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Understanding Company Law

by

Alastair Hudson

LLB LLM PhD NTFS FRSA FHEA
Professor of Equity & Law
Queen Mary University of London
Of Lincoln's Inn, Barrister
National Teaching Fellow

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Preface

A fresh approach to company law

A company is merely a device created by human minds to achieve identified goals: nothing can be understood unless that central fact is recognised. That is, in effect, how this book begins, and I mean every word of it. This is a book in which, to use EM Forster's idea, I seek to connect the prose with the passion in company law. It is a book which is intended to be used by university students seeking an overview of the subject before class, seeking a guide through revision, or seeking some context within which to understand company law more generally. There is sufficient technical detail to satisfy professionals seeking either a refresher or an introduction to the subject, or students wanting assistance with particular company law problems; and yet there is also enough theoretical analysis to present a single coherent view of company law at the beginning of the twenty first century.

This book is accompanied, as are all of my books, with a series of podcasts on my own web-site which parallel an entire undergraduate course in company law at: www.alastairhudson.com/companylawindex.htm. There are also vidcasts hosted on that site, as well as advice on answering exam questions prepared originally for my students in the University of London, and podcasts and essays which probe further issues.

The scope of this book

We begin with a discussion of the history of the company and the development of the *Salomon* principle of separate legal personality. Then it sets out how a company is structured, set up and run. All the while, however, we shall be considering how companies are used in the modern world, and how company law theory tends to locked into a narrow conception of the company. We will then spend a large proportion of our time considering the legal obligations of directors and the rights of shareholders – both of which are fascinating in terms of the differences between the decided cases, in terms of the development of the statutory principles, and simply at the conceptual level. In essence, I think that the inter-action of directors and shareholders through the prism of the company as a distinct legal person is the beating heart of studying this subject. Related to those issues is the new vogue for studying corporate governance outside the strict legal sphere but very important for how many companies operate in practice. Once we have considered the human dramas within companies between directors and shareholders, we turn to the organisation of the company's capital and its shares.

From there it is a short hop to the growing field of securities law in relation to the means by which companies raise capital so as to fund their activities. This is a very new offshoot from mainstream company law and one which most of the books have yet to embrace fully. The securities field is part of a new zone in which companies are regulated by statutory and other bodies, which is considered in the following chapter. The management of large companies today is commonly concerned as much with the outside world as control of the inside politics of the company itself. Having moved through the birth and life of companies, we come to the death of companies by means of corporate insolvency and the means by which outsiders recover (or do not recover) what they are owed.

To that extent, the book may seem to have moved from a contextual, historical discussion to a large amount of discussion of technical matters. However, these later chapters consider the company's place in the larger world, and its economic, political and ethical place in society more generally. The final chapters of the book consider corporate social responsibility head-on. This growing field (which is important now in the management and/or the public relations of large companies, depending on your view) relates particularly (but not exclusively) to the activities of larger companies and their effects on developing economies, their workforces and the environment. The final chapter then draws together much of the critique of company law which runs through this book like a seam of iron ore through rock. To think properly about company law is to think about the whole of the modern world. It is a fascinating zone of engagement. Let us begin with the historical roots of company law.

The writing of this book

I have written this book for anyone who is interested in company law. It covers all of the key ideas which one might need to confront for a university course in company law. It does not pretend to be a full textbook, although most of the major cases, schools of thought and statutory provisions are considered here. I am a teacher and so I have attempted to teach the key principles of company law through this book. All good teaching, however, must also seek to enthuse the learner, to open her mind, and to point out interesting paths through the thicket of ideas. So, what the book does seek to do is to encourage those with an interest in the subject or with an open mind to think about what company law is, how it relates to the rest of our law, and how it effects our world. Principally, however, if I can communicate a little of my enthusiasm for the subject to you then that is one of the key goals of this book achieved. In my own mind, this book was intended to be a long, elegant essay on modern company law, and it has been a joy to write. In it, I have been able to meet lots of favourite ideas as though they were old friends.

This book was written in the early mornings in one continuous period during the autumn months of 2009, often before dawn and before the rigours of the day began. The law is as I found it from the materials available to me on 1 October 2009. Writing any book on law is a different activity from the activity it used to be. Once upon a time there were only a few paper law reports from which one drew one's understanding of the law, together with the journal literature and of course the prevailing statutes in company law at the time. However, there are now literally thousands of cases available to us through electronic law reports, and excellent web-sites like www.bailii.org which provide all of the decisions of the English and Irish senior courts free of charge on the internet. Consequently, anyone writing a book today must sift through an enormous number of cases, instead of reading only a few cases reported in the official law reports and taking them to be the established canon. Therefore, it is more and more difficult to state "what the law is" because there are so many otherwise unremarkable decisions which seem to state maverick (and possibly simply incorrect) understandings of the law, as well as cases which fall into the mainstream. Spotting new trends in the law is therefore as complex as stating definitively "what the law is". So, in writing this book I have assembled a large amount of material and metaphorically shut my study door so that I can get on with setting out how company law should be best understood without too

many interruptions from the buzz of new cases. Our goal here is to think and not simply to gaze in wonder at what is “new”.

I have sought to make company law as clear as possible to a law student, a professional lawyer or to a non-lawyer coming new to the subject. An equally serious aim in writing this book is to communicate my enthusiasm and affection for this area of the law to you, dear reader.

Alastair Hudson
Professor of Equity & Law
New Year's Eve 2009

Introduction

A company is a means to an end. It is an abstract legal device created by human minds. Companies are not found growing in fields. They are not a part of nature. Nothing can be understood about company law unless we absorb these facts.

Companies are the products of human minds and human ambitions

Everything that is said and written about companies and about company law is the product of human minds and human ingenuity. Companies are entirely artificial but they are very useful in a number of contexts. The whole of company law has been brought into existence as part of our jurisprudence both to explain the operation of companies and also to regulate their activities. In this book I will suggest to you that the company law device is an empty shell into which human beings pour their ambitions, their aspirations and their activities. There is nothing intrinsically good or bad about any particular company: instead it is a vessel into which capital and work is poured and a conduit through which activities are carried on. Whether a company is used to achieve immoral ends or productive ends, to raise the common wealth in society or to plunder it, to provide a communal workplace for human beings or to shield assets from taxation, is entirely the result of the human beings who have called this company into existence. As the poet Milton said: nothing is either good or bad, but rather thinking makes it so.

While companies are artificial creations, they nevertheless seem to live

Companies are so much a part of our modern life that it is somewhat counterintuitive to think of them as being merely empty vessels. This is partly due to the fact that most of the companies which are household names are the owners of the large brands which seem to people our high streets, our houses and our workplaces with their gaudy logos and exciting products every bit as much as the human beings who walk there. All companies whose names or logos we recognise will create an image in our minds. For example, when we think of the Nike corporation we probably think instinctively of their “swoosh” logo and their sportswear products. Immediately, we will also have an association in our mind with that name and brand: perhaps we will think of clean, minimalist stores full of trainers, or healthy athletes competing on television, or even of fears whether sweatshop labour is used in the manufacture of those products. What is important is that thinking of that company, the Nike corporation, will automatically cause us to make an association with that brand. The success of the company’s advertising is precisely that we have come to associate that company with something immediate in our brain.

In consequence, companies can seem like living people because they create an association in our minds in the same way that the mention of a human being will also create an association in our minds of fondness or dislike or nostalgia or whatever.

Companies have therefore come to occupy a particularly important emotional role in our societies. They are part of the warp and weft of life in developed and in developing countries. We should not think that sophisticated branding or corporate presence is solely the preserve of fashionable shopping districts. The global brands reach out to most parts of the world. In some circumstances, however, we will experience companies as our employers (with their letter-headed notepaper and logos), even if in other places they are experienced primarily as manufacturers or as shops or as service providers. The emotional inter-action with companies on this basis is a different one. The workplace is a place which provides people with a living wage or community or a sense of self. Importantly, again, the company stands for something incredibly significant in the human mind as though it actually existed as a distinct person.

Thinking calls companies into life, as though from a blank sheet of paper

Nevertheless, it is important to remember that the company is only a device, into which we can pour effort, ideas and investment so that they help us to achieve our goals, to sell our products or to organise our affairs. A company is something that is created. Think of a blank piece of paper. With that piece of paper you could do a great many things. You could write a poem on it, or a love letter, or an essay; or you could plan the rest of your life and so keep that letter always around you, or you could write a grocery shopping list on it and discard it in a few hours, or you could write a revision timetable on it and gaze at it regularly in a mixture of fear and awe through the springtime. The blank piece of paper is a tool for you to use for any one of a million different purposes. A company is very similar. It is a device which can be customized to suit an infinite number of purposes.

In English law, a company is a legal person distinct from all other people in the world (*Salomon v A Salomon & Co Ltd* (1897)). That means a company can own its own property, it can make contracts, and it can do everything in law that an adult human being can do. There are laws governing the way in which a company is brought into being and how it must be operated, but most of those laws provide that a constitutional document governing the company's activities (principally, the "articles of association") is pre-eminent in deciding how the company is to be run formally. Most of the laws restrict particular types of undesirable activity (many of which have their roots in frauds that occurred in previous ages). Importantly, company law describes the limits on the liability of the human beings who invest in a company (the shareholders) in the event that the company goes into insolvency, so as to encourage people to invest in companies without fear that they are putting all of their personal wealth in jeopardy precisely because their personal liability as investors will be limited if the company should fail. These ideas are considered in detail in Chapters 1 through 6 of this book: at this stage, we only want to grasp the big picture.

By offering an entrepreneur limited liability in the event that her business fails, we encourage entrepreneurs to set up businesses, to take risks, and to help our economy to remain vibrant. That a company is treated by company law as being a legal person means

that a company can create contracts and so on in a way which makes business dealings much more straightforward. Before there were companies with legal personality, it was necessary when creating a contract or transferring land to a business that all of the managers of the business (under partnership law, or agency law, or under trusts law) to be a party to the contract and for dealings to be very complex indeed. It was difficult from the outside to know how the business was organised between all of the various business partners. By creating the company, English law made it possible to deal with the company as a single entity, instead of worrying about the human inter-relationships. A contract could be signed on behalf of the company and be enforceable against the company; property could be sold to a company and bought from a company. Furthermore, companies could also use novel ways of raising capital from the public by means of shares and bonds and so forth. All-in-all, the company offered a much more efficient and attractive way of doing business for commercial people. Company law grew up so as to formalise the ways in which companies were required to operate, as considered in the early chapters of this book.

Nevertheless, in spite of all these rules which we consider in this book, a company is still a blank sheet of paper on which human beings are able to design their perfect future. An entrepreneur wanting to create a business may choose to create a company because company law will limit her personal liability for any losses from her business to the amount of capital which she chooses to invest in the business herself. If she is lucky or skilful then she may manage to procure investment capital from banks or outside investors so that she has to risk very little of her own money. If the business fails and the company goes into insolvency, then the entrepreneur can walk away with her personal property intact. Many captains of industry who are in business today have seen early businesses go into insolvency and they have merely come back to the market again and again with new business ideas until they have had success. This suggests that the company preserves the possibility of entrepreneurs making a success of themselves whereas if their personal property had been at risk then they might have been ruined by their first failure.

Alternatively it may make us think that there is potentially something immoral about our company law model if the entrepreneur may bear little or no risk (except for wounded pride) if her business goes into insolvency. We may think that there is “moral hazard” here: that is, the possibility that people will take unconscionable risks in the management of their businesses because they know that they bear little personal risk of loss. We might also be concerned about all of the third parties who traded with that company and who will never be paid what they are owed because the company went into insolvency, even though the entrepreneur is allowed to start up another business after a period of forced inactivity which is required by law.

This fear about the ethical problems with limited liability for entrepreneurs may become heightened when we realise that companies are also used simply to hold assets and often to *hide* assets. Most companies in existence do not trade. Instead they exist solely to help organise people’s affairs. Suppose Myra owns property which she does not want other people, like Her Majesty’s Revenue and Customs, to know that she owns because it

generates income on which higher rate tax would be payable. Because a company can own property, Myra could simply create a company and transfer this property to the company. If Myra retains control of the company by means of owning a majority of the shares in it, then the outside world may never realise that she owns that property but she will be able to retain effective control over it by means of her shareholding. This is a very simply example of how people use companies to organise their affairs. The company which Myra sets up could be created in the UK or it could be created in another jurisdiction where no tax is payable.

There is a legal requirement that shareholdings in companies in the UK are registered with Companies House and that the register can be consulted by anybody. Companies are also required to lodge accounts with Companies House. (These detailed rules are considered in Chapter 6). Therefore, we might think that there is little practical concern about Myra's attempt to avoid tax nor any risk of her managing to hoodwink her creditors. Myra's business creditors could also check up on the company. However, this registration requirement does require that the outside world acts as detectives in all of their dealings with companies. It may be difficult to know who the controllers of the company are if, for example, Myra decides to use her friend Amanda as a clandestine holder of Myra's shares, under an arrangement whereby Amanda does whatever Myra asks on payment of a small annual fee, so that it would be very difficult to know that Myra was really in control of the company. Much of our company law is concerned in consequence with the sorts of information which must be made public and the avoidance of fraud. Nevertheless, companies can clearly be used simply to achieve clandestine motives in the real world.

Before we get carried away with the idea that companies are only used for reprehensible purposes, we should remember that it need not always be like this. Companies can be formed for very positive social reasons. Most obviously in this regard, companies can be used as charities in England and Wales if they are operated for charitable purposes in the public benefit. Many companies operate businesses which make profits, which therefore pay taxes which fund important social services, and which gainfully employ a large proportion of the working population. There are many who would say that operating companies for profit is in itself a good thing because that provides employment for the populace and profits means more taxes being paid, with the result that a virtuous circle of productive economic growth is created. Companies may pursue avowedly positive goals, like the Body Shop did when it began business, as well as naked profiteering (whatever one may think of profiteering, naked or otherwise).

Company law really sets out the template which companies must use to receive the support of the law, and company law also sets out controls on the use and operation of companies. As a result, our company law will sometimes be concerned to prevent abusive use of companies and it will sometimes be concerned simply to set out the formalities which must be performed for a company to be run lawfully. What company law is doing, therefore, is one of two things. Company law may be regulating the use of companies so as to prevent abuse – whether in the form of fraud or abuse of financial markets or whatever – or so as to provide means for compensation or redress for some wrong.

Generally, however, what company law is doing is to provide us with a model. Like contract law or express trusts law, company law is saying, in effect, “if you organise your company in the following way, then the courts will enforce your rights, your contracts and so on”. In that sense, company law offers us a template. Provided we obey the formal rules, requiring that we register our company appropriately and so forth, then the law has given a means by which we are able to achieve our goals. Our blank piece of paper is actually a piece of headed notepaper: that is, there are some limitations as to the form and activities of our company, but otherwise we are free to do with our company whatever we please. A company is something which we create to achieve our own goals.

Creation, Frankenstein and the modern company

The analogy which I am going to use to describe this creation of a company in this book is that of Dr Frankenstein. Mary Shelley’s novel *Frankenstein* tells the story of Victor Frankenstein, a Genevese student, who discovers the ability to harness electricity so as to give life to inanimate body parts which he has sewn together into a travesty of human form. What Frankenstein was trying to do was to create something artificially which would appear to act like a person. In effect, companies are artificial creations which are treated by English law as having legal personality as though they were human beings. The metaphor which we will use to explain the creation of companies in the early parts of this book will be the metaphor of a young Frankenstein trying to create an artificial person to do his bidding. As was mentioned above, a company is treated by company law as being a person in the same way that an adult human being is treated as being a legal person. In the following passage from *Frankenstein*, the young chemistry student has just made a breakthrough when he realised that he could create life artificially so as to mimic ordinary life:

‘When I found so astonishing a power placed within my hands, I hesitated a long time concerning the manner in which I should employ it. Although I possessed the capacity of bestowing animation, yet to prepare a frame for the reception of it, with all its intricacies of fibres, muscles, and veins, still remained a work of inconceivable difficulty and labour. I doubted at first whether I should attempt the creation of a being like myself, or one of simpler organisation; but my imagination was too much exalted by my first success to permit me to doubt of my ability to give life to an animal as complete and wonderful as a man. . . . I was encouraged to hope my present attempts would at least lay the foundations of future success.’

I would suggest that creating a company gives us exactly this same power. We can create anything our minds can imagine. Sometimes we may even create monsters. The company gives us great power, at law. The company can open a bank account, acquire land, employ human beings, create contracts with suppliers and buyers, and so on. While the company is a blank sheet of paper at the outset, once the company begins to conduct business then the company *as a company* will appear to have a life of its own which is entirely separate from the human beings which have created it. The original human

beings who began the company may die or they may sell the company to other people, but the company continues in existence as though nothing had changed. As I suggested earlier, we have emotional and automatic connections with companies very often in our daily lives whether as customers, employees, or simply as people occupying the same lifeworld as those companies. In that sense the company exists separately because we as human beings inter-act with that company. Our reactions cause its existence. If we ignored Nike and their products then Nike would cease to exist. But the very fact that we have a reaction to the Nike brand and its products means that the Nike corporation exists: whether that is because we covet their trainers as birthday presents or even dislike people who wear their tracksuits as though they were fashionable leisure-wear. Our company law causes these companies to exist also precisely because it grants companies legal rights (even human rights in our modern jurisprudence!) and so imposes obligations on the rest of us. Companies *exist*.

Finance is exactly the same in the sense that our reaction to it causes it to exist. When our salaries are paid into our bank accounts we receive a piece of paper or can see on a computer screen (at a cashpoint in the street or via the internet) that we “have £x in our bank account” and so we feel slightly richer. In fact, all that we have seen is an expression of a computer record that promises us that we will be allowed to acquire goods and services up to that amount if we present our debit card or write a cheque. It is precisely because we all treat the computer record that represents our bank account as constituting an amount of money that we call that computer record known as a “bank account” into existence. You see, something remarkable happened in Europe in the early eighteenth century. Before that time, coins had always been made of precious metal (i.e. gold or silver) and therefore the coin was worth the amount of gold or silver in it. However, it was expensive to produce this many coins and it made it difficult to put more money into circulation if there was insufficient gold or silver to support it. So, a Scotsman called John Law hit upon the idea in France of replacing coins with paper money. If money was simply expressed in the form of pieces of paper with a promise from the King on their face to the effect that the bearer of the note would be entitled to call for gold from the King on presentation of the note, then people would be able to use these pieces of paper to pay for goods and services instead of gold or silver coins.

A truly remarkable feat was achieved here (over time, and not without some difficulty) of encouraging people to accept that they did not need to keep their gold or silver coins because a piece of paper printed by the royal mint would be accepted across the country as having the same value. People let go of gold and instead embraced the idea that something intrinsically valueless had a cash worth. You might, of course, take the view that people had simply attributed to gold a value which it did not really have, because after all on a cold winter night a plate of stew worth £1 is much more valuable than £1 in gold. You cannot eat gold after all. Similarly, we might think that since the dawn of time human beings have come to believe in things they could not see: few religions could survive unless people believed in something they could not see or touch. In that sense, worshipping the sun or worshipping bowls of stew seems positively rational.

Company law does something similar in the nineteenth century. It causes people to believe in something that cannot be seen or touched. People come to believe that companies own property and can create contracts and so forth because the law tells us that they do. In our modern economies it is the largest public companies which are typically considered to be the most significant actors in our economies. Like young Frankenstein, the creator of a company has great power in his hands. She dreams of “future success” through her creation just as an entrepreneur dreams that a company will create future success for herself. What is also important about the company is that it can be as simple or as complicated as the creator wants, just as Frankenstein imagines how complex he could make his creation and how much he could hope to achieve with it. Similarly, companies have been brought into being through the ages by enterprising commercial people to achieve particular goals.

The development of company law

Company law is a tremendously enjoyable subject to study. Even though it is entirely the creation of human minds, it nevertheless feels very rooted in “the real world” in the sense that it is the lifeblood of much commerce. There is no proper way of understanding how company law is the way that it is unless one understands its history. Company law has developed incrementally from a condition before there were really companies into its present shape. There has not really been a revolution in the way companies are thought about in law; just a series of very large extensions built onto the main building. Imagine early company law as being a small cottage to which several large extensions have been added so that the original cottage constitutes only a fraction of the total size of the building. Company law has developed to meet commercial circumstances over throughout the 20th century by means of a number of statutes culminating in the Companies Act 2006 (and many other pieces of legislation besides) which is the longest single statute in the UK. And yet, while that may sound daunting, company law operates on the basis of a few central principles and long-standing ideas.

In essence, as is discussed in the next chapter, companies began life as contracts between people who agreed to form a partnership and to employ other people to act as their trustees in the management of the business. From that seed grew the idea that investors in a company should have only limited liability if the company were to fail (as opposed to open-ended personal liability to meet the company’s debts) and that the company should be seen as a separate legal person (in *Salomon v A Salomon & Co Ltd* 1897)). During the twentieth century, the bureaucracy which has grown up around the administration of companies, the way in which they raise capital, and so forth has led to more and more law being created to meet modern circumstances. However, that small cottage remains at the heart of the enlarged building. Nevertheless, understanding the basic lay-out of the original cottage is essential to understanding the company law we have today.