MODERN COMPANY LAW FOR A COMPETITIVE FRAMEWORK THE STRATEGIC FRAMEWORK CONSULTATION DOCUMENT

A RESPONSE

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GENERAL COMMENTS

The overall approach

The title of the document is "the strategic framework." It might have been hoped from this title that the document would therefore establish a clear conceptual framework for the company. Such a conceptual framework would address the goals which company law is intended to achieve. It is submitted that the objectives stated in Chapter 2 A of the consultation document and the guiding principles stated in Chapter 2 B of the consultation document are insufficiently specific to serve this purpose. The following guiding principles might somewhat hesitatingly be put forward as an alternative starting point[1].

Proposed guiding principles

Broad policy base

Sound legal foundations

Flexibility in establishment and administration

Ease of raising money

Competence and integrity in decisionmaking

Good faith and good relationships

Broad policy base

[1] These guiding principles and the commentary upon them are based on an article originally published by the author in Chartered Secretary (January 1999) p. 28 entitled *Company Law Reform: The Legal Framework* and a paper presented at the IIR Ltd Conference on *Corporate Governance in Practice, The Changing Relationship Between the Institutional Investor & Corporates* under the title *A Vision for Corporate Governance* (London, April 1999).

- The consultation document itself recognises a considerable variety of policy considerations, for example, Chapter 2 recognises the need for a modern law, a law for a competitive economy, the trade-off between freedom and abuse amongst others. The policy considerations upon which company law is based should always take into account the full range of wider values which the law recognises[2]. Company law should not be focussed too heavily upon one issue such as economic efficiency but on a range of goals such as the need to ensure quality of life.

- The impression left by the consultative document is that a primary policy goal is a fear that businesses will choose to incorporate overseas if company law is seen as unduly prescriptive, inflexible, inaccessible or onerous.[3] yet there is little evidence that company law currently has this effect. By way of example, the Financial Times annually surveys the world's largest corporations. It can readily be seen that the share of the United Kindom of the world's top company's is disproportionate. The 1999 survey revealed that 53 of the top 500 companies by market capitalisation are based in the United Kingdom. Only the United States, with 244, has more of these companies based within its borders. By comparison, Germany and France together are the base for only 50 of the world's top companies, whilst Japan has only 46. Accordingly, it would be wrong to assume that radical changes to the substance, as opposed to the form, of company law are required to reflect the policy goal identified.

Sound legal foundations

- Much emphasis has been placed in the consultation document on the need to update company law in line with broad social trends, for example, globalisation. However, it is helpful to recognise the foundational role provided by other areas of law in the development of company law which themselves have been subject to much change since the inception of company law. The most important is the law of contract but property law, trust law and criminal law all play a part as well. These areas of law, like company law, have not remained static. For example, within contract law there are substantial debates taking place on the role of a doctrine of "good faith"[4] 1 which has a direct bearing on our understanding of companies . A further example is in relation to property law where there is growing interest in the use of "stewardship" property rights. The company law review should attempt to take on board these trends in addition to those identified.

- Beauty may be in the eye of the beholder but there are few who would describe UK company law as an attractive sight. Equally, many criticisms of company law could fairly be directed at other areas of law, not least taxation law (the simplification of which is currently drawing much attention) and

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2 Dias, has classified these as follows: sanctity of the person; sanctity of property; national and social safety; social welfare; equality; consistency and fidelity to rules, principles, doctrines, and tradition; morality; administrative convenience and international comity, see *Jurisprudence*, Butterworths 1985. This is not an exhaustive list but is a useful starting point.

3 See, for example, para. 2.12.

4 See, for example, *Good Faith in Contract* ed.'s Brownsword, R., Hird, N.J. & Howells, G. (Dartmouth: Ashgate, 1999).

reflect deficiencies in the English legal system which it is unlikely that a review of company law in isolation can correct. Good legislation in this context has to strike a balance between stability and flexibility; comprehensiveness and accessibility; standardisation and specifity. The problem is that these desirable objectives cannot all be achieved simultaneously. There is a real danger that an attempt to focus on a limited objective alone, such as accessibility, on which the consultation document places considerable emphasis, could result in unexpected and undesirable consequences. For example, if accessibility results in deregulation this could open the doors quite unintentionally to further corporate scandals such as dogged the turn of this decade and have adverse effects on investment in the London Stock Exchange.

- The company law reform process must commence with a firm understanding of the corporate form and its implications. Firstly, incorporation remains a legal privilege in the United Kingdom and therefore the government is entitled to regulate companies and indeed should regulate companies in accordance with the broad public interest. Yet in doing so the extent and effect of other regulation on companies should also be borne in mind, in particular, the role played by environment law, product liability law, employment law and other specialist areas of law which are often neglected in considerations as to how to protect the various constituencies involved with the company. Not least, it should be remembered that the purpose of placing "limited" after the name of a company was not merely decorative. It was to serve as a warning, a "red flag", to those who deal with companies. It still should perform that role.

Flexibility in establishment and administration

- Setting up or owning an interest in a company (even as a small minority shareholder in a listed company or as the beneficiary of a pension scheme) is ultimately a matter of personal choice. The law should therefore provide the greatest variety of legal structures to enable this to be done in accordance with different people's values. Whilst this does not generally present a problem in terms of the small or medium sized company it does with the listed company. Beneficiaries of pension schemes in particular have little choice as to the basic model of company in which their funds are invested or how the pension scheme holds the company accountable. Consideration should be given to how more flexible structures for such investment can be created.

- Given the evidence of the economic benefits created by the company form generally it would seem eminently desirable that full corporate personality be conferred on all companies and the final remnants of the ultra vires rule removed from the statute book. Further, there should be an explicit provision as to when the benefit of incorporation with limited liability can be lost, set within an appropriate conceptual framework, so it can readily be identified as to when liability will be transferred to some other party. For this purpose, it is unimportant whether liability is being imposed on directors or shareholders or other business vehicles because such rigid boundaries simply do not reflect the reality of commercial life, particularly in private companies.

- Administration should never be a goal in itself. Any organisation which focuses on internal matters to the exclusion of external matters will inevitably decline and fail. Administration should always be the servant to some greater goal. The directors of a company should be entrepreneurs first and foremost and one of the objectives of good administration should be to provide a system which frees directors for that role. The UK already has such a system - the mandatory company secretary - with a professional body able to provide effective training for that role. No substantive criticism is believed to have been directed at that role and there is a strong argument for further bolstering it. Furthermore good administration should be facilitated by the law not discouraged by it. Accordingly, there is a crying need for a more permissive system of company administration so that companies should be able to experiment with improved methods of communication, the use of information technology and so on in the interests of all company participants without facing a minefield of legal hurdles.

Ease of raising money

- The ability of a company to raise capital whether by giving security over its assets or by the issue of shares is one of the key factors in the success of limited liability[5]. For example, in the five years from 1st January 1844 to 31st December 1848 the total capital raised for railroads rose from £65 to 200 million (prior even to the conferral of limited liability). By 1846 there were stock exchanges in Manchester, Liverpool, Bristol and Dublin; by 1845 there were 200 - 300 brokers in Leeds alone; by 1854 a government report identified how shares were being increasingly used for trust fund investment. Gladstone commented on the explosive rise of the company that " ... with regard to joint stock companies and speculation we are a nation of children who will not allow our nursery maids to govern us ..."

- The raising of equity capital has now become one of the most highly regulated areas of corporate life no doubt because of the scope for abuse by the unscrupulous. Yet despite this it has been concluded that " ... it is sad to watch a stock market that prided itself on managing to exclude nearly all completely fraudulent operations being forced to lower its standards and run the risk of damaging scandals that it has not faced for 50 to 100 years ..."[6] Given the substantial bulk of legislation and other regulation in this area there would appear to be a need for a return to first principles in relation to this key feature of the company, notwithstanding the general exclusion of financial services legislation from the review.

Competence and integrity in decisionmaking

- Sealy made the excellent observation[7] that "If our forefathers among the legislators in 1855 had shown the same preoccupation with possible abuses and the same anxiety to avoid potential risks as the framers of our Companies

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5 See generally *The Development of the Business Corporation in England 1800 - 1867* by Carleton-Hunt (Harvard, 1936).

6 *Public Offers in the UK: the new regime*: (1996) 17 Company Lawyer, 262.

7 *Company Law and Commercial Reality*

Acts do today, we would never have *had* limited liability." We must recognise the enormous benefits companies have brought to society and be determined to safeguard them. This requires a culture change in the way companies' legislation is drafted. The focus for legislation to ensure competence and integrity is at present disproportionately orientated towards directors of smaller companies, where many of the relevant provisions are operative primarily on insolvency, a risk which is far greater for small companies than a listed company. Yet it is submitted that there should be a greater focus upon the directors of listed companies. The reason for this is that the directors of such companies are to the greatest extent dealing with "other people's money" to quote Adam Smith and the present accountability gap arising from extensive institutional ownership demonstrably gives rise to problems, for example, in relation to directors' remuneration levels.

o There should be a fundamental reconsideration of the doctrine of disclosure upon which much reliance has been placed in company law. The doctrine of disclosure operates on the basis that " ... sunlight is the best of disinfectants, electric light the best policeman ..."[8]. To put it another way, it is an assumption that " ... behaviour can be influenced merely by requiring it to be disclosed, without the need of negative prohibition or positive regulation"[9]. This principle has attracted widespread support and should, no doubt, be retained in any law reform process. However, it should be recognised that it is not a "cure all." In particular, there is evidence that some forms of corporate behaviour are not influenced by the approach of "naming and shaming" - the classic example must be that of directors' remuneration. The role of disclosure is so fundamental to company law that it merits a high priority in the reform process.

o There should be a fundamental reconsideration of the role of institutional investors, especially with the growth in "tracker funds." Goyder[10] has criticised the extensive chain of accountability with pension schemes as follows:

- pension scheme member (saver);
- (independent financial advisor);
- pension scheme trustee;
- consulting actuary;
- fund manager (investor);
- fund manager's researcher/ investment analyst;
- market-maker/ stockbroker;
- investee company.

Such a chain of accountability can do little to produce the good relationships which the consultation document recognises are so important for the success of the company.

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8 Mr Justice Brandeis, cited in *Company Law and Commercial Reality* , Sweet & Maxwell, 1984: L.S. Sealy

9 *Farrar's Company Law*, Butterworths,1998, J.H.Farrar & B.M. Hannigan

10 *Living Tomorrow's Company* (1998).

Good faith and good relationships

- The need for effective decisionmaking in a company requires an appropriate balance of power between the various parties concerned with the company to be maintained. The consultation document recognises the polarisation of the "stakeholder" debate. It will be submitted later below that a new approach - a "third way" is needed between these positions.

- Probably the most unsung success of companies is the way in which they encourage co-operative relationships between large numbers of people and organisations of all kinds. The consultation document deserves much praise for the emphasis that has been placed on this concept in Chapter 5.1. A relatively brief consideration of companies' legislation indicates quite how much is geared towards questions of the maintenance of relationships and the need to provide for their breakdown. Yet there is little in the way of any guiding principle as to how to how relationships should be facilitated. It is submitted that consideration should be given to the formulation of an overriding duty of good faith between the participants in a company to reflect the need to facilitate good relationships in a company context. Depending on the scope of such an obligation and the consequences of breaching it, it might be possible to reduce some of the substantive bulk of company law. One possibility might be to draw upon the interesting work of the Relationships Foundation, Cambridge, as to approaches to facilitate good relationships[11].

Methodology

The methodology for the consultation document is unclear. The dominant approach is that of "black-letter" doctrinal legal analysis. However, in many places literature or concepts are drawn upon from other conceptual frameworks and it is unclear as to how these processes have been conducted or how they are to be evaluated. One striking example of this is Chapter 5.1. This expressly states that the Review is concerned with law reform, with emphasis placed upon the word law, and then goes further to state that it is not concerned with wider ethical or managerial issues about the behaviour and standards of participants in companies except to the extent that it is appropriate to reflect them in company law. It is additionally surprising, following the extensive use of "law and economics" methodology by the Law Commission, that consideration of the role that this might play is given little attention.

A further criticism of the consultation document is that it represents a curious mixture between debate of a high level of abstraction and technical detail. For example, Chapter 2 is an example of the former whereas much of Chapter 5 falls into the latter. This gives rise to a confusion of purpose in the consultative document. It would have been preferrable if the document had been limited to an examination of controversial issues in more depth with a view to setting out principles to provide a way forward. The success with which such issues have been dealt with is patchy. In my view, much of the material on company formation, capital maintenance and international issues fails to hit the mark and represents a distraction from what should be the true purpose of this document.

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11 See, for example, *Building a Relational Society, New Priorities for Public Policy* ed. Baker, N. (Arena 1996).

SPECIFIC COMMENTS

Scope of company law

1. (a) No.

   (b) Yes. Indeed such a declaratory declaration might well be expanded to make it clear that it extends to members both present and future. However, thought must be given to the appropriate means of enforcement to avoid a repetition of the problems perceived to have arisen with section 309.

2. (a) Yes. Any proliferation of reliance upon non-statutory material in the development of company law is to be deplored.

   (b) No.

3. Section 309 should be unnecessary in the light of 1 (b).

4. (a) No.

   (b) Yes.

   (c) Yes.

   (d) Yes.

5. No.

6. (a) Yes.

   (b) Both (i) and (ii) are considered desirable.

7. No. The takeover mechanism is arguably the only effective measure of ensuring board accountability in listed companies and therefore should not be tinkered with. There is too great a danger otherwise that an unscrupulous board would pay lipservice to the interests of employees as a way of saving their own jobs.

8. Whatever proposals are adopted should aim to ensure that the owners of a company have as much choice as possible. At present such choice is denied in practice (if not in strict legal theory) to the true owners of listed companies - i.e. the beneficiaries - and therefore refocussing such companies with changed reporting and increased institutional accountability has been considered necessary. In the case of private companies where there is substantial commonality of ownership and control such solutions are not necessary as there is a greater measure of effective choice available to the owners as to the values which should be applied in the operation of the company.

Generally, as has been indicated above as part of the general comments it is essential that a "third way" be found between the sterile positions taken on the "stakeholder" debate. Not least there is a strong argument that the listed company must be refocussed to reflect that its owners are now ultimately the *beneficiaries* of institutional investors, frequently ordinary men and women from a diverse range of occupations seeking to provide for their retirement, and such companies should so far as possible be conducted in a fashion that complies with the broad values of such people or at the least provides them with a greater range of choice. Such people are unlikely to have any desire to see either extreme position on corporate governance adopted. Whereas on the one hand they are likely to wish to maximise the return on their investment, they are unlikely to wish to see this achieved by a system which is likely to encourage bad employment practices - many are likely to be employees themselves - or bad treatment of suppliers and others - many are likely to be self-employed and themselves vulnerable to such practices. Nor would such people be likely to support a system which encouraged directors to spend other people's money - i.e. theirs - on charitable projects of dubious benefit to either the company or society more broadly. They may well suspect that such largesse would ultimately be more likely to be advantageous to the directors' social standing and a distraction from the business of running a company. If directors are given enhanced powers there must be greater transparency and accountability which must come from the adoption of a system which will ensure greater recognition of beneficial interests and values. This would be greatly assisted by the adoption of social accounting and auditing measures along the lines identified.

Small and closely-held companies

9. Yes.

10. (a) & (b) No. Access is already arguably restricted by, for example, the Company Directors' Disqualification Act 1986, and there is no reason in principle that the requirements should not be tightened up, for example, by requiring a minimum age and qualification for directorship.

11. (a) Yes. They should be simplified and made more conceptually coherent. In addition, the accounting requirements for dormant companies should be considered.

(b) Any protection must be regarded as very limited in scope. Where small sums are at stake there is probably little interest in a company's accounts; where large sums are involved alternative means of protection, notably personal guarantees from directors and/ or shareholders are likely to be required in any event regardless of the accounts.

12. Yes.

13. This approach is not favoured.

14. The "integrated approach" should be truly "SME-centric" as suggested in para. 5.2.23 and thereforetherefore there should be no need for the measures set out in (a) to (e).

Company Formation, Objects and Capacity

15. (a) Yes.

(b) No. The documents serve different purposes. Certain of these only relate to the incorporation of the company, such as the Form G12; certain relate to the ongoing life of the company, such as the Articles of Association. Those matters which relate to the ongoing life of the company should not be confused with those which do not. Accordingly, it is submitted that the Forms G10 and G12 could be merged and that the requirements for the subscribers' details to be placed on the Memorandum and Articles of Association be abolished.

(c) No, the requirement for a statutory declaration is more likely to ensure that the consequences of non-compliance are appreciated.

16. The substantive rules themselves are regarded as satisfactory but not their presentation whereby some rules are contained in the statute and others in statutory instrument and still further rules are effectively contained in the practice of the Registrar of Companies.

17. Yes.

18. Yes.

19. No. The law in this are should be simplified.

20. Yes.

21. No. Such a provision is of more theoretical interest than practical importance.

22. Yes.

23. No.

24. Any such residual objects clause should be deprived of any effect whatsoever without prejudice to the ability of the members to provide for internal effect by way of a contract outside of the Articles of Association.

25. Yes. In practice it would appear that any protection could be as effectively provided by way of section 459.

Capital Maintenance

26. This is believed to be minimal.

27. (a) Yes, in the case of private companies, but no in the case of listed companies.

(b) A range of sanctions should be provided, both criminal and civil, so as to enable a court to deal appropriately with the severity of any given case before it.

28. (a) No. In the case of listed companies the need for a court application by a member would place too heavy a burden on a member seeking to object.

(b) See (a) above.

29. No.

30. (a) Yes.

(b) No.

31. (a) Yes.

(b) Not applicable.

32. Yes.

33. No.

34. (a) No.

(b) Yes.

(c) No.

35. Yes.

36. Not applicable.

Generally, the question that must be addressed is whether the doctrine of capital maintenance in its current form has any real value, which in this context must mean whether it affords any protection to creditors. To do this effectively the origins of the doctrine must be traced to attempt to ascertain what abuses in the commercial sense existed which it was developed to redress. Central to these is likely to be the risk that where a company was in financial difficulties the shareholders could improve on their priority in an insolvent liquidation by selling their shares to the company and becoming unsecured creditors as a consequence. Such a risk would have been more serious at a time when insolvency law was in its infancy and the courts were grappling with novel problems. The reality now is that insolvency law is quite sophisticated and there are a range of provisions (whether as currently drafted or with minor amendment) under which a court could seek to set aside such a transaction. In this event it is quite conceivable that the overwhelming majority of the provisions dealing with capital maintenance could be repealed unless some other justification could be

found, for example, in the case of distributions or the holding of shares in a holding company.

Regulation and Boundaries of the Law

37. No. Two issues arise from this question, one relating in essence to the source of and presentation of rules and the second their substantive effect.

In relation to the first issue, that of the source and presentation of rules, it is helpful to refer to the example of the regulation of corporate governance (which the author dealt with in a response to the previous consultation document) where it was argued that it was questionable whether best practice was the most appropriate method for regulating corporate governance. Firstly, it must be remembered that the impetus for the development of best practice was the impetus of scandals which risked market confidence of which that which was perhaps the most significant might not have been prevented thereby. Secondly, the regulation of corporate governance is the proper role of government. Thirdly, the proliferation of "soft law" should be avoided. The author has previously argued that part of the problem with company law is the increased fragmentation of its presentation and the encouragement of codes of practice will only continue this trend.

In relation to the second issue it would be most unwise to move away from rules being enforced by criminal sanctions. It is, of course, accepted that company law contains far too many sanctions: Schedule 24 in listing the voluminous number of criminal offences to which just one piece of companies' legislation gives rise to demonstrates the absurdity of the present position. However, this should not lead to a general move away from rules being enforced by criminal sanction. Firstly, the paucity of prosecutions for some of the offences can be given a number of interpretations, either that the existence of the offence is providing an adequate sanction or that procedures for prosecution should be improved or others still. Secondly, that a criminal sanction remains appropriate as a matter of public justice for certain forms of misconduct and as an effective deterrent. Instead there should be a thorough review of the rules themselves to ascertain whether they themselves are still justified.

38. The proposal for an integrated SME-centric model of company law should provide an opportunity for the simplification of the regulatory bodies so that in general regulation would be by the DTI with the additional rules separately applying to listed companies being regulated by the London Stock Exchange. The administrative role of the court as well as the role of the accounting and auditing bodies could be abolished being subsumed by the DTI. The Takeover Panel could likewise be subsumed by the London Stock Exchange. Company law reform could be monitored by a separate review body as suggested elsewhere in the consultation document and it would be through this body (with its no doubt specialist committees) that the views of different professional groups could be mediated.

39. See 38 above.

International Issues

40. Given the evidence cited that company law is not a major consideration in the decision whether or not to locate business in the United Kingdom it would seem inappropriate to base a reform programme upon removing irritants that are seemingly immaterial. To take the example of directors' loans cited as an irritant it should be borne in mind that these rules provide a considerable protection of shareholders from abuse by management.

41. See 40 above.

42. In the light of the answer to 40 above it would be sensible to perhaps question the need for the reform of company law. If it is not a material problem now the danger is that it might well be after the reform process!

43. (a) Yes.

(b) Perhaps.

44. (a) Yes.

(b) It would be preferrable if there were simply one regime.

(c) No.

(d) The overriding concern should be the protection of creditors in this context where lack of information could be more serious in its consequences than in other situations where alternative means of protection might be more readily available and/ or practicable.

45. No.

46. (a) There does not appear to be any significant harm although there may be some inconvenience where charges created by a foreign company are concerned.

(b) See (a) above.

47. (a) No. However, the growth of electronic commerce does give rise to a general issue which should be addressed separately to the company law review but which should not form part of it.

Information and Communications Technology

48. Yes. However, references to the telephone and fax were perhaps unnecessary!

49. Yes.

50. Yes. The correct approach would appear to be that sofaras possible the legislation should be technology neutral in its drafting and aim to focus upon the objective to be achieved rather than the means by which it might be

achieved. Questions of authentification should apply equally to traditional means of communication as much as to the new.

51. No. If the principle outlined in 50 above is followed this should be unnecessary. As the author pointed out in a response to the previous consultation document 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 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 refer to these.

High Level Reporting and Accounting Issues

52. The issues identified are correct. However, it is submitted that priority should be given to the conceptual basis of disclosure and auditing requirements with particular reference to the need for greater social reporting. This response has already indicated concern over the polarisation of viewpoints over the "stakeholder" debate and that social reporting could play an important role in developing as "third way" alternative to the existing positions. Accordingly, the question of social reporting should not be viewed in isolation as an "accounting" matter but rather as one of a fundamental nature to the purpose of the company in society.

Legislative Options and Future Machinery for Reform

53. (a) Company law should so far as is possible be enshrined in primary legislation with minimal secondary legislation and be subject to a bar on revision apart from pre-ordained intervals other than in wholly exceptional circumstances.

(b) The safeguards proposed in the consultation document are admirable.

(c) A serious attempt to get it right the first time!

54. (a) The real question is the commitment and resources devoted to company law reform rather than the institutional structure.

(b) There are a number of risks attached to the idea of a standing committee: its very existence will tend to support change for change's sake; it will be become captured by professional and academic interests where there is time for such engagement; and may become isolated from business.

The Way Forward

55. (a) Yes. However, some of the working groups appear to have a very wide remit making it difficult for them to perform their task.

(b) See (a).

56. (a) Yes.

(b) No.

57. Yes.

58. It seems a little tight. Given the need for further consultations on each aspect there is a danger that consultees will become rather consultation weary!