Chapter 1

The Birth of Modern Company Law

The meaning of a "company"

The word "company" is derived from the Latin words "com" and "panio" and gave rise to the word "companio" (from which comes the English word "companion") meaning literally "someone with whom you broke bread". Therefore, in its earliest usage, a "company" was a group of people who ate together. If you mix in polite society you might occasionally belong to a "company" of people going to the theatre, or you may form part of a "company" having dinner together. A good friend is someone we might think of as being "good company". Therefore, the concept of a company began as an agreeable collection of people joining together for some social or joint purpose.

The birth of the joint stock company

In time companies also came to represent people who banded together to trade. Literally, the traders formed a company of people who has interests in common with one another. It is from this root that our legal conception of the company grew. The earliest companies of that sort can be identified most clearly in England in the Elizabethan era when the trading nations of Europe were seeking new lands which they could colonise, where they could collect treasure and with whose people they could trade. In truth, Europeans had been doing this for centuries: just as Christopher Columbus had done in 1492 when he reached America. In the sixteenth and seventeenth centuries, though, the idea of the joint stock company can be understood as having begun. A number of rich English merchants and traders would acquire the use of a ship which they filled with their different items of stock. In that sense the boat contained their "joint stock". Someone was appointed to act as captain of the ship. The captain's job was to sail the ship to whichever destination had been chosen and to trade the joint stock for the fabulous wealth which was believed to exist in faraway lands. The "South Seas" were a popular destination at the time – what we now call South America – because it was believed that gold lay on the ground there, once one had sailed past sea serpents and dragons, and that this plentiful gold could be acquired in exchange for the stock on the ship. (In effect, somewhat optimistically perhaps, it was hoped that sheepskins could be exchanged for gold.)

In legal terms, the traders formed a contract between themselves which we would analyse today as being a partnership. That means that the traders agreed to share the profits and losses of this venture between them in accordance with the terms of their partnership contract. The ship's captain was understood as being a trustee who had legal powers to deal with the stock held on board the ship just like a trustee and who also owed the fiduciary duties of a trustee to the traders to sell their goods for the best price and to bring the profits home. The captain owed duties to act fairly and even-handedly between all of the traders just as any trustee would. The traders were therefore not only partners in contract law but they were also beneficiaries of this trust arrangement under trusts law. The trust property was the stock held on board ship, and any property or money for which it was exchanged on arrival in the South Seas. Therefore, the joint stock company was an imaginative use of the centuries-old ideas of contract, partnership and trust to achieve a very particular relationship which permitted trade to be conducted overseas. The commercially useful idea of the joint stock company developed.

From illegality to necessity

The earliest companies were, however, beset by fraud. As was discussed in the *Introduction*, a man called John Law had the exceptionally clever idea of encouraging people to exchange their gold and silver coins for paper money so that the French king could control the amount of money in circulation in France. This also created the possibility that money could be raised from the public more easily to wage wars or expand French trade. A company was formed in Paris to trade in America, called the Mississippi Company. In 1719 in Paris, speculative fever was at its height as people fought to give their money over to the Mississippi Company to acquire a "share" in the riches which everyone agreed was sure to be earned by members (or, shareholders) of the company from the company's prospective trading activities in America.

In 1720 in England a man called John Blunt had a similar idea. A century of waging war had left the English monarchy in debt. Money had to be borrowed from the public and those investors had to be paid interest on their loans as well as being paid their money back. When the new king George [I] had acceded to the throne he was a stranger in the country he ruled because he was a German import needed to succeed to the thin, Protestant blood-line of English royalty. Saddled with a huge national debt and few friends, the new king and his government fell under Blunt's thrall. Blunt's idea was to encourage people to exchange their right to receive money from the state as part of the national debt and instead to be given shares in the South Sea Company. The South Sea Company was intended to trade in the South Seas and to scoop legendary amounts of precious metal which could be shared among those fortunate enough to hold shares in the company. A speculative fever spread in London just as it had spread in Paris. Everyone, from members of the royal family down to the petit bourgeoisie wanted to own shares in these new companies. It was a common belief that they could not fail. Indeed, in London each new issue of shares was greeted with tremendous public excitement.

Trading in the shares in the London coffee houses [around] Exchange Alley was feverishly excited. Huge fortunes were made. But, in truth, John Blunt was operating a sham. He had loaned money to well-placed individuals from the company's funds to buy shares in the company so that it appeared that the company's shares were much sought after. This is known today as "making a market" in shares and is a criminal offence (see

Chapter 11). In fact the company had no business and this share speculation went on before a single ship had sailed. People willingly exchanged their bonds against the government, which entitled them to be paid money by the State, for shares in an illusory company. When the fraud became public knowledge, many people were ruined, including members of the royal family and Cabinet ministers. As a result, companies were made illegal for about a century because they were associated with fraud and immoral speculation.

By the time we reach the nineteenth century and the early days of the industrial revolution, however, there was a need for more investment capital to fund and fuel economic expansion. The construction of the railways and the infrastructure of modern English towns (for our sewers and so on still rest on Victorian ingenuity and skill) needed to be funded. To do this, companies were legalised again in [1824] so that investment capital could be raised from the public, instead of relying on ordinary bank borrowing which could not meet the pace of growth. It is important, however, that companies have a heritage and a root in English law as being based both on commercial expediency and the possibility of systematic fraud.

Limited liability

One of the key developments in the growth of the company was the development of *limited liability*. An investor in an early company faced the risk that he would be personally liable for all of the company's debts in the event that the company went into insolvency or that it failed to make enough profit to pay off its creditors. Under partnership law, for example, unless the arrangements had been very cleverly organised, each partner would be personally liable for all of the debts of the business. So, partners and therefore all investors in companies ran the risk of losing all of their property if the business failed. This was a huge disincentive to investors. So, in [1844] a statute was passed which permitted companies to award limited liability to their shareholders. This meant that a company could be created by investors paying an amount of money agreed between them and set out in the company's *constitution* as an initial investment which would form the company's *capital*.

That the investor had limited liability meant two things. First, the investor would not be personally liable for the company's debts over time. Secondly, the investor was risking only the loss of that original investment in the company, and not an open-ended exposure to the company's future losses. On the upside, the investor could receive a share in the company's profits proportionate to his shareholding. This encouraged more investors to invest in companies, particularly given the pace of economic growth in Victorian England as not only did the companies build railways, bridges and viaducts which were engineering wonders of their time, but the British also established one of the largest empires ever known across every continent which created further trade and ever greater wealth. Consequently, the combination of limited liability and the conspicuous generation of great wealth through the marvels of the Victorian age encouraged more and more people to invest in companies.

The joint stock company became a different animal. Professional managers operated the companies not simply as servants of rich aristocratic patrons and traders, but rather as a growing bourgeois class in their own right. The new age changed the British class system irrevocably as people who had formerly been serfs in the fields moved into the dangerous, dirty new factories in the new towns effectively as slave labour and, if they were lucky or clever, as a new petit bourgeoisie who could earn a living with their brains instead of their brawn. The empire offered prospects for imaginative men (mainly) to make their fortune. The company was an important part of spreading the fruits of this activity by spreading the possibility of investment gain among the bourgeoisie. It also created a larger class of bourgeois professionals who worked in the banks, around the Stock Exchange, and in law and accountancy offices. It is sometimes said that most of modern history is actually the history of the growth of the bourgeoisie, and there is much in that. Social change in Britain has had a lot to do with the steady dismantling of monarchical and aristocratic power such that most power in modern society is held uneasily between companies and "the markets" on the one hand, and government and the State on the other.

However, all of this discussion of breathless growth and of limitations on investor liability has catapulted us to the centre of the modern company as a means of effecting trade but it has overlooked two important dimensions in the development of the concepts of company law: the roots of companies in the law on associations and the development of the idea of corporate bodies in the corporations formed by Royal Charter.

Associations, and their links with modern companies

Anyone who has studied property law at an English or Welsh university should be aware of the law on unincorporated associations. Associations are clubs or societies or groups of people which are not organised as companies. In that sense they are said to be "unincorporated", whereas a company is a body which has been *incorporated* (see Chapter 3). When companies were unlawful, people still wanted to group together. They did so lawfully in the form of associations, which had long been a part of English law. An association is a contract between a group of people who want to carry on an activity in common. A good example of such an association is a student law society at university. A well-organised association will have a *constitution* which sets out the rules, in contractual form. Typically, members will pay a subscription to join the association (just as an investor in a company buys *shares* at the outset so as to become a shareholder in that company). This stands for the necessary contractual consideration in an English contract. The constitution will deal with questions like the powers of the various officers of the association, the election and dismissal of those officers, what happens to property which people give to the association (such as subscriptions or legacies), the members' rights to vote so as to control the activities of the association democratically, the rights of the members to receive accounts as to the association's property and activities, the circumstances in which the association will be wound up, and the rights of the various members to take property rights in the association's property after it has been wound up.

The joint stock company and the modern company are built on these foundations. Modern companies have members. They are known as shareholders, unless they are described technically as “members” who joined the company when it was created originally. (The terms “shareholder” and “member” are often used interchangeably by many company lawyers.) Company law sets out the rights of shareholders if something goes awry, and company law specifies which matters need to be decided by a voting procedure. However, while company law presents a default setting for companies with inadequate constitutions and deals with many types of abuse within companies, it is the company’s own constitution which specifies the company’s objectives, the powers of the directors, the rights of shareholders, and many, many other points of detail concerning the operation of the company, as discussed in later chapters. A company’s constitution is known formally as its *articles of association* today. There was once another constitutional document, known as the *memorandum of association*, which set out the company’s objects, but the memorandum of association is no longer required after the enactment of the Companies Act 2006 (“CA 2006”), although some companies still have them. These constitutional documents are discussed in Chapter 6.

What is important to understand at this stage is that the somewhat peculiar looking articles of association which purport by [s.14 of the CA 2006] to create a contract between the shareholders when those shareholders may never have met, let alone created a contract as to all of the complex provisions in the articles of association. However, this contract makes complete sense when we understand it as being simply a modern evolution of the old contract between the members of an unincorporated association, as has been the practice of the law of associations for centuries, which has remained in our company law.

Let us think of a university student law society as a clear example of an unincorporated association. Members join and leave a student law society all the time, and the constitution binds them as a contract without any difficulty. New joiners are bound by the same contract as long-standing members. The constitution of a company operates in the same way, constituting the rules by which that company operates without the parties needing to say anything more between them. The rights of the original members of a company when it is created and the rights of people who become shareholders later will be governed by the articles of association (as well as by company law). In an unincorporated association, the constitution and the officers in charge of the association decide how to run the association, how to allocate its property and how best to pursue the association’s goals. The association’s constitution explains how the members are able to object to the officer’s decisions, and what rights they have to share in any profits. Similarly, in a company it is the management (primarily the directors in most companies) who manage the company and the members (as shareholders) have specified rights to vote at annual general meetings, to receive accounts, to vote out the directors if they wish, and to receive a distribution from any profits by way of a dividend. Clearly, modern companies have emerged from this fertile soil of the law of associations, which is itself a combination of contract law and property law ideas.

(Most students meet unincorporated associations in the law of trusts when the issue is how an association can receive property when it is not a legal person: the risk is that the association is deemed to be a void trust because the officers seem to take the property as trustees for an abstract purpose. See Hudson, 2008(2), 50.)

Corporations, and the growth of legal personality

The idea of a corporate entity was not one created by commercial activity in the nineteenth century. The notion of a corporation has a much older provenance than that. The first companies to be formed in English law were the product of the municipal corporations of the thirteenth century. The feudal system did not apply evenly across England. Rather, a number of towns remained subject to direct monarchical control subject to the terms of their Royal charters. Out of these charters grew an understanding that the people of the town were more than merely individuals but rather constituted a collective. These municipal entities formalised their rules within the scope of their applicable Royal charter and acquired "older men" (or, the more familiar "aldermen") and wardens as their officers. In parallel, trade "gilds" (or, guilds) were formed - most notably the twelve grand liveried companies in London. These early corporations saw conflicts common to the modern company. For example in the Founders' Company there was a dispute between the liveried members (who quite literally wore liveried coats and who carried most of the control over the activities of the company) and the yeoman (effectively junior members of the same company) as to prices fixed by offices of the company. The Court of Star Chamber intervened in favour, ultimately, of the yeoman in part.[1] This mirrors the disputes between majority and minority shareholders in modern company law today.

Out of the pomp and circumstance of liveried companies and town corporations, and the emerging notion of collective entities through which the people could act, grew the company. The company was an expression of the personality of those individuals acting together. The joint stock company evolved as a commercial undertaking which (subject to the historical controls on companies considered later) was made up both of the "joint stock" provided by the members and also of the "company". The two elements being separate issues of property and of contract until the jurisprudence of the late nineteenth century. As we shall see in the next chapter, even in the famous decision of the Court of Appeal in *Smith v. Anderson* in 1879, there remained an explicit understanding of the company as merely an expression of the common endeavour of its members and not as an entity with its own personality. While it may seem remarkable now, the unincorporated companies of the early nineteenth century were considered to be illegal contracts[2] by Lord Eldon.[3] It was not until 1843 that the idea that companies constituted illegal, and therefore unenforceable, contracts was displaced in the common law.[4]

[1] *Butlond v. Austen* (1508) from Leadam, *Select Cases in the Court of the Star Chamber*, 262.
[2] On which cross-refer with the criminal liability attaching to membership of trade unions considered in chapter 13 below.
[3] See Atiyah, *Rise and Fall in the Freedom of Contract* , 564. For example, *Josephs v. Preber* (1825) 3 B&C 639, 107 E.R. 870.
[4] *Garrard v. Hardey* (1843) 5 M&G 471, 134 E.R. 648; *Harrison Heathorn* (1843) 6 M&G 81, 134 E.R. 817. See also *Walburn v. Ingleby* (1833) 1 My & K 61, 39 E.R. 604.

In England, there were many town corporations created by Royal Charter whereby the administration of a given town would be carried on by the body identified in that charter. The corporation had a distinct set of legal powers which were held by the corporation as a corporation, rather than acting legally through the agency of the human beings who peopled it (Cooke, 1955). The guilds in the City of London were also treated as corporations. In essence, guilds acquired monopolistic rights to manufacture and sell particular types of the product by Royal Charter in England.

What is important to take forward from this discussion about the company into the next chapter is that a decision of the House of Lords in *Salomon v Salomon & Co Ltd* (1897) was that a company should be recognised as being a distinct legal person from the human beings who had created it. So, even though Aron Salomon had traded as a bootmaker in Whitechapel for many years, when he incorporated his existing business by forming a company and transferring that business to the company, but otherwise continuing to trade much as before, all of the creditors of the business could proceed only against the company and not against Aron Salomon personally. From this simple notion grew the most important idea in the whole of modern capitalism. That is what we consider next.