MODERN COMPANY LAW

[A RESPONSE TO THE DTI CONSULTATION PAPER]

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The Government's decision to embark on a fundamental review of company law is welcomed and commands widespread support. It comes at a time when fundamental questions are being debated as to the purpose of the company and how the company should be regulated, not least because of public concern at major corporate scandals and with excessive directors' remuneration. The Consultation Paper is of a high standard. It is balanced and addresses key areas of concern. It has established a process which demonstrates a high level of commitment to the reform process which should lead to a successful outcome.

This response to the Consultation Paper is divided into two parts. Firstly, some general and overriding observations are made as to the need for reform, the process for reform and the limitations of reform. Secondly, comments will be made as to particular aspects of the Consultation Paper by reference to the original chapter headings.

GENERAL OBSERVATIONS

The need for reform

The Consultation Paper has proceeded on the basis that the current framework of core company law has become seriously outdated for three main reasons: the time elapsed since the last broad review; economic globalisation; and the current pace of change in areas such as information technology[1]. This is a major assumption and the basis for it should be rigorously tested.

The pressure for reform of company law has largely come from two sources: the academic community and professional bodies. Academic writers who have called for reform include L.S. Sealy whose argument was that English company law had become more out of touch with business and its needs and had lost touch with the commercial values and priorities which it ought to recognise and serve[2]. P.L. Davies pessimistically concludes a review of current trends and future possibilities for company law by remarking that reform is likely to be piecemeal without any review of the basic structure and with a marked reluctance to tackle fundamental problems

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1 *Modern Company Law* DTI Consultation Paper (March 1998), para. 1.1.

2 *Company Law and Commercial Reality* (London: Sweet & Maxwell, 1984) p. 75. See further L.S. Sealy *Small Company Legislation* Law Society Gazette 8th December 1993, p. 16.

except to the extent forced by the EC[3]. The Company Law Committee of the Law Society has reported that company law is less than satisfactory because it often fails to meet its stated aims ("the immediate problem") and because of a systemic failure to take a long term view of company law in order to set the right aims in the first place ("the underlying problem")[4]. Trenchantly, they state that "no government can escape responsibility for the quality of its legislation."[5] Mary Arden[6] has drawn a cautionary note arguing that simplification will be difficult to achieve because of the premium on certainty. Other bodies which have called for reform include the Institute of Directors which has argued that company law does not stand up too well against the standard that it should ensure that business is done with integrity but should also ensure that enterprise should flourish[7].

It would take a brave person indeed, therefore, to question the weight of opinion in favour of reform. However, it should be questioned. The reason for this is that what empirical evidence there is suggests that other areas of law which affect businesses are in far greater need of reform[8]. Further, empirical evidence suggests that UK companies are in fact in rather better health than might be thought[9], in turn, suggesting that the framework of UK company law, whilst inevitably not perfect, is not necessarily as poor as might be thought. It is submitted that the problems which fall to be considered in relation to the reform of UK company law are instead more sophisticated and multifaceted than might at first be thought. In particular, the following issues should be considered by the Government:

(1) To what extent do the calls for company law reform reflect factors which are endemic to the UK legal system and therefore incapable of, or difficult, to cure by a review of company law in isolation?

For example, the complexity of UK company law is typical of growing complexity in law more generally. This in part derives from the basic approach to statutory drafting which, although much criticised, is a natural consequence of a precedent based system with traditionally inflexible modes of statutory interpretation.

(2) To what extent do the calls for company law reform reflect factors which are in substance the result of changing and fragmenting social values and therefore present difficulties in resolution because of the need to reconcile divergent viewpoints?

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3 *Gower's Principles of Modern Company Law* (London: Sweet & Maxwell, 1997) p. 71.

4 *The Reform of Company Law* Law Society Company Law Committee Memorandum No. 255, July 1991, p. 1.

5 Ibid., p. 1.

6 Justice of the High Court of Justice and Chairman of the Law Commission for England and Wales, see *Company Law Reform* [1997] CfiLR159 at 161.

7 P. Morgan *A Cold Climate For Business* Law Society Gazette 8th December 1993, p. 3.

8 K. McGuinness and S.F. Copp *The Reform of Company Law: A Search For Guiding Principles* Chartered Secretary May 1998, p. 30 at 31.

9 Ibid., p. 31.

For example, the "stakeholder" debate raises fundamental questions as to the purpose of the company in society raising policy questions which go beyond the traditional frontiers of technical law reform.

(3) To what extent do the calls for company law reform reflect the incorporation of EC requirements where it may be difficult to secure change?

For example, some of the most criticised aspects of company law, such as bulky disclosure requirements have their origins in EC requirements which cannot be simply changed by amended companies' legislation without more.

(4) To what extent do the calls for company law reform reflect the differing needs of different users of company law and how should this be reflected in the reform process?

For example, one of the most criticised areas of company law is the doctrine of capital maintenance, in particular, the restrictions on a company providing financial assistance for the acquisition of its own shares[10]. There can be little doubt that this doctrine is more likely to be of direct concern to practitioners and academics because of the likelihood that it would be relatively infrequent that many companies engage in the types of transactions where the doctrine would be potentially relevant and in such transactions professional advisors may well be involved in any event.

Unless these questions are fully taken on board at the outset high expectations may lead to a heightened sense of disappointment at what might finally be accomplished.

The process for reform

Given the questions that arise from a consideration of the need for company law reform it is essential that the initial Working Group whose task is to bring forward proposals for the overall strategic framework[11] will be in a position to establish an appropriate methodology to govern both its deliberations as well as subsequent Working Groups. The Paper sets out clear objectives for company law and other regulation[12] as well as identifying a number of subsidiary objectives, such as flexibility[13] and stability[14]. However, underpinning these objectives, which are generally uncontroversial, there is little hint of how the company is perceived as a theoretical construct and how the success or failure of particular reforms to law and regulation can be assessed. It is important that insights which have been gained through non-legal disciplines such as economics, sociology and management science into how the company operates are made integral to the review process and that where possible reform proposals are supported by empirical evidence rather than anecdotal material.

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10 *ss. 151 to 158 Companies Act 1985.*

11 *Modern Company Law* DTI Consultation Paper (March 1998), para. 7.4.

12 Ibid., para. 5.1.

13 Ibid., para. 3.8.

14 Ibid., para. 1.4.

The limitations of reform

There are limitations on what can be achieved through law reform and it is important that these be recognised at the outset. In particular, it will readily appreciated that although it is a relatively straightforward task to set high objectives for company law, that in reality there will need to be trade-offs between particular objectives. Examples of these are as follows:

Quality of regulation vs. cost

Clarity and brevity vs. certainty

Consistency and predictability vs. flexibility

Equally, it is significant that many no longer regard the achievement of high standards of corporate regulation as being in conflict with international competitiveness. The primacy of the interests of shareholder capital appears likely to result in "safe," i.e. well regulated jurisdictions, attracting capital and "unsafe" jurisdictions being avoided.

SPECIFIC OBSERVATIONS

CHAPTER 1 INTRODUCTION

The two factors identified as being responsible for the current framework of company law becoming seriously outdated are economic globalisation and the pace of change in areas such as information technology. However, it is submitted that although the general importance of these factors to the environment in which companies operate is highly significant they do not have the impact suggested. The framework of company law and the way in which it is implemented must be distinguished. Information technology may have an enormous impact, for example, on the implementation of the company law doctrine of disclosure; it does not render the doctrine out of date. Likewise, globalisation may, for example, render the UK predilection for appointing directors from the "great and good" obsolete compared with the more meritocratic approach of some other jurisdictions; it does not render redundant the role of a director under company law. Notwithstanding this it is important that these changes are reflected in the review of company law.

The intention that the review should at one and the same time be both wideranging yet place a premium on stability is important and to be welcomed. The provisions of company law form an integral part of the business culture of the UK, their broad effect often appreciated by company officers even if their legal pedigree is not. It takes time for changes in legal regulation to filter down into business culture. The process of assimilation is more likely to be successful if stability in their development is maintained. This may additionally be important where changes in legal regulation bring about change in the applicability of sanctions. The Government is right to be concerned in addition to the costs of change.

CHAPTER 2 BACKGROUND

The analysis of the reasons why company law has developed as it has is helpful, both in terms of providing a contextual setting for the review but also because it emphasises rightly the importance of an understanding of historical perspective to the reform process. The conclusion that the framework is becoming obsolescent so that piecemeal reform cannot significantly reduce the amount and complexity of law is one that might be questioned.

It becomes apparent from a review of the historical origins of company law that the quality of company law started to deteriorate in the 1970's but has gone downhill rapidly since the mid-1980's.Notwithstanding this the 1985 consolidation was felt by many at the time to mark a significant improvement with much effort expended to improve the structure and language of the companies' legislation and to remove obsolescent provisions. It is surprising that within such a short period of time these aspects are again the subject of criticism. What would appear to be at fault is the fragmentation of the presentation of company law by the enactment of the Insolvency Act 1986 and the Financial Services Act 1986 combined with the need for the amendments contained in the Companies Act 1989, compounded by the growth in the use of delegated legislation. These have left the original consolidated legislation in the emaciated shape that now attracts such criticism. The immediate conclusion to be drawn from this analysis is that instead of looking to criticise the basic legal framework bequeathed to us by the Victorians it is necessary to look to causes far closer to home - the legacy of the 1980's.

CHAPTER 3 CURRENT ISSUES

The following specific issues were identified:

Complexity

The Consultation Paper takes the view that arrangements cannot be fully effective if companies and their directors cannot clearly identify and understand their legal responsibilities, a problem seen as particularly acute for small companies without ready access to legal advice[15]. This raises an important policy question which must be considered as a prerequisite of considering how the problem of the complexity of the law should be addressed, namely, to whom is company law addressed.

Two extreme possibilities may be conjectured. On the one hand, company law may be seen as so inherently complex that it can only be understood by those with a relevant professional qualification. This is an unsatisfactory position for a variety of reasons. It is unreasonable to expect those in business to comply with rules they cannot in any sense "own." It is impracticable for the professionally qualified to advise on every single aspect of corporate life which would be the inevitable result if those in business were deemed unable to have the understanding necessary to even act as a filter of appropriate questions for professional advice. On the other hand, company law, particularly in its current form where the same code essentially applies to all sizes of

15 Ibid., para. 3.2.

company, is so inherently complex that it is unlikely ever to be reduced to a level where it can be appreciated by anyone who happens to be a director.

The answer must surely lie in attempting to find a middle ground. It is submitted that this will lie in the creation of a central corpus of legal rules applicable to private companies combined with a legal requirement for all directors to demonstrate some minimal level of competency - a "driving test" for company directors, so to speak. In the case of existing companies directors could either be required to pass such a test or comply with a requirement to appoint a suitably qualified company secretary.

The Consultation Paper also suggests the use of secondary legislation to enable easier updating[16]. There are attractions to this approach in terms of flexibility. It would enable the law to be updated more easily to deal with changing circumstances and would enable matters to be legislated that are perhaps currently thought better to be dealt with by best practice because of the inherent flexibility of that approach. However, in terms of the overall edifice of company law it is submitted that this would be mistaken. If the Government wishes company law to be more accessible to the non-professional user it would be highly desirable for the legislation to be exclusively incorporated into a principal statute which the user can have a reasonable degree of confidence is reliable without a constant need to ascertain whether amendments have been made by delegated legislation or to cross-refer to these. Indeed, it would be preferable for similar reasons if the practice was adopted of attempting to avoid the amendment of company law apart from pre-ordained intervals of, say, 10 years. It would focus the minds of legislators if their product was to have some degree of permanence.

The problems of complexity were defined as follows:

Over-formal language

It is difficult to generalise as the level of formality of language used in the companies' legislation as this varies depending on the context. However, the example given of Table A is not one which is perceived to give rise to difficulties of interpretation. Perhaps more problematic in day to day usage is the practice of incorporating Table A by reference and making substantial modifications and exclusions so that the company's constitution can only be understood by cross-referencing two documents. Whilst "plain English" is self-evidently a good objective this should not be at the expense of clarity.

Excessive detail

It is difficult, again, to generalise as to the level of detail in the companies' legislation as this varies depending on the context. The example given of the distinction between special and extraordinary resolutions at general meetings is a good example. There are essentially two aspects to the problem of excessive detail. On the one hand certainty is invaluable in commercial transactions. It would be difficult to complete many commercial transactions if tests such as "reasonableness" had to be considered at each

16 Ibid., para. 3.8.

juncture or highly prescriptive rules of case law. On the other hand if the sanctions for non-compliance with each and every technical rule of company is set too high they become onerous. Perhaps a middle course would be to attempt to create a distinction between what might be termed "mandatory" and "directory" rules[17].

Over-regulation

It is agreed that the overall approach of companies' legislation is over-regulatory and the illustrations derived from the capital maintenance rule are well chosen. There is no obvious need for the principle of capital maintenance to dominate the companies' legislation in the way that it does. Insofar as the principle is deemed to protect creditors of a company (a rather doubtful assumption in itself) a more direct form of protection could be more simply provided by an amendment to the insolvency legislation to provide creditors with a specific remedy where a company has returned capital to a member within a specified period of insolvency commencing.

Complex structure

It is agreed that the structure of the companies' legislation could be improved and again the illustration of the rules applicable to different classes of company is well chosen. It would clearly be beneficial to separate the rules applicable to public companies only, perhaps consolidating these with the financial services legislation where a range of other important provisions applicable only to public companies are incorporated[18]. Indeed, there might alternatively be some merit in considering whether the rules applicable to public limited companies could be effectively merged with those of the Stock Exchange.

Costs

The estimate of the costs attributable to compliance with the capital maintenance rules is noted but more evidence is needed as to the basis for this estimate, given that it would seem rare for a fee to relate specifically to this rather than to be part of the fees for acting in respect of a larger transaction.

Obsolescent or ineffective provisions

It is not believed that the problem of obsolescent or ineffective provisions is as great as is sometimes believed. The requirement cited as an example of recording the date on which a person ceased to be a member can be useful particularly where there is, for example, a group reorganisation. The example of the general commercial company clause is, of course, a recent development and an object lesson for would-be reformers of company law!

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17 Perhaps by analogy to administrative law. The significance being that some lesser but specified consequence would apply to a breach of a "directory" rule. This could simply involve conferring upon an aggrieved party a right to object to the court if, say, "substantial prejudice" could be demonstrated within a very short time frame, such as 30 days.

18 Such a consolidation could extend to the *Public Offers of Securities Regulations 1995*, S.I. 1995, No. 1537, given their importance.

Obstacles to progress

It is agreed that company law should be reviewed specifically to ascertain how developments in information technology can be reflected. In particular, the following possibilities should be considered:

Corporate disclosure

Consideration should be given to enabling disclosure of information by companies to shareholders via the internet to avoid the necessity for hard copies of documents such as accounts.

Corporate decisionmaking

Consideration should be given to enabling decisionmaking at board and shareholder levels to be conducted via the internet to avoid the need for physical attendance at meetings.

Relationship with corporate governance

The Consultation Paper expresses the view that the issues to be covered in the new Combined Code of the Stock Exchange are more suitable for best practice than legislation on the ground of flexibility, provided that best practice is seen to be working, with the exception of a limited range of areas. Those areas are identified as directors' duties, the conduct of AGM's, and shareholder control over directors' pay.

Generally, it must be seen as questionable whether best practice is the most appropriate method for regulating corporate governance[19]. Firstly, it must be remembered that the impetus for the development of best practice was the incidence of scandals which risked market confidence. It has been commented by many that Robert Maxwell might have complied with much of what is now seen as best practice[20]. Secondly, the regulation of corporate governance is the proper role of Government and greater effort should be made to ascertain which principles are and which are not suitable for legal regulation. The appropriate sanctions for breaches of that legal regulation can then be devised, potentially to include criminal law sanctions which are inherently outside the scope of a self-regulatory system. Thirdly, the proliferation of "soft law" should be avoided. It has already been argued in this response that part of the problem with UK company law is its increased fragmentation. The encouragement of codes of practice will continue this trend. Nonetheless, subject to these general reservations, it is agreed that the Government has selected a suitable range of issues to be considered for legal regulation.

CHAPTER 4 THE INTERNATIONAL PICTURE

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19 See, for example, the devastating critique of the Cadbury Code by C. Boyd *Ethics and Corporate Governance: The Issues Raised By The Cadbury Report In The United Kingdom* (1996) 15 JBE p. 167.

20 See, for example, A. Sawers *The Czech-list mentality* Financial Director, May 1998, p. 28.

It is to be welcomed that the review process will take into account the experiences of other countries company law systems. Indeed, the use of international comparisons has already become a welcome feature of company law reform proposals.

CHAPTER 5 OBJECTIVES; TERMS OF REFERENCE

The substantive issues arising from the objectives and terms of reference stated here have already been commented on in this response and no further specific comments are required.

CHAPTER 6 SCOPE OF THE REVIEW

It is appreciated that a full review of the insolvency and financial services legislation would be inappropriate for this review because both are relatively newly enacted and the issues therefore fully considered. However, it is well noted in the Consultation Paper that the boundaries are not precise and that the implications for these areas of changes must be fully taken into account. Nonetheless, it is submitted that the review should be extended to reconsider where the boundaries are drawn. The purpose of this would be so that on a day to day basis those who are considering the legal position of a company need not consider insolvency[21] or financial services legislation[22].

The identification of the need to review questions of sanctions and enforcement is welcomed[23]. A cursory glance at *Schedule 24 Companies Act 1985* indicates a total of 21 pages merely *listing* details of punishments for criminal offences committed under the Act. Whilst some of these deal with matters which are clearly morally reprehensible or heinous in some way[24], others are less obviously so[25]. Considerable initiatives were taken in relation to the de-criminalisation of taxation law in the 1980's following the Report of the Keith Committee[26], in particular, by the introduction of civil penalties. Whereas it would be undesirable from a business perspective for provisions of the rigour of those introduced for taxation purposes to be introduced there would be some merit in a similar approach being adopted.

CHAPTER 7 PROCESS FOR THE REVIEW

The process for the review is welcomed, particularly the intended inclusion of wider interests such as those of small business and shareholders who are, arguably, central

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21 It is noted in this context that it is stated that the review will develop a legal framework to include the "death" of companies.

22 This would also enable the considerable importance of provisions such as those contained in *Chapter X of the Insolvency Act 1986* (malpractice before and during liquidation; penalisation of companies and company officers; investigations and prosecutions) to the conduct of a company's affairs to be emphasised.

23 Ibid., para.'s 6.3 - 6.4.

24 Such as *s. 389A (2) Companies Act 1985* (officer of company making false, misleading or deceptive statement to auditors) which, given the volume of other matters criminalised under the Act, was surprisingly only enacted by *s. 120(3) Companies Act 1989* with effect from 1st April 1990!

25 Perhaps *s. 294(3) Companies Act 1985* (director failing to give notice of his attaining retirement age; acting as director under appointment invalid due to his attaining it).

26 *Committee on Enforcement Powers of the Revenue Departments* (March 1983) Cmnd. 8822.

to much of the substance of what is being considered. There might also be some merit in including those who have been the victims of corporate scandals or their advisers.

The illustration given of the possible structure of the subsequent Working Groups is welcomed. It is far more appropriate for issues to be considered under broad conceptual headings such as those adopted rather than by the utilisation of conventional company law headings.

CHAPTER 8 TIMETABLE

The timetable is clearly well thought out. However, given the magnitude of the task it might be doubted whether a firm commitment to a White Paper being published in 2001 is feasible. Since the resulting legislation will, in any event, fall to be considered in the next Parliament there might be good reason for this to be put back for a short period of time. This would enable greater time to be allowed for consultation on the report of the first Working Group on the strategic framework to take place before subsequent Working Groups start work.

CHAPTER 9 SUMMARY AND CONCLUSIONS

No comment is necessary.

Stephen Copp
8th July 1998