Boyle & Birds' Company Law

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Editors

John Birds LLM, FRSA
Emeritus Professor in the School of Law, University of Manchester and Honorary Professor in the School of Law, University of Sheffield

Bryan Clark BA, LLM, PhD
Reader in Law, University of Strathclyde

Iain MacNeil LLB, PhD
Alexander Stone Professor of Commercial Law, University of Glasgow

Gerard McCormack BCL, LLM, PhD
Professor of International Business Law, University of Leeds

Christian Twigg-Flesner LLB, PCHE, PhD
Professor of Commercial Law, University of Hull

Charlotte Villiers LLM, Solicitor
Professor of Company Law, University of Bristol

Consultant Editor

A. J. Boyle LLM, SJD, Barrister
Emeritus Professor of Law, Queen Mary, University of London

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PREFACE TO THE 8TH EDITION

With the publication of this edition, we seek to keep the work up to date by incorporating significant case-law developments over the past two years, as well as, for example, covering the UK Corporate Governance Code 2010 and recent developments at the European level. We have also been able fully to incorporate the implementation of the Shareholders' Rights Directive.

As we said in the prefaces to the last two editions, time will tell whether or not the Companies Act 2006 will prove to be all that has been claimed for it in terms of deregulation and simplification. The sheer volume of statutory company law to some extent militates against that view, as does the fact that it has already been amended in some quite significant ways. Although a review for government of the Act in 2010 seemed to indicate a general level of satisfaction, it is notable that the Department for Business, Innovation and Skills is working on various possible further reforms. In particular it is expected that there will soon be formal proposals to modernise and simplify the current system for the registration of charges, there is to be a review of whether a new corporate form for single person businesses could reduce costs for small entrepreneurs and consideration is being given to a range of options to simplify accounting and audit requirements, especially for small and medium enterprises.

It is hoped that this book continues to be a reliable and fairly comprehensive guide to this difficult subject.

Responsibilities for this edition have been as follows: John Birds (chapters 4, 9, 12, 13, 15, 16 and 17 and overall editorial responsibility), Tony Boyle (chapters 1, 3 and 18), Bryan Clark (chapters 7 and 8), Iain MacNeil (chapters 19 and 20), Gerard McCormack (chapter 21), Christian Twigg-Flesner (chapters 2, 5, 6 and 10) and Charlotte Villiers (chapters 11 and 14).

John Birds

August 2011

CHAPTER 1

THE DEVELOPMENT OF THE REGISTERED COMPANY

1.1 INTRODUCTION

This chapter is concerned with issues that have a general bearing on the various specific aspects of company law examined in the chapters that follow. It also seeks to explain in a concise way how the body of legislation[1] and case-law that today governs the affairs of registered companies first developed and came to take its present form. There are two other issues with an important bearing on company law as a whole. These are the impact of European Union company law on the relatively recent history of company legislation in Britain, which is considered in Chapter 2, and the key concept of corporate personality as developed by the courts, considered in Chapter 3. This chapter concludes with a brief discussion of the relevance of 'law and economics' theory for company law.

1.2 HISTORICAL BACKGROUND

The first topic is the development of modern company law. The account given here is in no sense a history of company law as a whole – too large an undertaking for our purpose. Instead, it is intended to show how the unincorporated joint-stock company of the early nineteenth century was transformed by the legislation of the 1840s and 1850s into a registered company of recognisably modern shape. For an understanding of the earlier history of company law, which had its origins in the sixteenth and seventeenth centuries, the readers are referred elsewhere.[2] There they will find an account of how the scandal and financial collapse produced in the early eighteenth century by the 'South Sea Bubble', and the resulting

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1 Ie principally the Companies Act 2006, although as will be seen, some parts of the earlier legislation have survived the passing of this Act.

2 For a lively and stimulating summary of this earlier period, see P Davies, *Gower's Principles of Modern Company Law* (Sweet & Maxwell, 6th edn, 1997) Ch 2. See further: CA Cooke, *Corporation, Trust and Company* (Manchester, 1950); AB Dubois, *The English Business Company After the Bubble Act, 1720–1800* (New York, 1938); BC Hunt, *The Development of the Business Corporation in England, 1800–1867* (Harvard Economic Studies, 1936). See Jean J du Plessis 'Corporate Law and Coporate Governance Lessons from the Past' (2009) 30 Company Lawyer 71.

Bubble Act of 1720,[3] not only put down an illicit trade in the charters of incorporated companies but also placed an already flourishing number of unincorporated joint-stock companies under a cloud of official disapproval for over a century. Until the repeal of the Bubble Act in 1825,[4] such companies had a shadowy legal existence. The more favourable legal opinion of them was that, so long as their shares were not freely transferable, they were not liable to prosecution under the Bubble Act. Even after the Act's repeal, the only hope for those forming a corporate business enterprise (however economically important and substantial its operations) was to form a 'statutory company' by means of a private Act of Parliament. This gave the obvious advantage of legal personality with the attendant privilege of limited liability. Only in the case of very major undertakings (such as the canal and railway companies and other early utilities) which needed to raise large amounts of capital from the public would the delay, trouble and very great expense entailed by the private bill procedure be justified. By this period the modern practice of refusing to grant a Royal Charter of Incorporation to those engaged in trade or commerce was becoming established.[5] It may be noted that, although the common law protected the members of trading corporations from liability, it was common for provisions in their charters to allow the corporation to make 'leviations' on members to pay its debts. The courts of equity permitted creditors direct action against the members.

1.3 THE INCORPORATION OF JOINT-STOCK COMPANIES BY REGISTRATION

At common law, despite the repeal of the Bubble Act in 1825, there remained some doubt about the legality of unincorporated joint-stock companies with freely transferable shares. These doubts had been fostered by Lord Eldon, who succeeded in inserting in the repealing Act a provision that their position at common law (with the taint of possible illegality) should be as it was before the Bubble Act was repealed. In the boom of the 1830s there was, nevertheless, a proliferation of unincorporated joint-stock companies, which in turn produced a growing demand for their legal regulation. In particular, there was a need to clarify their right to sue and be sued. There was also a growing demand for limited liability as a protection for shareholders who invested in them. In the case of formal written contracts, this was often obtained by express terms in those contracts, but this was obviously not possible in the case of the everyday informal contracts of a growing number of industrial and commercial companies. It has been seen that incorporation by charter was now deemed unsuitable for industrial and commercial companies, and a private Act of Parliament was prohibitively expensive.

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3 6 Geo I, c 18.

4 6 Geo IV, c 91.

5 As to types of business organisation other than the registered company, see **1.5**.

1.3.1 Legislative control

The Trading Companies Act 1834 and the Chartered Company Act 1837 made a half-hearted attempt to deal with the problems of joint-stock companies, but the first was very restrictively applied by the Board of Trade and the second had little more success. Without conferring incorporation, these Acts made available some of the incidents of that status (eg the right to sue and be sued) and even (in the 1837 Act) limited liability to those seeking and obtaining the appropriate letters patent.

Especially during the cyclical slumps that followed economic booms in the nineteenth century, fraudulent promotion and other abuses were frequently revealed. This led to the appointment of a Committee of Parliament (which was eventually chaired by Gladstone when he became President of the Board of Trade). Gladstone undoubtedly had a strong influence on the eventual report.[6] This seminal report resulted in what is still referred to as 'Gladstone's Act' – the Joint Stock Companies Act 1844.[7]

It is this piece of legislation that laid the foundation of the modern registered company; but modern company law still owes very much to those principles of partnership and trust law that the courts had already developed to cope with the unincorporated joint-stock company. However, 'Gladstone's Act' set company law on what is still its modern course by conferring ready access to incorporation by a process of registration.[8] It set up the office of Registrar of Companies who had not only to supervise the original registration, but had to keep up-to-date information about each company's constitution, directors and annual returns and make it available on 'public file'. At this stage the company's constitution was expressed in a 'deed of settlement', essentially the same document used by unincorporated joint-stock companies. It had broadly the same function as the modern articles of association, but in its original form was a trust deed which provided, *inter alia*, for the trustees in whom the assets of the old-style unincorporated joint-stock company might be vested.

The new Act applied henceforth to all joint-stock companies with more than 25 members or which allowed shares to be transferred without the consent of all the members. Thus began the divorce of partnership law from company law and the origin of the legislative practice that used to limit the size of membership in a 'private partnership', although the limit of 20 partners has since been abolished.[9] Existing unincorporated

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6 1844 BPP Vol VII.

7 This Act did not apply to Scotland where the more liberal Scots common law applied until the Joint Stock Companies Act of 1856.

8 There was a system of 'provisional registration' prior to the filing of the appropriate deed of settlement. Only after a full registration was the company incorporated.

9 With effect from 20 December 2002; see 24 Co Law 113–114. See further *Gore-Browne*

joint-stock companies could gain the privileges conferred by the Act if they altered their existing deeds of settlement and registered in compliance with the Act's provisions.[10]

1.3.2 Limited liability

Limited liability was not conferred by Gladstone's Act. This was still a hotly debated issue in 1844 both in respect of 'private partnerships' and joint-stock companies. Thus the new type of registered company was like a modern unlimited company. There were some hesitations in the legislature's policy on winding up these new registered companies. The earliest winding-up Acts applied the ordinary bankruptcy law to companies while producing a conflict of jurisdiction between the bankruptcy courts and the Court of Chancery. By 1857, this confusion was resolved by conferring sole jurisdiction on the Chancery.[11] At the same time, certain principles of bankruptcy law were carried over to a new corporate setting.

The question of conferring limited liability on the new registered companies (and also upon certain forms of partnerships) was a strongly debated issue in the mid-nineteenth century in Parliament, in officially appointed committees, and in the press and the business community.[12] While there was a strong movement for introducing a form of 'limited partnership' (based on the French model of the *société en commandite*), this had to wait in limbo for eventual enactment in the Limited Partnerships Act 1907, by which time it proved to be of little practical utility.[13] Instead, in the mid-nineteenth century, the Government chose to confer limited liability only upon registered companies[14] – or more exactly upon those registered companies which opted to register in compliance with the requirements for a company limited by shares (then, as today, the vast majority).

As at first introduced (in the Limited Liability Act 1855), there were a number of important safeguards attached to the concession of limited liability. Some of these have a contemporary ring in that they have been reintroduced in modern legislation. Thus there were requirements of at least 25 members as well as specified amounts in respect of issued and paid-up capital. The word 'limited' had to be added at the end of the

on Companies (Jordans, 45th edn, loose-leaf) at 4 [17]. As to the practical choice to be made between the small private limited company and the limited liability partnership, see **3.3**.

10 Those that did not do so still had to file certain information.

11 See the Joint Stock Companies Act 1856 and the Companies Winding Up (Amendment) Act 1857.

12 For an account of the 'struggle for limited liability' see Davies, *op cit*, at pp 40–44.

13 The more flexible form of the registered company was by then readily available to small private companies. This gave the advantage of limited liability for all members and much else besides.

14 Banking and insurance companies were at first excluded.

company's name everywhere it was displayed as an awful warning of the new risks faced by creditors. There were also safeguards to maintain the capital raised against the hazard of improperly paid dividends or unjustified loans to directors. The company had to have auditors approved by the Board of Trade. However, within a very short time, what has been termed the first 'modern Companies Act' – the Joint Stock Companies Act 1856 – consolidated and reformed earlier legislation. It abolished the old system of registering deeds of settlement and introduced the twin constitutional documents – the memorandum of association and the articles of association. Rather less happily, this Act removed most of the safeguards for limited liability in the 1855 Act. In somewhat different form, most of these safeguards have been reintroduced into company law in the legislation of recent years.[15]

Undoubtedly, the grant of the benefit of limited liability helped to make possible the growth of the large modern company that today dominates the private sector of the economy. At an earlier period in the nineteenth century, those enterprises which had need to raise share and loan capital on a grand scale (notably the railway companies) had enjoyed limited liability as statutory companies created by Act of Parliament.[16] The conferment of the same privilege on the registered company made it available to entrepreneurs and investors in industry and commerce generally.

It can be argued that in the case of the old unincorporated joint-stock company, with large numbers of shareholders whose liability was unlimited, this was not (for procedural and practical reasons) of great use in satisfying the claim of the unpaid creditors. Nevertheless the absence of limited liability was undoubtedly a major deterrent to investors in large-scale enterprises under the management of others. This does not of course silence the past and present critics of the unrestricted availability of limited liability for every small private company (or indeed for the subsidiaries in groups of companies). Where such companies are seriously (and deliberately) under-capitalised, the possibilities of abuse are self-evident.[17]

[15] See Chapters 8 and 14.

[16] The Companies Clauses Consolidation Act 1845 standardised the procedure in respect of statutory companies which were still used for new railways or utilities. This Act allowed the standard provisions normally included in private bills seeking to incorporate companies to be incorporated by reference. A separate Act in 1845 (8 and 9 Vict c 17) dealt with Scottish statutory companies.

[17] For a valuable review, with references to the earlier literature, see Freedman 'Limited liability: large company theory and small firms' (2000) 63 MLR 317.

1.4 DEVELOPMENTS IN THE LATE NINETEENTH AND TWENTIETH CENTURIES

During the remainder of the nineteenth century the legislature made only minor changes in company law, but the courts were responsible for the development of a number of important principles. As regards legislation, a general pattern began in 1862 of reforming legislation followed by a consolidating Act. The Companies Act 1862 was the first Act of that name. This process continued at regular intervals (1908 and 1929) until the Companies Act 1948. The courts were faced with the task of evolving a number of new principles to fill out the statutory structure. In many areas, they could elaborate upon an existing body of partnership, trust and agency law already evolved to meet the needs of the old unincorporated joint-stock companies.[18] Alternatively they might draw wide inferences from hints dropped by the legislature. Thus, from a somewhat slender statutory foundation, a substantial body of new judge-made principle might be created. Two obvious examples are the *ultra vires* doctrine[19] and the principles governing the raising and maintenance of share capital.[20] In other areas of company law, new concepts owed their origin to commercial practice and the skills of conveyancing counsel. These in due course received the scrutiny and approval of the courts.[21]

In the twentieth century and into the twenty-first century, two issues continued to preoccupy those who write official reports on company law reform and shape the consequent legislation. These issues are the need to increase the disclosure requirements in the Companies Act and the related question of how far to exempt private companies from the accounting and other publicity requirements that apply to public companies. While the expense and administrative burden of disclosure has continued to grow, the question of how to handle the small private company has produced different answers at different times.

As regards publicity in respect of company accounts, this started with an annual balance sheet and then moved to a profit and loss account, to consolidated accounts for groups of companies and certain information as to 'associated companies'.[22] Today it includes further refinements such as information as to turnover and details about methods of valuation of assets, as well as requiring the accounts to be based either on a historical cost basis or, alternatively, on 'alternative accounting rules'. The general effect of these is to allow certain assets to be included in the accounts on the basis of their market value or their current costs. A wide range of

[18] See, eg, directors' duties (Chapters 16 and 17), minority shareholders' actions (Chapter 18).
[19] See Chapter 5.
[20] See Chapter 8.
[21] Eg preference shares (see Chapter 8), debentures and floating charges (see Chapter 10).
[22] See Chapter 14.

other information must also be given about the company's activities, relating to its members and to its share and loan capital. An area of particular growth in respect of disclosure requirements in recent years relates to directors and their various interests in their company (or group of companies) such as interests in its shares, material contracts with it, loans made to them, etc. All this information is usually disclosed on an annual basis via publicly filed annual returns (or the accounts, or the directors' report). Much of this information (in addition to being made available at the Companies Registry) must be made available on a more immediate basis by means of registers kept at the company's own registered office.[23]

A good deal of the information that must thus be disclosed is (and was) inappropriate in the case of those private companies whose small numbers of shareholders had the remedy in their own hands, and where outside investors (or lenders) could bargain for themselves. Only unsecured trade creditors need the disclosure of such accounting and other information as was appropriate to their needs. Although the private company as a distinct species with certain privileges of its own dates back to the Companies Act 1908, it was not until the Companies Act 1948 that the legislature decided that the burden of the accounting obligations imposed on most companies should not apply to small family or 'closely held' companies. These were termed 'exempt private companies'[24] and were exempt from the necessity to file public accounts (and were given certain other special privileges).[25] The pendulum of policy swung the other way in the Companies Act 1967 which abolished the exempt private company, thus visiting most of the accounting and auditing requirements (increased by that Act) on private limited companies of any size.[26] In the Companies Act 1981 the policy of the 1948 Act was reverted to in some measure. In line with the requirements of the EC Fourth Company Law Directive (on company accounts), new categories of 'medium' and 'small' companies were created with publicity and accounting requirements appropriately scaled down.

Despite these changes, the general burden of disclosure (both at the Companies Registry and at each company's own registered office) has been the target of considerable criticism both in the business community and in those learned professions concerned with company administration, as well as by some academic writers.[27] The clear lines of segregation between public and private companies first laid down in the Companies

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[23] As to the registered office, see **5.8**.

[24] See Sch 7 to the 1948 Act as to the complex conditions that had to be met to retain exempt status.

[25] Loans could be made to directors, and the company's auditors did not need professional qualifications.

[26] Unlimited companies provided an escape hatch for those dismayed by the new burden imposed as well as the risk of exposure to competitors.

[27] See Sealy, 'The Disclosure Philosophy and Company Law Reform' (1981) 2 Co Law 51.

Act 1980[28] had already made it possible for the legislature to place a lesser burden on the private company (or at any rate medium or small private companies). However, while limited liability remains overwhelmingly the norm for private companies, and while they are in most instances seriously under-capitalised for the risks involved, there must be a limit on how far the burden of disclosure can be lifted. There has not been much reduction on the burden placed on public companies either by Parliament or by the UK Listing Authority.[29]

1.5 OTHER TYPES OF CORPORATE BUSINESS ORGANISATION

The brief historical account given in this chapter has concerned the development of the registered company, since that is the subject of this book. Over the same period of time there also evolved a number of different types of association based not upon the principle of investment for profit by proprietors but on quite distinct principles of co-operation or mutual self-help. In this the archetype was originally the unincorporated friendly society. In the course of the nineteenth century, bodies and associations concerned with specialised activities of this kind came to be regulated by their own special legislation. This usually conferred corporate personality as well as limited liability. One feature common to this type of legislation is that the body for which it was intended might not register under the Companies Acts. This is true of co-operative societies, working men's clubs and other friendly societies. It also applied to trade unions, trustee savings banks and building societies.[30] In the case of trustee savings banks legislation brought their business activities within the sphere of company law. The 'privatisation' of trustee savings banks converted them into public companies offering their shares to the public as well as existing investors.[31] The building societies legislation made it possible for them to convert themselves into public limited companies.[32] Many of the larger building societies have converted into public limited companies under this legislation. A new form of business association, which is a hybrid of partnership and company law, suitable for privately owned profit-making businesses, was created by the Limited Liability Partnerships Act 2000.[33]

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28 See **4.2**.

29 As to the requirements under the *Listing Rules* as to continuous disclosure, see Chapter 14. The UK Listing Authority is now the Financial Services Authority; see Chapter 18. See Companies Act 2006, Part 15, Chapter 8 (Public Companies: laying of accounts and reports before general meetings) and Chapter 9 (Quoted Companies: Members' approved of directors' remuneration report).

30 As to the legislation applicable, see *Gore-Browne on Companies* (Jordans, 45th edn, looseleaf) at 4 [20].

31 Savings Bank Act 1985.

32 Building Societies Act 1986, as amended by the Building Societies Act 1997.

33 See further **3.3.1**.

Another modern form of business enterprise is the 'community interest company' (CIC).[34] The CIC is a new, flexible and easily registered corporate vehicle for businesses whose profits and assets are to be used for the benefit of the community. Bodies wishing to become CICs must pass a community interest test and produce an annual report to show that they have contributed to community interest aims. A new independent regulator oversees CICs, with wide powers including the power to approve registration, to appoint, suspend or remove directors, to make orders concerning their property, to set a dividend cap and to apply to wind them up.

1.6 THE COMPANIES ACTS: CONSOLIDATION AND RECONSOLIDATION IN THE 1980S

The unwieldy mass of legislation in the Companies Acts 1948–1983 was consolidated into the Companies Act 1985. Even at a technical level, it can be argued that neither the timing nor the scope of the 1985 consolidating legislation was entirely happily chosen. While this legislation was going through Parliament, the Bill that became the Insolvency Act 1985 was also being enacted. This process entailed amendment of substantial parts of the Companies Act 1985 in respect of the winding up of insolvent companies. Scarcely were these two Acts of 1985 on the statute book when a change of policy was made. This produced a reconsolidation of the parts of the Companies Act 1985 concerning the winding up of *solvent* companies with the recent legislation on insolvency. This produced the Insolvency Act 1986. At the same time the Department of Trade and Industry decided to reconsolidate the legislation on the disqualification of directors.[35] In this same period, the provisions in the Companies Act 1985 relating to public issues, insider dealing and the compulsory acquisition of shares, were substantially changed by the Financial Services Act 1986.[36] This Act broke much new ground by introducing a long overdue system of 'securities regulation'. It was itself expanded by the Financial Services and Markets Act 2000.

Following the consolidating legislation of 1985 there was one major legislative development regarding company law in the strict sense. The Companies Act 1989 contained a mélange of significant legislative innovation and a great number of technical reforms. It implemented the EC Seventh and Eighth Directives on group accounts and the appointment of auditors.[37] It also contains a new regime for private companies.[38] This allowed more scope for avoiding the formality of

[34] The Companies (Audit, Investigation and Community Enterprise) Act 2004, Part 2.
[35] The Company Directors Disqualification Act 1986.
[36] This Act has been substantially amended and extended by the Financial Services and Markets Act 2000.
[37] See Chapter 14.
[38] See Chapter 13.

company meetings by means of written resolutions or by the adoption of a more generalised 'elective regime'. In addition to these major changes, the 1989 Act contained a great number of significant reforms of the Companies Act 1985.[39]

There was much to be said in favour of the companies legislation of 1985. In terms of its simplicity and lucidity of style and the ordered clarity of the arrangement of subject matter in the principal Act, it represented a considerable achievement for the draftsman and those who instructed him. Nevertheless, even the most dazzling skills of draftsmanship (in the case of a consolidating Act) cannot cure the substantive defects in the state of existing legislation to be consolidated. The cogent criticism made of the unconsolidated Companies Acts 1948–1983 by, among others, Professor LS Sealy[40] went beyond matters of legislative style and arrangement. The general thrust of this criticism is that our company legislation (whether carried forward from the past or the subject of recent reform) is over-technical and over-'sanctioned'. It was not directed to enabling businesses large and small to be run honestly and efficiently in the real commercial world. It was law created by civil servants and company lawyers who have had insufficient regard for the real needs of the industrial and commercial world. Our legislation made very out-of-date assumptions about how private companies are formed, how public companies develop and about the realities of shareholders' meetings and resolutions as a genuine way of expressing shareholders' consent or effectively restraining directors and others who manage companies. While increasingly influenced by the rigid, elaborate and often inappropriate example of the European Union harmonisation programme, our legislation has ignored the more radical and simplifying reforms that have been successfully adopted in the Commonwealth and the United States.

There is much force in Professor Sealy's detailed critique of the then existing company legislation which was deployed to support this more general thesis, and indeed the Companies Act 2006 responds in part to such criticisms, as will be seen below. It is inevitable, however, that not everyone will agree that the general policy of those reforming company law (especially in regard to large public companies) should be how best to meet the institutional needs of businessmen. The real political and social world will inevitably demand that company law reflect a more complex, if sometimes competing, range of interests. In that sense, it is entirely understandable that the DTI, what is now the Business Department, regard company law (like labour law) as too politically sensitive to be left without close supervision to the Law Commission or to any other 'neutral' reforming body. The political priorities will inevitably change with the colour of the government in power. Thus, both in the UK and in

[39] See in particular Part III 'Investigations and Powers to Obtain Information' and Part VII 'Financial Markets and Insolvency'.

[40] See *Company Law and Commercial Reality* (Sweet & Maxwell, 1984), especially Ch 4.

the European Union, company law remains more than a matter of commercial law. This latter body of law may be well described as 'the totality of the law's response to the needs and practices of the mercantile community. This then is the essence of commercial law – the accommodation of principles, rules, practices and documents fashioned by the world of business: the facilitation, rather than the obstruction, of commercial development'.[41]

Company law, as part of a different body of law – the law of institutions – must inevitably have a different character from that governing the law of commercial transactions. It will retain this character, even when freed from the burden of history and the 'Chancery mentality'.

1.7 THE COMPANIES ACT 2006

After a long period of gestation by the Company Law Review Steering Group (CLRSG) and the Department of Trade and Industry,[42] the Company Law Reform Bill began its parliamentary progress in the autumn of 2005 and became the Companies Act 2006 a year later. In the course of this progress (as the change in title indicates) its scope was broadened from a piece of reforming legislation so as to include the codification of existing legislation (ie where this was unaffected by the reforms). It is now the longest Act of Parliament in history with 1,300 sections. Insolvency legislation remains (as under the earlier legislation) beyond the scope of the new Act. Likewise the law relating to company investigations by the Department of Trade and Industry, though amended, has not been consolidated into the 2006 Act, nor have the provisions regarding CICs.

The CLRSG was originally set up by the Department of Trade and Industry in March 1998 with the following terms of reference:[43]

> '(i) To consider how core company law can be modernised in order to provide a simple, efficient and cost-effective framework for carrying out business activity which:
> (a) permits the maximum amount of freedom and flexibility to those organising and directing the enterprise;

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41 RM Goode *Commercial Law* (Penguin, 1982) p 984, cited by Professor LS Sealy in *Company Law and Commercial Reality*, *op cit*, at p 81.

42 See *Modern Company Law for a Competitive Economy*, Final Report (DTI, 2001) and *Modernising Company Law*, Cm 5553-1, July 2002. Note that the Department of Trade and Industry is now the Department for Business, Enterprise and Regulatory Reform (DBERR).

43 For general reviews of the reform process, see, eg, Birds and Parkinson 'Company Law' in D Hayton (ed) *Law's Future* (Hart, 2000); Birds 'Reforming United Kingdom Company Law in a European Context: a Long and Winding Road' chapter 2 in SM Bartman (ed) *European Company Law in Accelerated Progress* (Kluwer, 2006).

(b) at the same time protects, through regulation where necessary, the interests of those involved with the enterprise, including shareholders, creditors and employees; and
(c) is drafted in clear, concise and unambiguous language which can be readily understood by those involved in business enterprise.

(ii) To consider whether company law, partnership law, and other legislation which establishes a legal form of business activity together provide an adequate choice of legal vehicle for business at all levels.

(iii) To consider the proper relationship between company law and non-statutory standards of corporate behaviour.

(iv) To review the extent to which foreign companies operating in Great Britain should be regulated under British company law.

(v) To make recommendations accordingly.'[44]

The CLRSG brought together over 200 interested parties in an effort to forge a consensus. In the 3 years of its deliberations, it produced four principal documents under the general title of *Modern Company Law for a Competitive Economy*.

These were the *Strategic Framework* (February 1999), *Developing the Framework* (March 2000), *Completing the Structure* (November 2000), and the *Final Report* (July 2001).[45] There were other related documents under the same general title of *Modern Company Law for a Competitive Economy*.[46]

Despite the lapse of time between these reports and the introduction of the Bill that became the 2006 Act, which was partly occupied by two Government White Papers,[47] two of these matters, company charges and capital maintenance, have only been partially tackled. Company charges were the subject of extensive further consultation, including two reports from the Law Commissions.[48] Capital maintenance, at least for public companies, is subject to the Second European Company Law Directive,[49] which is still being reconsidered at a European level. Powers to amend these areas by statutory instrument have been taken.[50]

44 Appendix A to the CLRSG Final Report, July 2001.
45 Respectively, URN 99/654, 00/656, 00/1335 and 01/942.
46 See also *Company General Meetings and Shareholder Communications* (October 1999), *Reforming Company Law Concerning Overseas Companies* (October 1999), *Capital Maintenance: Other Issues* (June 2000), *Registration of Charges* (October 2000). See respectively URN 99/1144, 99/1145, 99/1146. 00/880 and 00/1213.
47 *Modernising Company Law*, CM 5553-I and 5333-II (2002); *Company Law Reform*, Cm 6456 (2005).
48 *Report on Registration of Rights in Security by Companies*, Scot Law Com No 197 (September 2004) and *Company Security Interests*, Law Com No 296 (August 2005).
49 1977/91/EEC.
50 Companies Act 2006, ss 657, 737 and 894. As to capital maintenance, see Chapter 7, at **7.11** below.

Even those parts of the CLRSG's reports on which there was relative unanimity were subject to further scrutiny and amendment. In its passage through Parliament, 1,800 amendments were accepted, very many connected with the late consolidation.

Notable examples of areas of significant reform in the 2006 Act are the law on directors' duties,[51] and that on shareholders' derivative claims,[52] the reduction of capital,[53] and the law on company resolutions and meetings.[54] The first two of these were among the ones that caused the greatest debate in Parliament.

Among the general recommendations of the CLRSG was one that the primary companies legislation be redrafted in order to leave much of the detail to secondary legislation, so that it could be easily amended and by a delegated company law review body. In the original Bill, the Government adopted the first of these recommendations, but proposed sweeping delegated legislation powers for the Department of Trade and Industry rather than a specific body. Controversy about the width of this power led to the relevant part of the Bill being dropped, but nonetheless the Act does contain many provisions that confer power to amend and repeal its provisions by regulation or order.

Reflecting the aims behind the establishment of the Company Law Review, the 2005 White Paper stated the purpose of the reform to be the following, aims that were restated in the parliamentary debates:

- to enhance shareholder engagement and a long-term investment culture;
- to ensure better regulation and a 'Think Small First' approach;
- to make it easier to set up and run a company; and
- to provide flexibility for the future.

We have seen that the last of these aims was substantially removed during the course of the Bill. Only time will tell whether the other aims will be achieved. While it cannot be doubted that the drafting of the Act represents a considerable improvement on earlier versions, it is still, and perhaps inevitably, a highly complex piece of legislation, which will be made even more so by the secondary legislation that has followed it. There is no hint of a response to points made earlier in this chapter about the possible abuse of the corporate form and limited liability, which remains a matter for insolvency legislation; indeed the thrust of the second and third

[51] See Chapters 16 and 17.
[52] See Chapter 18, Part 1.
[53] See Chapter 10.
[54] See Chapter 13.

aims, and the change in focus from provisions aimed at public companies with small company exceptions to small company provisions with public company additions, is very much against this. It also remains to be seen whether enhanced shareholder engagement and a longer-term investment culture will in practice be achieved. Overall it is not thought that the 2006 Act is in any sense revolutionary and that even the controversial codification of directors' duties, which is considered in Chapter 16, is unlikely to have any great effect in practice. Some of the economic and political assumptions that shaped the CLRSG proposals may need to be re-assessed as a result of the changes in the economic climate brought about by the 'credit crunch' of 2008–09.

A key question, certainly so far as the objective of simplification is concerned, is the application of the 2006 Act to companies already existing before it comes fully into effect. This will depend on the transitional provisions that are to be made. Among other things, these are likely to provide for the following:[55]

- Consequent on the removal of the importance of the memorandum of association, as described in Chapter 4, that most existing provisions in memoranda become part of existing companies' articles.
- The removal of authorised capital, given the abolition of that as a requirement.
- The removal of requirements that the articles of private companies authorise various alterations in share capital.
- The removal of the articles that require a private company to have a secretary and to hold annual general meetings, given that the Act abolishes these requirements.

1.8 THE IMPACT OF LAW AND ECONOMICS THEORY

Some attention may here be given briefly to the work of the law and economics theorists. This theory has been applied to many branches of law, including tort, contract and, above all, commercial law. This intellectual movement has been very influential in the United States[56] but

[55] The detail is and will continue to be available on the DBERR's website, where general progress regarding the implementation of the Act can be found; see www.berr.gov.uk/bbf/co-act-2006/index.html.

[56] See RA Posner *Economic Analysis of Law* (Boston, Little Brown & Co, 1992); FL Easterbrook and DR Fischel *The Economic Structure of Corporate Law* (Cambridge, MA, Harvard University Press, 1991).

also has a number of adherents in Britain.[57] It will be seen that law and economics theorists have provided a distinct analysis of company law as viewed from the perspective of this type of economic theory. Inevitably, this 'movement' has its critics among other corporate theorists, including economists.[58] Some critics object to the theory as 'anti-regulatory bias', but its adherents reject this charge. They maintain that the aim of their work is to encourage a better quality of legislative intervention based on sound economic theory.[59]

It is not appropriate in a book which does not claim to be influenced by law and economics theory to engage in detailed discussion of the assumptions made and the concepts employed by this theory,[60] except insofar as they have a particular bearing upon company law. One key idea advanced by this type of economic analysis is to stress the contractual basis of company law. In economic terms the company is analysed as a 'network of contracts'. This essentially means that all the relationships within any particular company are best described in terms of a network of explicit or implicit bargains. This way of characterising the company is obviously at odds with the legal conception of the company[61] which centres upon the legal personality of the registered company. Nevertheless, it is argued that, from an economic standpoint, thinking about the company as a nexus of contracts is an illuminating analytical exercise. The key participants – shareholders, directors and employees – can be said to become involved with their company on a voluntary basis, and to continue to interact on the basis of reciprocal expectations and behaviour. A linked theory is that of the 'role of the firm'.[62] Here again, the term 'firm' does not have its usual legal meaning. Theorising about the economic utility of the 'firm' applies to enterprises which may adopt various legal forms (eg a partnership, a private or public limited company, or even a sole proprietorship with a number of employees). In the light of such economic 'realism', it has been observed that 'company legislation has had, in and of itself, only a modest impact on the bargaining dynamics which account for the nature and form of business enterprises. Thus, analytically an incorporated company is, like other types of firms, fundamentally a nexus of contracts'.[63]

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57 Eg A Ogus *Regulation, Legal Reforms and Economic Theory* (Oxford University Press, 1994); B Cheffins *Company Law: Theory Structure and Operation* (Oxford, Clarendon Press, 1997).

58 See generally J McCahery, S Picciotto and C Scott (eds) *Changing Structures and Dynamics of Regulation* (Oxford, Clarendon Press, 1993). See further: Goodhart 'Economics and law – too much one way traffic' (1997) 60 MLR 1.

59 See Cheffins, *op cit*, at p 7.

60 See generally Cheffins, *op cit*, Ch 1: 'Economics and the Study of Company Law' for an excellent introduction to the subject.

61 See the historical section of this chapter (above) and Chapter 3 as to the concept of legal personality and the consequences of incorporation.

62 See RH Coase *The Firm, the Market and the Law* (University of Chicago Press, 1988).

63 Cheffins, *op cit*, at p 41.

Another theory applied by law and economics theory to the company (or any substantial enterprise) is that of 'agency costs'. Here yet again, the term 'agency' (or the correlative 'principal') is not used in a legal sense. The theory of 'agency costs' is designed to deal with inevitable conflicts of interest between the various participants in a business enterprise. From an economic perspective, an agency relationship arises when one participant depends on another for business activity. This obviously applies to the trust that shareholders must place in company directors or officers who manage the assets and undertake the business activity of their company. This delegation by the 'principal' of the power to manage to the 'agent' raises the problem of 'agency costs'. This means the costs of monitoring the performance of the management to prevent an 'agent' putting his own interests above those of his 'principal'. Here again, a bargaining process should establish legal arrangements that will seek to reduce agency 'costs' both in terms of the costs of continuing monitoring and the costs caused by misbehaviour or incompetent management.

In Britain, law and economics theorising about company law has received a mixed reception. Some scholars argue strongly for its application in order to understand the impact of company law upon business enterprises so as to maximise their economic welfare.[64] It has been adopted in a Law Commission Consultative Paper concerned with reforming the law of directors' duties.[65]

Other scholars, however, find serious shortcomings in the 'nexus of contracts' analysis of the company and indeed in the whole approach of the law and economics school. They question the neo-liberal economic assumptions on which this theory rests. It can be argued that it is particularly inappropriate when applied to the legal regulation of public listed companies. Its application may compound the weakness and ineffectuality of the present system of company law in restraining corporate abuses in such companies.[66]

[64] Cheffins, *op cit*. For a more qualified appraisal, see Deakin and Hughes 'Economics and company law reform: a fruitful partnership?' (1999) 20 Co Law (Special Issue) 212. See also Riley 'Contracting out of company law: section 459 of the Companies Act 1989 and the role of the court' (1992) 55 MLR 782. See further Maugham and Copp 'Company law reform and economic methodology revisited' (2000) 21 Co Law 14; Copp 'Company law and alternative dispute resolution: an economic analysis' (2002) 23 Co Law 361.

[65] See *Company Directors: Regulating Conflicts of Interests and formulating a Statement of Duties*, A Joint Consultative Paper of the English and Scottish Law Commission, Law Com No 153 (1998). See Part III by Deakin and Hughes 'Economic Considerations'. See also the Law Commission's final report: 1B in Law Com No 261 (Cm 4436, 1999).

[66] See Sugarman, 'Is Company Law founded on contract or public regulation? The Law Commission's Paper on Company Directors' (1999) 20 Co Law (Special Issue) at 178–183; Dine 'Fiduciary Duties as default rules, European influences and the need for caution in the use of economic analysis' (1999) 20 Co Law (Special Issue) 190, at 193–195.

The neo-liberal assumptions that lie behind the 'law and economics' theory are today much more open to question as a consequence of the failure of 'market forces' to prevent the economic collapse of 2008–09.

The stimulating and continuing debate these arguments have produced may be further pursued in the literature referred to in the footnotes. Any more detailed assessment clearly lies beyond the scope of an introductory chapter to a company law text.

Other corporate scholars have advanced alternative theoretical approaches to company law which stress many non-economic dimensions in formulating a more comprehensive conceptualisation of company law and corporate reality.[67]

1.9 THE MARKET FOR CORPORATE CONTROL

In the case of listed public companies, the role of 'market economics' must be taken seriously at an everyday and severely practical level. Here there is not only a market for the company's goods or services but also an active market for its listed securities. Where all (or at least a controlling majority) of the company's voting shares are issued to the investing public at large,[68] it is clearly possible for control of the company to pass a result of a successful takeover bid.[69] Even where this does not occur, the discipline of market will operate through the rise or fall of the company's share price to reward or punish successful or unsuccessful performance by the management. This may prove much more significant as a sanction against incompetence or carelessness than any legal remedy.

The idea of the market for corporate control had gained increasing attention since the early 1980s. It obviously reflects the neo-liberal ideology which has prevailed in a period when the concept of 'markets' and 'market forces' has been at the centre of most political as well as economic discussion. The undoubted pragmatic basis for this concept is to be found in the regularly occurring battle for control of large public companies by means of contested takeover bids. The conditions that make this possible in Britain (perhaps alone among the member states of the European Union) require at least a majority of the voting equity shares in the target company to be widely distributed among institutional

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67 See especially JE Parkinson *Corporate Power and Responsibility, Issues in the Theory of Company Law* (Oxford, Clarendon Press, 1994). This study is especially concerned with directors' duties and the issue of corporate governance. It is further considered in Chapter 11. See also the classical study of the separation of ownership and control in large corporations: AA Berle and GR Means *The Modern Corporation and Private Property* (New York 1932, rev edn 1967). See a recent assessment of this classic work by Ireland, '"Back to the future", Adolf Berle, the Law Commission and Directors' Duties' (1999) 20 Co Law (Special Issue) 203.

68 As to public issues, see Chapter 19.

69 As to the regulation of takeover bids by the City Code on Takeovers and Mergers, see Chapter 20.

investors as well as individual shareholders. Institutional investors (such as pension funds, insurance companies and unit trusts) are 'key players' in the takeover market. Their role is an essential one not only in deciding the success or failure of a takeover bid (or rival bids) but in generating such bids in the first place.

There is a significant connection between an active takeover market and the efficient and honest management of large public companies. It has long been argued that in such Stock Exchange listed companies, with very widely distributed shareholding, pressure from institutional investors performs a vital function in disciplining incompetent or corrupt boards of directors. It is the threat or actuality of a takeover bid which brings the main shareholders' voting power to bear.[70]

Until relatively recently, the whole question of corporate governance was largely unregulated by company law or indeed by City self-regulation. The corporate governance issue describes the practices and committee structures by which boards of directors conduct their affairs and seek to monitor senior management so as to make them accountable to the board. Such questions were seen as being an internal matter for each listed public company and not one for the law maker or City regulator. As a matter of basic political policy the Government throughout the 1980s and much of the 1990s regarded the way boards of directors functioned as part of 'the prerogative of management to manage'. It was contended that the market for corporate control would provide the necessary corrective to any corporate abuses that might occur.

In more recent years, the harsh experience of corporate fraud and company failure, extending to well-known public companies, reduced confidence in the market for corporate control to cope on its own with this problem. The system of self-regulation of corporate governance, by what became the 'Combined Code', is examined elsewhere in this book.[71] In the present century the development of 'shareholder activism', mostly by institutional investors, has sought to challenge, sometimes successfully, incompetent senior executives in public listed companies as well as similar executives who have been excessively rewarded despite their obvious lack of success in managing their companies.

The serious shortcomings in financial regulation revealed by the banking collapse of 2008–09 will require a major revision in the way the boards of banking companies operate and will also require a more effective role for the Financial Services Authority.

[70] For a variety of reasons, including board control of the proxy-voting machinery, most general meetings are dominated by the board. This includes the procedure to elect and re-elect directors.

[71] See Chapter 11.

1.9.1 Venture capital and private equity

In recent years the development of 'private equity' companies has provided a new way of acquiring and funding large public companies. There are two kinds of private equity funding. The older version of private equity, known as 'venture capital', involves outside investment in small 'start-up' companies. The other form is more contentious and operates on a much larger scale. The aim is to target large businesses (usually Stock Exchange listed public companies) that may have been badly run, under-valued and in need of more aggressive management. Private equity buys the shares in such companies with money raised from wealthy individuals and financial institutions (such as pension funds), supported by substantial bank loans which are then secured on the target company's assets. 'Private equity' has flourished in Britain partly because the public companies acquired can then claim tax relief on the interest payments on the bank loans raised as part of such 'financial leverage'. The interest payments can be set against profits earned by the company. This sharply reduces the company's liability to corporation tax.

As has been seen, the most 'high-profile' acquisitions involving private equity concern public companies so that they cease to be listed on the Stock Exchange. The aim is to restructure the business by loading the target company with debt secured on its assets. This is linked to changing the managers and cutting costs by reducing the work force and disposing of some of the company's assets. All this should produce returns by way of dividends and management fees over a period of a few years. This in turn should enable a profitable exit to be made either by floating the company again once more on the stock market or by 'selling it on' to another public company or group.

In contrast, the role of 'venture capital' in funding small private companies is necessarily more benign. The option of slashing costs by reducing the number of employees and disposing of assets is non-existent. Instead the emphasis is on the opportunity presented by a new business opportunity in a start-up company.

The private equity method of acquiring and funding public companies has many critics (especially among the trade unions) who point to the job losses as well as the reduction in job security and pension rights for those employees who are not dismissed. There is also a lack of the disclosure requirements imposed both by the Stock Exchange rules and by company law on public listed companies. Even leading figures in the private equity 'industry' have called for more openness in operation of the private equity system. However, there are strong arguments advanced in favour of the system not only by significant figures in the private equity world and in the City of London generally, but also by Government ministers and Treasury civil servants. They point to the industrial growth and employment opportunities created by that growth. The sheer financial

success of private equity controlled companies make it likely that the system will long survive but with more regulations as to transparency. The devastation of many private equity funds as a result of the 'credit crunch' and their role in the banking crises of 2008–09 is bound to lead to a careful consideration of how they should be regulated both nationally and internationally.