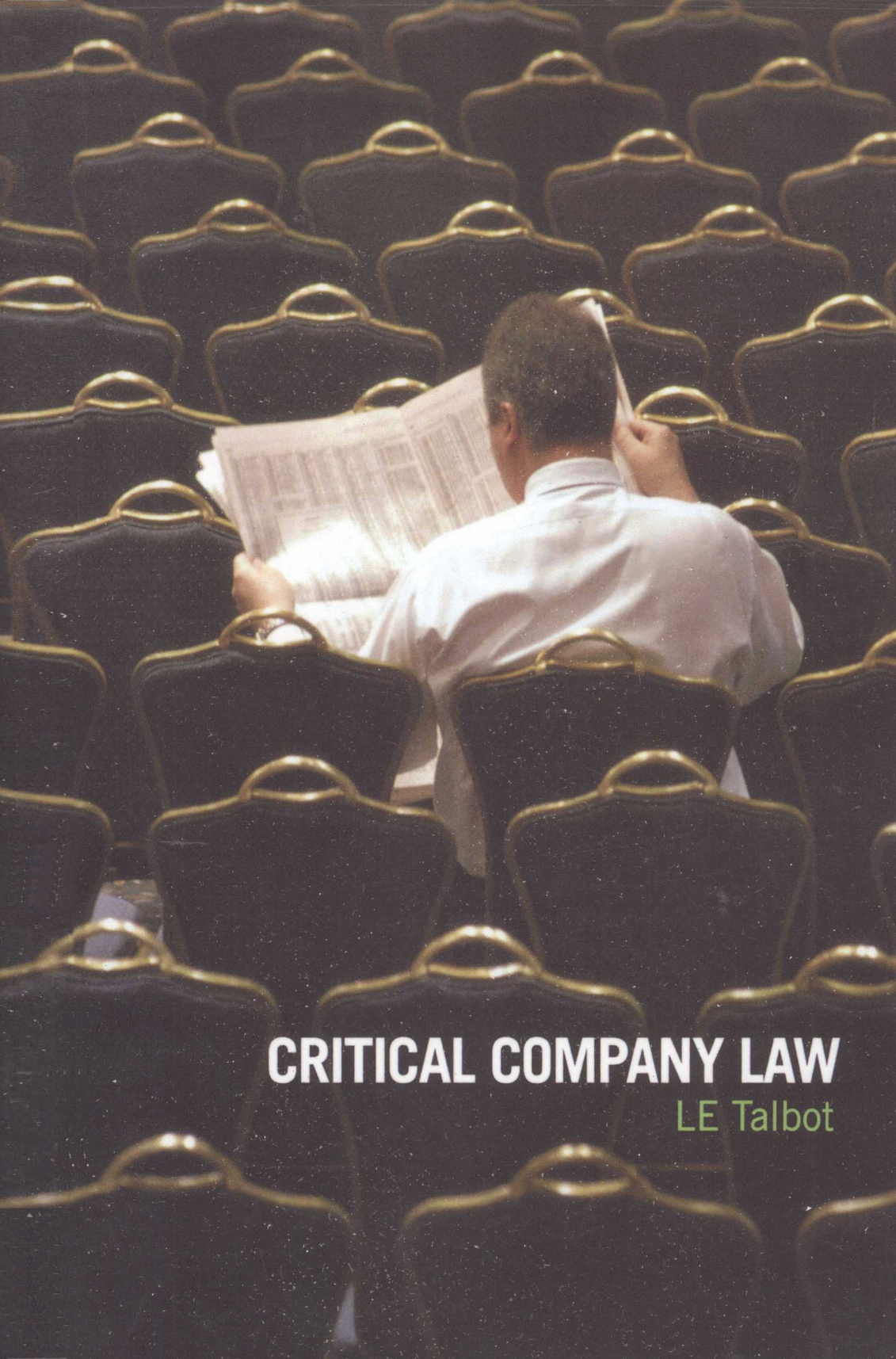

CRITICAL COMPANY LAW

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Dr Talbot traces the history of the fundamental principles of English company law, including the doctrine of separate corporate personality, directors' duties, minority protection and the doctrine of *ultra vires* from both a black letter and contextual perspective. Relevant aspects of the Companies Act 2006 are thoroughly examined.

Drawing on the influence of American law and American scholarship, the book considers the ideas which have informed corporate governance in England. It includes a case study of mutual building societies' march to the market and corporate identity. The hybrid approach adopted in the text provides a contextual and critical framework in which to understand company law as well as a broad picture in black letter law terms.

The aim is to invigorate what many students and academics consider a dry subject by uncovering the social factors which continue to inform this area of law – and the political nature of the law itself. Dr Talbot maintains that modern company law is shaped by three main factors – economics, ideology and existing law. The state of the law at any one time is determined by the constantly shifting relationship between these factors.

Dr Talbot lectures in company law and comparative company law at London Metropolitan University. Her research interests are in American and English corporate law, business associations and corporate governance from a critical and contextual perspective. She has delivered a number of papers on these areas and has published in the *Company Lawyer*, *Law and Critique* and the *Cambridge Journal of Financial Crime*.

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Introduction

The purpose of this book is to provide a black letter law account of the fundamental principles of company law within a critical and often historical context. By taking this hybrid approach to the study of company law it is hoped that a richer understanding of the subject may be gained. Company law scholarship in Britain is largely composed of highly accomplished black letter technicians and equally accomplished socio-legal scholars with very little dialogue between the two. This book is a small contribution towards bridging the gap.

The theoretical work which is referred to in this book broadly falls into two camps, socio-legal scholarship and contractarianism. Socio-legal scholars understand the law to be an expression of social processes which can include class, culture, ideology politics and the (political) economy. They contend that company law is a reflection of a particular social dynamic, rather than an internally generated legal process. Socio-legal scholarship in its different forms tends to bring a critical and radical approach to the study of law. Many scholars in this tradition would advance as a broad aim the need to change society to serve a social or humanist ends. Accordingly, socio-legal scholarship is a minority perspective today as it is at odds with the current political allegiances to the free market.

Conversely, contractarianism, partly because it does celebrate the free market, is very much in the hegemony. Contractarianism constitutes a huge body of work that has comprehensively reinterpreted all areas of company law. It radically reconsiders the company as being a mass of contractual arrangements between those involved in the business including shareholders, managers, creditors, consumers and employees. Its purported aim is to find mechanisms to enable those arrangements to be cheaply conceived and financially productive. In achieving this, some contractarians argue for a non-interventionist company law which allows the free market to organise exchange, while others argue for regulations which enables efficient bargaining between players. In so doing it reformulates many of the basic tenets of company law and discards the notion of the company being anything other than a profit-maximising vehicle.

Company law scholarship, in both the socio-legal and contractarianism traditions, is largely located within American academies. Throughout this book, reference is made to American scholarship which is applicable to both English companies and American corporations.[1] Historically, the American corporation has been much more politicised than the English company and scholarship has been much more vigorous in both its criticism and praise of corporate law. Thus in order to understand these dynamics and to grasp some of the backdrop to the scholarship which is so widely used in this book, the history of company law set out in Chapter 1 will also include a history of American company law.

It is a further measure of the strength of contractariansm that it did seem to play a role in the construction of the Companies Act 2006. In the company law reform process leading up to the passage of the 2006 Act, there is evidence of this influence. The new Companies Act and its reform process provide a unique opportunity to assess the role of ideology in the formation of law and comprises much of the content of this book.

Reform of company law began with the Law Commission's recommendations on minority shareholder protection and their later work on company directors and Part 10 of the Companies Act 1985. The Commission published its report on company directors in 1999[2] having previously published its report on minority shareholder protection in 1997.[3] This piecemeal approach to reform was superseded by a government initiative to overhaul the entire body of company law. By the time the Commission's report on company directors was published the Government had already announced its intention to commission the Company Law Review (CLR) to critically assess existing company law and to recommend such reforms as would enable British company law to support a competitive economy.[4] Therefore the Commission's work became part of the overall reform process with many of their recommendations being taken up by subsequent CLR Reports, particularly in the area of directors' duties. The CLR itself was an independent group of scholars, practitioners and business people and it was chaired by the Director, Company Law and Investigations at the DTI.

The CLR published its Final Report to the Secretary of State for Trade and Industry in July 2001 having previously published a number of other

1 The terms company and corporation will be used interchangeably without them necessarily denoting an English or American business.

2 Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties, Law Com No 261.

3 Shareholder Remedies, Law Com No 246.

4 This was announced in the DTI's document of March 1998, 'Modern company law for a competitive economy', the leading title for all subsequent reports from the CLR.

reports.[5] The Government consulted on the recommendations from the CLR that it intended to include in proposed legislation in two white papers, 'Modernising Company Law' (July 2002) and 'Company Law Reform' (March 2005). The Companies Reform Bill was introduced into the House of Lords in November 2004 and received Royal Assent in November 2006. Consultation on implementing most parts of the Act are due to begin in February 2007 and it is the Government's intention to implement all parts of the Act by October 2008.[6] It also intends to implement s 463, Part 28 of the Act and s 1281 by January 2007. Furthermore, it intends to repeal a number of sections with effect from 6 April 2007. These include ss 41, 293 and 294 of the 1985 Act and those parts of the 1985 Act which relate to the disclosure of share dealings by directors and their families. It will also repeal ss 311, 323, 327, 343, 344, 438, 720 and 729.

This book falls into seven chapters. The first chapter sets out the history of English and American company law with some comparative analysis. The purpose of this chapter is to lay down a historical structure within which to better understand legal and intellectual developments in company law. The second chapter assesses the doctrine of separate corporate personality and considers the question of why incorporation led to the notion that the company was a distinct legal person. The third chapter looks at the contractarian notion of the company as a nexus of contracts and at the effect of it on reforms to the company constitution and the statutory contract between shareholder and company. It argues that contrary to contractarian notions, this area of law is guided by regulation rather than contract. The fourth chapter assesses the principle of corporate governance theories of the twentieth and twenty-first centuries within the historical and political context in which they emerged. The purpose of this is to provide an overview of these theories and to understand the contextual dynamics which inform them. The fifth chapter, 'Corporate governance II', assesses the law relating to a director's fiduciary duties and the reforms presented in the 2006 Act. The sixth chapter, 'Corporate governance III', assesses the law and the reforms on

5 These included 'Modern company law for a competitive economy: completing the structure' (November 2000), 'Modern company law for a competitive economy: trading disclosures' (October 2000), 'Modern company law for a competitive economy: registration of company charges' (October 2000), 'Modern company law for a competitive economy: capital maintenance: other issues' (June 2000), 'Modern company law for a competitive economy: developing the framework' (March 2000), 'Modern company law for a competitive economy: company general meetings and shareholder communication' (October 1999), 'Modern company law for a competitive economy: company formation and capital maintenance' (October 1999), 'Modern company law for a competitive economy: reforming the law concerning overseas companies' (October 1999), 'Modern company law for a competitive economy: the strategic framework' (February 1999) and 'Modern company law for a competitive economy' (March 1998).

6 Lord Sainsbury, HL Hansard, 2 November 2006, Col 433.

minority shareholders' protection and considers the ideological influences that have been bought to bear on this area of law. Chapter 7 provides a case study of how a semi-commercial body, the mutual building society, developed into a fully commercialised company, the converted building society and considers how the themes of economy, politics and ideology have affected this transition.

Chapter 1

The history of English and American company law

This chapter gives an historical account of the emergence of modern company law in England[1] and America. In both countries early companies, or corporations as they are called in America, were created by charters and were known as charter companies. Charters were granted by the sovereign power. In England, charters were granted by the Crown, in America they were granted by state legislatures. In both countries they bequeathed and were designed to bequeath privilege. This could be in the form of limited liability for the members or monopoly trading rights, but in both countries this was justified because these corporations formed some quasi-public function such as providing revenue for the state or building public utilities. Later, in the nineteenth century when companies could be formed under general incorporation laws the charter company form in America largely fell into disuse. In England they had already fallen into disuse following the scandalous collapse of the South Sea Company. As companies were incorporated under general incorporation Acts they gradually lost their public character and the privileges and powers inherent in the company form became less apparent.

The companies and company law in England and America are so similar that they are often termed 'Anglo-American companies' governed by 'Anglo-American law'. However, there are some significant differences between the two which may be traced to the different paths companies in the two countries took historically. It is these paths that are followed in this chapter.

PRIVILEGE AND CHARTERS

Early corporations, created by the granting of a charter, were exercises in inequality and an unfree economy. Indeed, inequality was the very virtue of such incorporations, as charters were granted in order to elevate the economic and legal rights of the corporation in question above those of their

1 All references in this book to English law are to include the law as it applies to Wales.

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actual and potential competitors. For example, in 1600, the East India Company's charter granted it monopoly trading rights,[2] covering the whole of the East Indies.

As charters were prestigious favours granted by sovereign power (originating with monarchical prerogatives), they created privilege rather than equality. Yet despite the desirability of such privilege, in Britain at least, such privilege precipitated the demise of the charter company as a viable business form following the dramatic and fraudulent activities of the most notorious of such entities, the South Sea Company.

The South Sea Company's scheme, to buy government debt and exchange it for its own company shares, depended upon persuading the holders of government bonds and debentures that these shares were highly valuable commodities. In order to do this the directors needed to push up the share price, and, as the company did no real trade, this could only be achieved by legal device, hype and extravagant claims designed to create demand. Problematically, its initial success in raising share prices spawned a general clamour to buy shares in other companies and associations which spurred the government, which was deeply interwoven in the South Sea Company's affairs, to pass the hastily drafted Bubble Act of 1719;[3] an Act which prohibited the sale of shares by associations operating without a charter.[4] It was thereby hoped that the more restricted availability of shares in the market would further enhance the value of South Sea company shares. This further enhanced the status of charter companies. However, the Act could only give a temporary boost to the South Sea Company and after just a few months' trading, its share price collapsed and with it the national economy. Therefore, as a result of this financial catastrophe, the Bubble Act, conceived as a short-term device, stayed on the statute books for 105 years and furthermore the ensuing shock and embarrassment to the English Government made it generally averse to the granting of charters of incorporation *per se*. The raising of joint stock had been described in the Act as 'dangerous and mischievous to trade', and the financial collapse of the South Sea Company seemed to evidence the truth of that statement.[5] Companies with freely transferable shares were not to be desired and in their place business developed under the form

2 Full name the Honourable East India Company, its first charter gave it a 21-year monopoly on all trade in the East Indies.

3 6 Geo 1 c 18.

4 The Act prohibited the raising of *freely transferable* stock without a charter, an emphasis which allowed the later growth of organisations which had some restriction on the transferability of stock.

5 Preamble to the Bubble Act. In contrast, the English judiciary was more sympathetic to those trading in shares. The first prosecution was in 1808 in Rex v Dodd, 9 East 516, and this was unsuccessful.

of partnerships and Deed of Settlement companies[6] so that ironically, an Act that was designed to suppress the use of unincorporated business associations resulted in encouraging their proliferation. In the words of AB DuBois, in his famous account of the 'business company' during the eighteenth century,

> The Bubble Act had decreed a 'new deal' for organised business, but the moral tone of the eighteenth century was not sufficiently advanced to appreciate the benefits of the new dispensation. In consequence, entrepreneurs and their legal advisors turned to the device of the unincorporated association to affect their ends, and in this they were remarkably successful.[7]

The obvious and unjustifiable privileges enjoyed by charter companies, exemplified by the activities of the South Sea Company, had contributed to the hardship of many small investors and general financial collapse. As a result, business in England retreated into a business form that was characterised by an *a priori* equality between members, the partnership. In contrast, America embraced the charter company form as a demonstration of political independence from England. As an English colony, the law relating to business in America originated in English common law; however, the colonialists' use or rejection of this tended to reflect the political relationship between colony and parent state. So, although the Bubble Act was extended to the colonies in 1741 it was for the most part ignored and there was therefore little resort to the burgeoning unincorporated associations of post-Bubble Act England as a vehicle for business.[8] Indeed, after the War of Independence, incorporation by a special Act, passed by individual state legislatures, became the most common method of incorporation.[9]

As in England, American States initially used charters to enhance the privileges of those so granted. In the early part of American economic history, incorporation by charter was first utilised by those dealing with basic utilities, transport (such as canals and later the railroads) and banking, where privilege was sought as a means to override other claims upon land and raw material that might have interfered with the development of these quasi-public services. Later, in the early part of the nineteenth century, charters were sought for, and utilised by, industry, thereby exporting privilege and

6 DuBois, AB, *The English Business Company after the Bubble Act 1720–1800*, Oxford: Oxford University Press, 1938.

7 Ibid, p 216.

8 14 Geo 2 c 37.

9 According to Professor Gower, this meant that American law distinguished the corporation as a public body rather than as a creature of contract, earlier than English law. Gower, 'Some contrasts between British and American corporation law' (1956) Harv L Rev Vol 69 No 8, 1372.

inequality into commodity production. The power to grant charters resided in individual state legislatures passing individual pieces of legislation. This effectively gave sovereign power to individual state legislatures to grant privileges for the same kind of benefits enjoyed first by the English monarch, and then by parliament, namely financial reward. However, unlike their reticent English counterparts, American state legislatures granted an enormous number of charters, the majority for general business usage and a few with the most desirable aspects of incorporation such as perpetual succession and limited liability.[10] As Berle and Means showed, State legislators granted less restrictive and more desirable charters to those who were able to influence or bribe them in some way.[11]

Other evidence suggests that the benefits accruing to State legislatures as a result of issuing 'special' charters were such that many States passed general regulating statutes (which set a model corporate form) to free up more time for the legislatures to concentrate on granting even more special customised charters.[12]

However, in the context of the emerging market economy, commercial practices that did not at least *aspire* to fairness were beginning to elicit criticism. The more industrially developed States in particular sought to replace the obvious privileges of the special charters with a generalised law. New York, for example, passed the first general incorporation Act in 1811. But, although a number of other States quickly followed suit passing their own general incorporation Acts, the effect was to further exacerbate inequalities. General incorporation laws tended to create a two-tier market for incorporations based on price; the wealthier capitalists maintaining their economic superiority through the 'purchase' of special charters, whilst the poorer capitalists endured the more restrictive criteria set out in their State's general incorporation Act.[13]

Another response to the inequity of special charters adopted by individual States was to make the practice of granting special charters unconstitutional, and therefore to prohibit their use. Louisiana, in 1845, was first to adopt an absolute prohibition and by 1875, 19 of the then 37 States had followed suit. Yet, despite the widespread practice of absolute prohibition, as late as 1875,

10 Butler, HN, 'Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges' (1977) Journal of Legal Studies.

11 Berle, A and Means, G, *The Modern Corporation and Private Property*, London: Macmillan, 1932. Privileges could include such things as perpetual succession and limited liability.

12 Op. cit., Butler, p 141. 'Since the general regulating statutes did not affect the demand for special charters and did not lower the marginal cost of production of many special charters (which did in fact occur after the passage of general regulating statutes) it leads one to speculate that the real purpose of these statutes might have been to enable legislators to capture additional rents from the production of additional charters.'

13 Ibid, p 143.

18 States continued to issue special charters. Indeed, as Butler indicates, so popular were the special charters and so keen were many legislatures to issue them that in those States where *partial* prohibitions in the constitution were ratified the granting and demand for special charters continued unabated. The first of such partial constitutions was ratified in New York in 1846, and contained a provision that became typical of the wording in constitutions subsequently adopted by other States.[14] It restricted the granting of special charters to 'cases where, in the judgement of the legislature, the objects of the corporation cannot be attained under general laws'.[15] This constitution proved a deterrent neither in New York nor in the four other States that adopted such 'qualified constitutional prohibitions against special Corporation Chartering'.[16] So, although Wisconsin adopted constitutional constraints in 1848, between this time and 1871 only 143 business corporations were created under a general incorporation Act whereas 1,130 were created as special charters.[17]

The inequity of the special charter was highly visible because those businesses that sought them were themselves highly visible. The larger the business, the more likely it would be to require a special charter, and to be able to pay for it. So, in the main, it was large manufacturing and mining industries that opted for the special charters. Burgeoning industrialisation meant that incorporators needed a flexible business vehicle that could accommodate commercial requirements and in this context the demand for flexible special charters increased, rather than decreased, and the State legislatures operating without constitutional prohibitions continued to profit. In the States that had some constitutional limitation on the issuing of charters, such as New York, legislators continued to benefit from lobbyists seeking a special charter. They were simultaneously appeasing public anxiety about unfairness and corruption by passing some restrictive legislation on granting special charters but significantly never having an outright ban.

In this context, the economic power that dominated corporate law was highly tangible and highly controversial; the best law was simply for sale and only the richest could afford it. However, this visibility deteriorated with the corresponding historical deterioration of the use of special charters that occurred with the conjunction of a number of developments. These included the expansion of previously state-based markets, the gradual domination of interstate trade and the clarification of a previously hazy area of law.

This 'hazy area of law' was the question of whether or not a corporation could trade in a state other than the one that had issued its charter. If it could,

14 Ibid. Illinois and Wisconsin in 1848, Maryland in 1851, North Carolina in 1868.

15 Op. cit., Butler, p 143, citing Poore, BP, Clerk of Printing Records, The Federal and State Constitutions, Colonial Charters, and Other Organic Laws of the United States 1363 (1878).

16 Ibid, p 144.

17 Ibid.

promoters could shop around in other states for the best, special charters thereby creating a national market in special charters. However, the material basis for this competition did not exist in the first part of the nineteenth century, as most industrialists were too small to engage in interstate trade generally and so the question was never tested in court. Thus, in the absence of clear guidance it was generally considered to be impossible.

This question only became significant in the second half of the nineteenth century, when post-Jefferson, America became a highly industrialised, economy. Civil war in the 1860s had accelerated growth, particularly in respect of infrastructure and mass production and, according to Hobsbawn, this propelled the American economy above the more 'quality-based' production of Europe. It was key to success in the war, particularly in respect of weaponry, where over three million rifles were consumed during four years of war.[18] Likewise, infrastructure was essential to the successful pursuit of war. By 1866, a country whose economy was previously characterised by geographical isolation was rapidly possessed of 36,801 miles of railroad.[19] More importantly, argues Hobsbawn, the norms of mass production established during the civil war continued in peacetime and production rocketed. Wool production in the 1870s was double that of the 1840s, and the production of coal and pig iron multiplied by five during the same period. Furthermore, America produced twice the amount of coal per person as was produced in England. In 1859, oil production stood at 2,000 barrels but by 1874, that figure was nearer 11,000,000 barrels. By 1876, the United States had 380 telephones compared to 200 in the whole of Europe.[20] Furthermore, in the post-war years up to 1900, the railroad grew from 36,801 miles to 193,346 miles. The GNP increased twelvefold during those years and the value of exports from American mills and factories grew from $434 m to $1.5 bn.[21]

During this period of rapid development, small local firms gave way to large companies that could and did monopolise whole areas of industry on a national level. Interstate trade provided the impetus to shop around for States with the most liberal charters, and in this context the 1869 decision in *Paul v Virginia*[22] was made. The question in this case was whether the state of Virginia could impose restrictions on a 'foreign' company (one incorporated outside Virginia), selling insurance in Virginia, that were not imposed on 'native' companies. Although the Supreme Court held that it could impose such restrictions, the by-product of the case was the judicial recognition that a state could not prohibit a foreign company from doing interstate business

18 Hobsbawn, E, *The Age of Capital 1848–1875*, Weidenfeld & Nicolson 1997.

19 Urofsky, M, 'Proposed federal incorporation in the progressive era' (1982) The American Journal Of Legal History Vol XXVI.

20 Figures from Hobsbawn.

21 Op. cit., Urofsky.

22 75 US (8 Wall) 168 (1869).

per se. This set aside the final barrier to a free market in incorporations, or in Butler's words, 'once the spatial monopolies for corporate privileges had fallen away after *Paul*, legislators faced new challenges and new opportunities in the changed legal environment'.[23]

One such opportunity open to state legislators was to attract incorporators from other States by passing desirable general incorporation laws which would enable that state to enjoy revenue from the sale of incorporations and associated taxes. This opportunity was first taken by New Jersey (a state which already had a history of innovation in respect of incorporations)[24] and in 1875, it passed the first in a number of Acts considered to be the blueprint of modern general incorporation Acts.[25]

The provisions of a cheap alternative to the special charter brought an end to that most lucrative activity. In addition to this, as we shall see, it set in motion a competition between States for incorporations which accelerated a tendency to make corporate law large-investor-friendly.

THE ORIGINS OF MODERN COMPANY LAW IN ENGLAND

In England the origins of *modern* company law derive from unincorporated associations rather than seventeenth-century charter company law. The bursting of the South Sea Bubble shifted the trajectory of English company law, so that instead of legal precedent arising from the seventeenth-century charter company activity, it arises from nineteenth-century partnership law because the modern company emerged in a period when businesses tended to organise as partnerships. So, as early-nineteenth-century companies drew from the normative legal values of the partnership based on contract and agency law, the law of companies could lay claim to contractual notions of choice, equality and consensus. And, although modern company law has since drawn a clear distinction between itself and partnership law, the ideological claims to contractual equality persist.[26]

Historically, the corporate form was not commonly used until the latter half of the nineteenth century. It was facilitated first by the Companies

23 Op. cit., Butler, p 156.

24 In 1846, in response to the huge demand for special charters, the Democrat-dominated New Jersey had passed a revised incorporation Act designed to increase the desirability of incorporation by general law and so dampen demand for the special charter.

25 Its procedure was simple: it required a manned office within the state, but there was no necessity for the incorporators to reside in New Jersey.

26 Most notably in the American academies. Exemplifying this contractual approach to company law is Easterbrook and Fischel's *The Economic Structure of Corporate Law*, Harvard University Press, 2001.

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