City Corporation* (2013) 249 CLR 1.

⁷⁸ *Minister for Immigration and Citizenship v Li* (2013) 249 CLR 332 ('Li').

⁷⁹ Ibid 351–2 [30].

the joint reasons of Hayne, Kiefel and Bell JJ.⁸⁰ Proportionality reasoning was not adopted in the administrative law context in *Li*, but the joint reasons in *McCloy* appeared to adopt proportionality reasoning with respect to both legislative and administrative review.⁸¹ While strictly obiter dicta in *McCloy*,⁸² the reference to ‘administrative acts’ was repeated by French CJ and Bell J in *Murphy v Electoral Commissioner*.⁸³ This may have caused some discomfort on the part of members of the Court concerned at a more intense level of scrutiny of administrative decisions, a concern that led to repudiation of that view in *Minister for Immigration and Border Protection v SZVFW*, where, for example, Kiefel CJ affirmed that ‘the test for unreasonableness is necessarily stringent’,⁸⁴ although no member of the Court referred to *McCloy*.

IV Conclusions

Chordia’s book provides a comprehensive and well-written account of structured proportionality as a mechanism for determining the constitutional validity of legislation. The controversial status of proportionality analysis in Australian jurisprudence derives in part from its origins and its formal development by the German Constitutional Court. An understanding of that history is essential for engagement in the important debate currently underway as to its relevance and usefulness in Australian constitutional, and indeed administrative, law.

The book has, however, a further and more profound value. It leads us to question the importance of key principles of our constitutional law. In particular, it raises questions as to the categorisation of Commonwealth legislative powers by reference to either subject matter or purpose. Even subject-matter powers, such as those relating to aliens, may have purposive limitations, as suggested by the reasoning of the plurality in *Chu Kheng Lim v Minister for Immigration, Local Government and Ethnic Affairs*.⁸⁵ Similarly, the analysis raises issues as to how one characterises a law with respect to a constitutional source of power. The standard test, asking whether there is a ‘sufficient connection’ between the law and the head of power, implies that an evaluative judgment is required. Whenever a law imposes a restriction, or otherwise adversely affects the interests of an individual, it is proper to ask whether there is an underlying value that is affected. If there is, it may be necessary to weigh the degree of connection with the subject matter against the intrusion on an individual.

Chordia addresses proportionality in considering the distinction between purposive and other powers, its value in characterisation, and also its relevance to

⁸⁰ Ibid 366 [73].

⁸¹ *McCloy* (n 2) 195 [3] (French CJ, Kiefel, Bell and Keane JJ). See also Mark Aronson, Matthew Groves and Greg Weeks, *Judicial Review of Administrative Action and Government Liability* (Lawbook, 6th ed, 2017) [6.520]–[6.530].

⁸² See Aronson, Groves and Weeks (n 81) [6.530].

⁸³ *Murphy* (n 31) 49–50 [32] citing *McCloy* (n 2) 195 [3] (French CJ, Kiefel, Bell and Keane JJ).

⁸⁴ *Minister for Immigration and Border Protection v SZVFW* (2018) 264 CLR 541, 551 [11] citing *Li* (n 78) 376 [108].

⁸⁵ *Chu Kheng Lim v Minister for Immigration, Local Government and Ethnic Affairs* (1992) 176 CLR 1, 32 (Brennan, Dean and Dawson JJ). See also at 57 (Gaudron J); Chordia (n 4) 107–8.

the Court's jurisprudence on s 92 of the *Australian Constitution* and the freedom of interstate trade and commerce.⁸⁶ This is an area in which, in the past, the High Court has largely relied upon conclusory labels without clear articulation of standards, criteria or values which are being applied. Sometimes labels (such as 'manifest unreasonableness' or 'strict scrutiny') convey all that can be conveyed; however, exercises in weighing different interests against each other are not value-free. In construing legislation, the High Court is sensitive to possible intrusions on interests variously described as fundamental principles and human rights and freedoms, now labelled the 'principle of legality'. Increased transparency as to the values at stake and the standards being applied has much to recommend it.

Proportionality reasoning is a topic that public lawyers can no longer avoid. What it encompasses and how it works are by no means closed issues. Empirical research in this area is a new phenomenon: the first significant report of such research, funded by the European Research Council, was published only last year.⁸⁷ We can expect further studies of the operation of proportionality analysis in countries closer to home, including by courts in Hong Kong and Macau.⁸⁸ Chordia's book is an excellent contribution to this burgeoning area of legal study: both she and The Federation Press are to be congratulated on its production and publication.

⁸⁶ Chordia (n 4) chs 6–7.

⁸⁷ Mordechai Kremnitzer, Talya Steiner and Andrej Lang, *Proportionality in Action: Comparative and Empirical Perspectives on the Judicial Practice* (Cambridge University Press, 2020).

⁸⁸ See, eg, Albert HY Chen and PY Lo, 'The Constitutional Orders of "One Country, Two Systems": A Comparative Study of the Visible and Invisible Bases of Constitutional Review and Proportionality Analysis in the Chinese Special Administrative Regions of Hong Kong and Macau' in Rosalind Dixon and Adrienne Stone (eds) *The Invisible Constitution in Comparative Perspective* (Cambridge University Press, 2018) ch 8.

