Company law - where now?

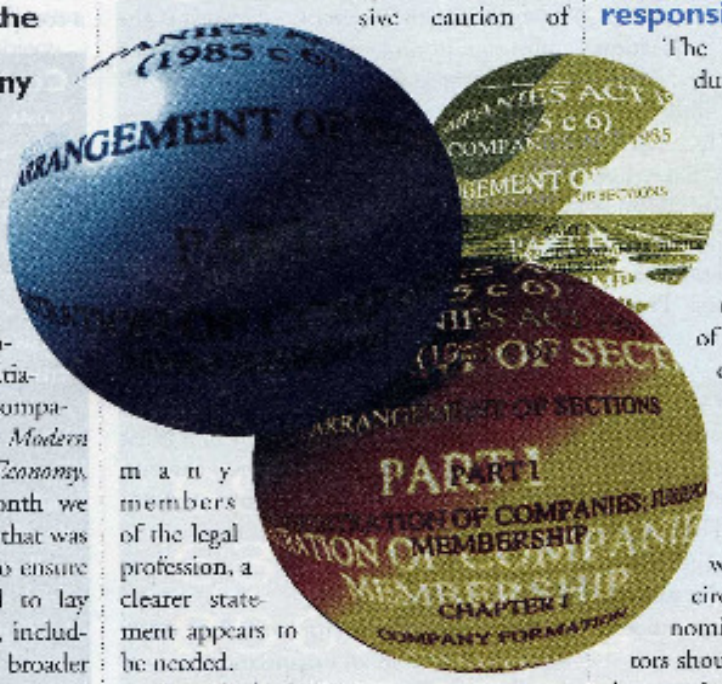
In the last issue, Kevin McGuinness and Stephen Copp examined the DTI's Consultation Paper *Modern Company Law, For A Competitive Economy*. Here they give their view on the directions which company law reform might take.

The Government has commenced a potentially radical initiative to reform company law with its consultation paper *Modern Company Laws For A Competitive Economy*, issued in March 1998. Last month we described the nature of the review that was being commenced and the need to ensure that basic issues were addressed to lay sound foundations for the review, including the need for changes in the broader legal framework, the need for sound empirical evidence, and the need for agreement as to how value conflicts will be dealt with. In this article, we will turn to some of the general subjects that we suggest should form the focus of the law reform effort. As the following points make clear, in our view the time has come for a fundamental re-thinking of many of the rules now embodied in our company law. We share the DTI's expressed belief that the reform process should not be limited to minor tinkering with the established body of rules. In many cases, the direction in which reform should proceed has already been taken by other common law jurisdictions.

The incorporation process and corporate objects

Incorporation necessarily involves the filing of certain documents. However, the documents that must be filed on incorporation could be merged into a single standard document, to simplify paperwork. The need for some of the present documents (e.g. a memorandum of association and the statutory declaration) is an open question, and should be critically reviewed.

In other jurisdictions, it is far easier to set up companies than the UK. Many common law jurisdictions have accorded companies the powers of a natural person and have abolished the requirement for a statement of objects. The enactment of *Section 3A, Companies Act 1985* indicates Parliament's willingness to move along these lines. Unfortunately, due to the excessive caution of many members of the legal profession, a clearer statement appears to be needed.



Outside the UK it is possible to incorporate a company with a sequentially issued number name (generally the same as the company' number). In the UK it is necessary for an incorporator to propose a stated company name. A very large percentage of companies do not really need to have a name because they do not deal with the public and do not carry on any active trade. They are incorporated solely for the purpose of holding and administering assets. The requirement to state a name has resulted in considerable ingenuity in crafting fanciful names, but this effort could be much more profitably directed elsewhere. The numbered company route should be adopted in the UK.

Unanimous shareholder agreements

Under the laws of some jurisdictions, it is possible to modify corporate governance structure and to limit the powers of a company or its directors under a unanimous shareholder agreement, which binds not only the shareholders but also (more importantly) successive shareholders and the corporation. Although more limited shareholders' agreements are common in the UK, current case law is restrictive of this highly flexible mechanism. Since it is useful for a wide range of investor and shareholder purposes, serious consideration should be given to its extension in the UK.

Director and officer responsibilities and liabilities

The common law respecting the duties of directors and officers is confused and archaic. It is impossible to give a clear statement as to the precise duties to which such persons are subject. Company Law should contain a declaration that every director and officer of a corporation in exercising his or her duties must act honestly and in good faith with a view towards the best interest of the corporation and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. The duties of a nominee director and multiple directors should be clarified and some procedure put in place for reconciling the potential conflicts of interest that may arise in the case of such persons.

The imposition of liability upon corporate directors for company wrongs sounds good in principle, but it may well tend to discourage good people from accepting directorships. The question of director liability needs to be examined. At present, personal liability is imposed upon directors without any clear explanation as to why. The law may be discouraging good people from being directors. There are now numerous statutory provisions scattered around the laws of the UK imposing liability upon directors. We need to establish a fundamental rule to govern the question of whether directors should be made personally liable for misconduct by their companies. That rule could be set down in the companies legislation, and could apply by extension to specific fields of law (e.g. environmental, worker safety, product liability, etc.), by way of incorporation.

Greater flexibility in board and governance structure

A great deal of ink has been spilled discussing the merit of proposals to create two tier boards, to provide employee representation on boards, to increase minority shareholder input and the like. In our view, the basic mistake in both proposed reforms and the existing rules is that they allow too little flexibility to a corporation. Rules governing the election of a board should be relaxed so as to permit the greatest contractual freedom to the shareholders, creditors, investors and workers who are interested in its future. For instance, one idea which might be considered is cumulative voting. Simply stated, cumulative voting provisions allow a person who holds a given percentage of voting shares to elect that percentage of directors. This proposal might well be considered as a method of increasing the participation of institutional investors in the corporate governance process. Cumulative voting coupled with an employee share scheme could allow employees to elect directors.

Capital and financing

A number of key aspects of the capitalisation and financing of companies need to be addressed.

Many common law jurisdictions have abolished par value shares and the authorised capital concept with no apparent detrimental effect upon the efficacy of company law. The present rules are unduly complex and present an obstacle to bona fide transactions which would frequently be in the best interests of a corporation. As we discussed in an earlier article, the par value requirement may complicate eventual conversion of share capital from sterling into the euro. Law reform proposals dating back to the Jenkins Committee (1962) and earlier have recommended the abolition of par value. It is time to give effect to this idea.

All of the corporate capital parts of *Companies Act 1985* are drafted on the assumption that there is a sharp and clear distinction between equity and debt. In fact there is not. There are innumerable forms of mezzanine financing which confuse the picture. Shareholder loans to corporations are as common as equity investments. There is a great deal of regulation of equity, but little of debt, even in cases where debt instruments present similar concerns to equity investments.

The present rules governing capital maintenance are complex and arbitrary.

There need to be precise prohibitions based upon some clearly defined criteria. Different regimes currently exist governing financial assistance, the market and off-market purchase of own shares and the reduction of share capital. These rules could and should be harmonised and simplified.

Simplification of company administration

The present legislation is excessively preoccupied with certain types of disclosure. The need for many labour intensive corporate filings should be reconsidered. It is not clear, for instance, why companies should be required to file the names and addresses of their shareholders, nor why it should be necessary to maintain an internal registry of debt securities when a public registry is also maintained. More generally, there is no clear need to maintain company statutory books, when they merely replicate information that is publicly available. The law should seek to reduce or eliminate the need for duplicate filings where possible.

There are also too many nitpicking distinctions under the legislation. For example, *Section 288, Companies Act 1985* requires notification within 14 days of a change in directors; *Section 380* requires a copy of a resolution to be filed within 15 days. There is no reason not to adopt consistent time limits.

Utilisation of modern technology

Many documents that a company might provide to its shareholders or other persons interested in it could be made available at lower cost and more readily through the use of modern technology such as the Internet. Consideration should be given to the suitability of electronic filing and disclosure.

Regulatory framework

In the interests of overall simplicity, some effort might be made towards the consolidation of company law. For instance, there is no apparent need for independent legislation dealing with insider trading and director disqualification. The relationship between the *1985* and *1989 Companies Acts* is already complicated, and would not benefit from a further statute which made piecemeal amendment to the law.

On a more fundamental level, there is far too great a reliance on criminal law in UK company law, as a casual glance at *Schedule 24, Companies Act 1985* will confirm. In our view, criminal penalties should be reserved for cases involving fraud of various kinds, or other forms of moral turpitude. Minor slip-ups should not be punished by way of criminal sanction. People who establish and operate companies are not normally engaged in a massive criminal conspiracy. They should not be treated as if they were. In many cases, a civil remedy is more appropriate than a criminal penalty.

Insider trading, for instance, is a criminal offence, yet there is no clear avenue for the injured party to obtain compensation for injuries suffered as a result of insider trading.

The legislative balance

Company law, and other branches of commercial law, are among the most important subjects with which Parliament must deal. The rules set down in these laws govern the terms on which people are employed, whether there will be jobs for all who wish to work, and the prices and conditions on which goods and services are supplied. But you would never realise the importance of these subjects by looking at the amount of Parliamentary time that is allotted to these subjects. In recent years, extremely important commercial matters have been enacted by way of secondary legislation, such as *Transfer of Undertakings Regulations, 1981*, *General Product Safety Regulations, 1994*, *Unfair Terms in Consumer Contracts Regulations, 1994*, with little legislative time being devoted to their consideration. In the meantime, a great deal of Parliament's attention is focused on public law matters of topical concern but of limited application or relevance to the overall competitiveness of the British economy.

The publication of the *Modern Company Law* consultation paper is welcome first step in restoring the balance. It needs to be followed up by a serious commitment on the part of the government to give legislation with an economic focus the attention that its importance merits.

● As readers might expect the ICSA is already in discussion with the DTI on the Modern Company Law Review. As soon as it is clear how the review process will be structured, and how the Institute might best contribute, the Policy Unit will be canvassing all the membership for their ideas and suggestions. ■

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