Chapter 5.1 The Scope of Company Law

Introduction

5.1.1 This part of the Document is concerned with identifying the proper scope of company law, that is, whose interests it should be designed to serve and the legal means by which it should do so. We acknowledge that these apparently philosophical issues may seem remote from the reality of business, but believe it is important that the framework of company law is built on sound foundations. The underlying objectives identified here will also influence our broader approach. In addition, the DTI's March 1998 Consultation Paper specifically invited us to consider these issues.

5.1.2 The Review is essentially concerned with **law** reform, not 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. So we focus on the components of such reform – i.e. directors' and shareholders' powers and duties, their extent and limitations, and related rights, remedies and liabilities. Proposals for **legal** reform can be expressed only in such terms. However, behaviour in this field is influenced by a wide range of other factors, which motivate and guide those involved. Design of the law needs to recognise the importance of these. It also needs to recognise that some important key concepts vary in meaning over time as well as in different contexts.

5.1.3 'Shareholder value' is an example[22]. As the law stands, it is essentially for the members of a company to define the objectives which they wish it to achieve. For example, a company may be set up for a social or charitable objective and in those circumstances it will be for the directors to operate the undertaking to achieve that objective, which can be said to represent value for shareholders in the context. Even in the case of commercial companies, with which this Chapter is primarily concerned, what amounts to the interest of the members is essentially for them to define and this can be expected to change over time and as the business develops. Also as societal values develop so those exercising power and influence over companies will adopt policies and attitudes which reflect these developments. There are often similar changes in the

22: 'Shareholder value' has been much emphasised recently as a concept which disciplines and focuses the powers of directors towards accountability to shareholders; as we make clear below, this is quite consistent with the present legal framework.

life-cycle of a company. The relationships of a young or start-up company with key constituencies, such as investors, employees and suppliers, will require very different treatment from those of a mature listed one. The objectives of 'shareholder value', ' shareholder wealth' and broader 'welfare', to which we refer frequently below, are therefore flexible and developing concepts. The law must be defined in a way which leaves room for all these variations and for an effective combination of legal engineering with wider market and societal dynamics. For example, one of the most important influences on the behaviour of directors and members is the market in corporate control (which operates typically through takeovers and mergers). Indeed, its direct effects on the behaviour of directors may be more important than those of the legal rules we examine below. But the operation of that market is in turn dependent on those rules.

Current Legal Framework

5.1.4 The present structure of the law reflects three purposes. Companies are formed and managed for the benefit of *shareholders*, but subject to safeguards for the benefit of actual and potential *creditors*. Accounting and disclosure requirements, too, operate for the benefit of actual, and potential, shareholders and creditors (including investors and savers) and, through public disclosure of information, for the benefit of *the community as a whole*.

5.1.5 The law on the formation and management of companies serves the interests of shareholders by conferring on them ultimate control of the undertaking[23]. This operates, broadly, as follows. They purchase shares in the enterprise with money or other assets, either by direct investment on the issue of shares, or by purchase of shares of earlier investors. In return the law confers control over management to ensure that the proceeds of that investment are managed in their interests, normally that its value is increased over time. They are entitled to get the benefit of that value either by distributions, normally cash dividends, or by the sale of shares, or by realising the value of the undertaking in a winding up. The directors are required to manage the business on their behalf, being obliged by *fiduciary duties* which require them to do so honestly,

23: The main economic justification offered for this approach is that members have greatest exposure to residual risk as a result of mismanagement of these resources and are therefore best qualified to ensure proper stewardship – see Easterbrook and Fischel, Economic Structure of Corporate Law, Harvard, 1991, pp. 11, 28-39, etc.

in their best judgement, for the benefit of the company. This normally means for the benefit of the shareholders as a whole. Directors must exercise the powers conferred on them for their *proper purposes*, and subject to duties of *care and skill*[24]. If a director fails to comply with his duties, the company, through its directors, (and in certain circumstances members individually or on the company's behalf) may sue him, and members may dismiss him. Company law confers an entrenched right on the members exercising a majority of the votes to dismiss any director. Shareholders also have ultimate control over directors' appointments[25]. The law recognises that it is essential for directors to have a discretion in the way they manage, and legal actions will not interfere with proper exercise of such business judgement. Moreover, in reality directors' market power, in particular scarcity of effective management skills, and influence over information, may inhibit shareholders' ability to exercise their remedies, as may the difficulties they face in practice in co-ordinating the use of their voting rights.

5.1.6 This system of ultimate control is exercisable subject to an overriding obligation to ensure that creditors are not wrongfully exposed to insolvency, through general duties imposed by company[26] and insolvency law and special safeguards which apply to protect creditors in particular transactions (such as distributions of profits or capital). As already noted this system is also subject to wider duties of accountability which apply to the enterprise as a whole, members and management.

5.1.7 Any proposals for change in the scope of company law thus need to focus on possible reforms in these key components, namely the fiduciary obligations of directors, remedies exercisable by members, at law for their breach and by powers of dismissal, and accountability to wider audiences. (More specific creditor protections are not controversial in broad purpose and are not therefore considered here).

24: Directors are also subject to a duty to act fairly as between members.

25: Directors' appointments in public companies come up for regular renewal, typically every three years; reappointments and new appointments require members' approval in general meeting.

26: See West Mercia Safety Wear v Dodd [1988] BCLC 250 (Court of Appeal).

The Main Arguments for Reform

5.1.8 We approach this within the framework of the principles outlined in Chapter 2, in particular that the objective of reform should be to achieve competitiveness and efficient creation of wealth and other benefits for all participants in the enterprise. At the same time, and to the extent it is appropriate to use the mechanisms of company law, the aim should also be to minimise the negative impacts of corporate activity on participants and to maximise welfare more widely.

5.1.9 The principal arguments which are advanced for change are that the present scheme of the law fails adequately to recognise that businesses normally best generate wealth where participants operate harmoniously as teams and that managers should recognise the wider interests of the community in their activities.

5.1.10 We focus first on relationships between participants in the business activity of a company. During the course of this century a range of concerns about how interests of such participants are balanced have been expressed. Prior to the high level of concentration of shareholdings in the hands of institutional investors, which we see today, and the development of an active market in takeovers, it was often argued that management escaped effective shareholder control and that in consequence many companies were inefficient. More recently it has been suggested that pressures from shareholders, or managerial perceptions of such pressures, have inhibited long-term investment in value-creating internal and external relationships, as well as in physical assets and other intangibles. Not all such relationships need to be co-operative and long-term; but very often relationships of this kind are important ingredients of success. Relationships founded on mutual trust make it more likely, for example, that employees of a company will acquire high levels of skill and knowledge, particularly of a firm-specific kind (i.e. of less value in another employment). Similarly, suppliers of goods or services to the company will make investments in plant or organisational capabilities geared to the needs of a particular customer. Such relationships between the company and its customers also lead to benefits of stable and efficient markets downstream in the supply chain. To express these points from a different perspective, in modern business it is arguably no longer necessarily the case that shareholders are the sole repositories of residual risk which cannot be diversified away. Other

participants may be in this position; and the relationships with such participants may be important (albeit intangible) assets of the company.

5.1.11 There are two broad forms of argument of this kind, which we shall call, for ease of reference, the Enlightened Shareholder Value[27] and the Pluralist approaches.

Enlightened Shareholder Value

5.1.12 Those who adopt an approach of this kind argue that the ultimate objective of companies as currently enshrined in law – ie to generate maximum value for shareholders – is in principle the best means also of securing overall prosperity and welfare. Many who take this view point out as well, however, that in practice neither maximum value for shareholders, nor overall prosperity and welfare, may be achieved. This is said to be because management may fail to recognise that the way to success is in many cases through building long term relationships dependent on trust (and that, where this is so, this is what the law requires). It is argued that exclusive focus on the short-term financial bottom line, in the erroneous belief that this equates to shareholder value, will often be incompatible with the cultivation of co-operative relationships, which are likely to involve short-term costs but to bring greater benefits in the longer term. Thus the law as currently expressed and understood fails to deliver the necessary inclusive approach.

Pluralist Approaches

5.1.13 Others argue that the ultimate objective of maximising shareholder value will not achieve maximum prosperity and welfare. In their view company law should be modified to include other objectives so that a company is required to serve a wider range of interests, not subordinate to, or as a means of achieving, shareholder value (as envisaged in the enlightened shareholder value view), but as valid in their own right[28]. This kind of approach inevitably

27: This concept is often referred to in the literature as 'enlightened self interest'. We prefer the label 'enlightened shareholder value' because the concept is of a broad and well informed view being taken of what is required to enhance the value of the business, by both directors and shareholders. But the point is only semantic – the concept is explained below.

28: See, for example: M Blair: *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (1995); J Kay and A Silberston: 'Corporate Governance' in National Institute Economic Review, August 1995.

involves a need to balance potentially conflicting interests. It envisages circumstances in which some sacrifice of the interests of shareholders will be needed in favour of some other interest. It is convenient to call this kind of approach 'Pluralist', because it argues that the interests of a number of groups should be advanced without the interests of a single group (shareholders) being overriding.

5.1.14 In this framework, if directors' duties are still to be envisaged as owed to 'the company', the company can no longer be regarded as just the association of shareholders which created it, and their successors in title. It needs to be regarded as embracing others who make commitments to it, typically employees and other suppliers of goods and services, and perhaps customers. The argument is that, by treating the commitments of such parties as investments deserving the same kinds of consideration as those of members, such commitments will be encouraged and better utilised.

5.1.15 One perspective on these approaches views companies as institutions, with their own distinctive personalities and capabilities, not wholly reducible to those of their shareholders, managers and other participants at any given time. Certainly the practice of referring to companies as entities in their own right, with their own ethos, has moved beyond the technical legal fiction of corporate personality to become a normal way of expressing the objectives and character of large businesses. But to the extent that the concept is to be reflected in law, the need to reduce it to rights, powers and duties remains. Management policies designed to further the success of the business as an entity will often be beneficial both to the shareholders and other participants in it, and might be distinguished from policies that merely respond to short-term financial indicators. There will inevitably be situations, however, in which the interests of the shareholders and other participants will clash, even when the interests of shareholders are viewed as long-term ones. Examples include a decision whether to close a plant, with associated redundancies, or to terminate a long-term supply relationship, when continuation in either case is expected to make a negative contribution to shareholder returns[29]. In such circumstances the law

29: Those adopting the pluralist position argue that a decision to close the plant or discontinue the relationship, while maximising shareholder returns, will not in all circumstances maximise social wealth. Where the employees or the supplier have made firm-specific investments they are likely to share in the economic surplus generated by the project; though the returns to the shareholders may now be negative, the overall returns may still be positive. See Blair, above, footnote to paragraph 5.1.13, ch 7.

must indicate whether shareholder interests are to be regarded as overriding, or some other kind of balance should be struck. This requires a choice, we believe, between the enlightened shareholder value and pluralist approaches. An appeal to the 'interests of the company' will not resolve the issue, unless it is first decided whether 'the company' is to be equated with its shareholders alone (enlightened shareholder value), or the shareholders plus other participants (pluralism).

5.1.16 We now examine the implications of these approaches for law reform in more detail.

Enlightened Shareholder Value, Directors' Duties and Section 309 of the Act

5.1.17 Because the enlightened shareholder value approach is not dependent on any change in the ultimate objective of companies, that is, shareholder wealth maximisation, there would be no need, under this approach, to reform the fundamentals of directors' duties. Similarly there would be no need to alter the rights of the shareholders to appoint or dismiss directors, though there is concern in some quarters that the use of these rights, particularly in the context of an active takeover market, may mean that directors are subjected to pressures of a narrow and short-termist kind. One way of reducing these pressures would be greater disclosure, which is addressed below. In this section we consider the most appropriate formulation of directors' duties to give effect to the enlightened shareholder value perspective. The argument is that these duties, as currently expressed, and as interpreted in practice, often tend to lead to an undue focus on the short term and the narrow interest of members at the expense of what is in a broader and a longer term sense the best interest of the enterprise, and thus its value to them as ultimate controllers able to realise that value.

5.1.18 The key company law provision is for the fiduciary duties of directors[30]. These require them honestly ('in good faith') to manage the undertaking for the benefit of the company. That

30: See Chapter 7 for a description of the current consideration by the Law Commissions of a number of related issues, including the case for restating the law in statutory or some other form.

benefit is defined by case law as the interest of members present and future[31]. The duties of directors to exercise their powers for their proper purpose are also relevant. These, for example, prevent directors from using their powers to impede the exercise by members of their rights to dispose of their shares, such as by issuing new shares to allies to defeat a takeover bid.

5.1.19 It is in our view clear, as a matter of policy, that in many circumstances directors should adopt the broader and longer-term ('inclusive') view of their role. This is indeed now widely acknowledged[32]. But we do not accept that there is anything in the present law of directors' duties which requires them to take an unduly narrow or short-term view of their functions. Indeed they are obliged honestly to take account of all the considerations which contribute to the success of the enterprise.

5.1.20 There is nevertheless considerable evidence that the effect of the law is not well recognised and understood[33]. This may be in part because the relevant principles are not enacted, but have to be derived from quite extensive case law, developed over 250 years and rooted in the eighteenth century law of trusts. The situation is also complicated by the statutory redefinition (or extension) of the directors' core duty in what is now section 309 of the Act, which declares that

> '309 (1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.
>
> (2) Accordingly, the duty imposed by this section on the directors is owed by them to

31: The reference to future members causes some difficulty; there is little sense in imposing a duty in favour of a class which is unidentifiable and unable to enforce it. But, once it is recognised that the interest of members at any time consists of an interest in the value of the enterprise as a revenue generating entity in the future, including the medium and longer term, this problem largely disappears and we doubt whether it requires any special new provision. If members choose to pursue directors on the grounds that their judgement of the value to them of the enterprise over the longer term is unduly high at the expense of their short term interests the courts can be expected to respect the directors' judgement; it is for the very purpose of exercising such strategic judgements that the directors' discretion is conferred.

32: Committee on Corporate Governance, Final Report (the Hampel Report), January 1998, para 1.18.

33: See Promoting Prosperity – A Business Agenda for Britain, CPP/IPPR (1997), pages 90–118; and M. Goyder, Living Tomorrow's Company, Gower Publishing Ltd, (1998), Chapter 7.

the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.'

5.1.21 Section 309 is arguably a statutory declaration of an enlightened shareholder value duty**,** requiring that directors consider the interests of employees in reaching a view of what is in the best interests of the company. That this is the effect intended is confirmed by its declaratory character, by ministerial statements in Hansard[34] and by the unusual statutory language emphasising that the duty 'is owed to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors'. If the intention had been to redefine how the interest of the company was to be determined the legislation might have been expected to have made this explicit. But an alternative view is possible – ie that the provision has changed the law by requiring the directors to consider the interests of employees *'as well as'* the interests of members so that, where they consider it appropriate to do so, they may override the interests of members and favour employees at members' expense. This approach is at odds with the framework of a *duty* to do so, owed to the company, however, since the company (which would enforce such a duty) and the composition of its board is ultimately controlled by the members. It is clear that employees have no remedy under the section; but the provision would nevertheless under this interpretation confer an immunity on the directors, who would be able to resist legal actions by the shareholders based on the ground that the directors had neglected their normal fiduciary duty to them in favour of employees[35]. If this is the effect of the section then it is a variant of the Pluralist approach[36].

5.1.22 That the law is widely misunderstood suggests that there is a strong case for making explicit its true character. The object would be to ensure that directors recognise their obligation to have regard to the need, where appropriate, to build long-term and trusting relationships with employees, suppliers, customers and others, as appropriate, in order to secure the success of the

34: 1979 PARL DEB – HoC Off Rep – Standing Committee A – COMPANIES BILL [LORDS] – Col 360 (Statement of Cecil Parkinson, Minister for Trade). See also 'Gore-Browne on Companies (44th edn. ed A Boyle and R Sykes) Vol II para 27.4.1.

35: The provision might also constitute a defence to an action for breach of contract so that any dismissal would lead to compensation.

36: There are some judicial dicta in support of this view – Fulham Football Club v Cabra Estates [1994] 1 BCLC 363 (CA).

enterprise over time. One option for achieving this would be primary legislation. This would need to be expressed in subjective terms, as current fiduciary duties are, to ensure that the difficult decisions involved in evaluating the relevant benefits are reserved to the directors' business judgement. The use of primary legislation would cause some difficulties in this area, where flexibility and responsiveness to changing needs is of particular importance. An alternative approach would be to make some kind of public statement of the position, authoritative but not in binding legal form ('a Highway Code'), to ensure the law was properly understood and applied[37]. It is important that such a non-statutory statement should be authoritative and there are difficulties involved in achieving this.

5.1.23 The uncertainty about the effect of section 309 also complicates the position. Mere repeal, with or without a non-statutory statement, would be technically feasible if it were thought desirable to resolve the uncertainty in favour of the enlightened shareholder value approach. Giving effect to the pluralist interpretation, on the other hand, would require the existing section to be amended to make clear that interests of shareholders are not necessarily overriding. It might also require reform of the rules conferring ultimate control on shareholders[38]. This brings us to the question of the merits, or otherwise, of going further in the pluralist direction.

The Pluralist Approach

5.1.24 The case for reformulating directors' duties to give effect to the pluralist approach is as follows. The present law, in making shareholders' interests ultimately overriding, may create, or reinforce, an environment in which relationships of trust are difficult to sustain. This increases the level of inefficient risk between those managing companies and employees, suppliers and others, on whom the company depends for factors of production[39] and who depend in turn on the

.37: Whether directors' duties should be restated in statutory form, or their content made accessible to users in some other way, is a matter which the Law Commissions are currently considering. The 'stakeholder' issues that arise here, however, are not within the Commissions' terms of reference. See paragraphs 7.3, 7.14 and following, below.

38: If the law is to impose effective pluralist duties on directors with remedies, rather than an open discretion or a duty owed to no one, which appears to be the effect of the second view on section 309.

39: This argument operates equally for suppliers of labour, or employees, as it does for other suppliers. We recognise that there may be a basis for differentiating, on the ground of employees' closer relationship with the business. But the extent to which this is the case will depend on circumstances, and good relationships within the supply chain are in many cases of critical importance.

company for a secure environment within which to make the commitments necessary to provide them. Since the duty of directors is ultimately to further the interests of shareholders, parties who might otherwise make firm-specific investments in a company (such as employees who acquire specialised skill or suppliers who invest in tooling necessary for a particular customer) will be reluctant to do so, because of the level of risk to which they are exposed. Such investments are risky because they cannot be transferred to other uses without significant loss of value, and are difficult to protect contractually because of their long-term nature and the problems involved in predicting and providing for future contingencies. The pluralist view asserts that present law (even when understood in an enlightened shareholder value form) fails to cater for these considerations, because such firm-specific investments are best regarded as assets of the company as a wealth generating entity distinct from its members. Its directors should be accountable for the stewardship of the company's assets and the maximisation of their value for the benefit of all contributors and not just its shareholders. Only against the background of a regime which permits or requires directors to treat non-member participants in that way can they be expected to undertake the necessary commitments. A further argument, which has the same effect, is that in modern companies it is no longer necessarily the case that shareholders are the sole repositories of residual risk which cannot be diversified away. The economic case[40] for giving shareholders ultimate control of the company is therefore no longer valid. Other participants may be in this position. The relationships with such participants should be regarded as important (albeit intangible) assets which directors should be bound to manage effectively.

5.1.25 There are a number of possible counter arguments to such pluralist views. First, it may be argued that in practice a broad enlightened shareholder value approach would provide an adequate environment for the development of such relationships. It is not clear that the trade-offs of shareholders' interests against those of other participants which the pluralist approach envisages would be necessary in practice. (This would perhaps be more effectively recognised if the value to shareholders of the relationships in question were more explicitly reported and accounted for).

40: Compare the first footnote to paragraph 5.1.5.

5.1.26 Second, it is not self-evident that the normal process of bargaining between suppliers and consumers of factors of production is incapable of generating appropriate safeguards or incentives for all sides. If there are problems because parties lack the information necessary for efficient bargaining it should be possible to make institutional arrangements to overcome these within the framework of company law as it is. For example, the company might opt for a representative of the relevant interest groups on the board, as a means of channelling information to and from them[41].

5.1.27 Third, it may be argued that if there are deficiencies in this area they are best made good by changes in other areas of the law and public policy, or in best practice, rather than by making changes in company law, which might have unpredictable and damaging effects. Examples include ideas about promoting co-operative 'clusters' of businesses and partnering in the supply chain. In the employment field, the possibilities include increased levels of consultation and information with, for example, provision of information about training policies to recognised unions and consultation in the workplace, perhaps based on partnership agreements. Such developments operate within, and consistently with, the present company law systems of control, accountability and responsibility. So they require no company law reform[42].

5.1.28 There is a fourth argument, that to change the present focus of directors on increasing the value of the business over time, subject to clear single channel accountability to members, in favour of some broader objective involving the trade off of interests of members and others (with whom the company is in some aspects in an adversarial bargaining relationship), would dangerously distract management into a political balancing style at the expense of economic growth and international competitiveness.

5.1.29 For the argument for pluralism to be accepted it needs to be maintained that the net benefit, in overall welfare terms, of encouraging firm-specific investment by the proposed legal

41: Such a step solves the information problem, but would not, of course, give true representation to such interests, as the representative member will continue to owe fiduciary duties to the company.

42: In the case of mandatory workplace consultation, which involves a bona fide inclusion of workers' representatives in the decision making process, albeit not in the decision, the boundary between labour law and company law looks an artificial one.

means, after taking account of the necessary disadvantage to shareholders, outweighs these possible objections.

5.1.30 At the minimum, implementation of the pluralist view would require a reform of the law of directors' duties to *permit* them to further the interests of non-shareholder participants – that is employees, customers and suppliers – even if this were to the detriment of shareholders. A possible variant would be a duty *requiring* them to promote the success of the company as a business enterprise in this way – ie with the interests of none of the participants, including the shareholders', being regarded as overriding. Such directors' duties would need to be expressed subjectively to confer a wide range of discretion, but we would not favour the contentious issues involved being litigable. At the same time we also see difficulties in merely enabling directors to diverge from the enlightened shareholder value objective, since there would be no formal remedy for abuse of the powers conferred (though the provisions against the directors furthering their own interests would remain in place). Arguably this would create a dangerously broad and unaccountable discretion, unless sufficient additional safeguards can be devised.

5.1.31 More extensive reform in a pluralist direction might require changes in the *shareholders' control* over the company through their ability to determine the composition of the board. This seems inevitably to raise the question of constituencies other than members having power to nominate board members, or of there being some self-electing or internally appointed component on the board tasked with securing broader objectives[43]. Wider issues on board composition, the role of non-executive directors, etc, will be addressed at a later stage in our work. But we note here that arguments are not being strongly expressed currently for employee, or wider, representation on company boards as a mandatory requirement and that even in the most well developed version of employee participation, in Germany, ultimate control of the company does in fact rest in the hands of members, through the casting vote of the chairman (appointed by the members) of the supervisory board. There is however an argument that such arrangements for modifying board composition could be structured in a way which reduced to some degree the pressure of members on management and created a system of broader accountability.

43: See Kay and Silberston (see the footnote to paragraph 5.1.13), the Dutch regime, paragraph 4.20, above, and the discussion of US stakeholder statutes (paragraph 4.14 and footnote) above.

5.1.32 Proposals to alter board composition to require wider representation as a mandatory requirement would represent a very radical change to British corporate culture and would be unlikely to command wide support[44]. There must in any case be doubt whether their objective cannot be more satisfactorily achieved through a regime of enlightened shareholder value combined with improved information flow and greater disclosure.

5.1.33 But there may be a case for *enabling* companies to adopt such board structures if they wish. Companies will differ in the extent to which firm-specific investment is important for their commercial success. There may be a case for a change in general company law to allow companies to adopt a more pluralistic board structure, leaving it to them, responding to market and other pressures and demands, to decide whether or not to exploit such a new option. It is in fact likely to be necessary, assuming that the European Company Statute is eventually agreed, to provide in UK legislation that a European Company which registers in the UK, and thus adopts UK law to govern its internal arrangements, may adopt a split board participatory structure. (Such a structure may be required to be agreed to by those forming such a European Company, in order to satisfy the demands of employees of one of the constituent companies, with supervisory board level employee participation in its country of origin, that the new European company should give them equivalent protection.) At present such structures are not possible under UK law, or are possible only by very artificial devices, because the duties and functions of all board members are ultimately the same[45]. However, the proposals for the European Company have been developed in the context of employee participation; as we have made clear we believe the case for optimising relationships to which companies are party is a broader one. To make such a mechanism available on an optional basis would be a major change and we could not advocate it unless there were strong demand for it.

44: Removing the ultimate control of the shareholders would inevitably affect the value of their interests. Such an impairment of their interests could well breach the provisions of Article 1 of the First Protocol to the ECHR, which protects the right to property. The German Constitutional Court, interpreting similar provisions in the German constitution protecting the right to property, upheld the constitutionality of the statute mandating employee participation in Germany. But this was partly on the grounds that the casting vote of the Chairman of the supervisory board, who was elected by the shareholders, preserved ultimate shareholder control. (Judgement in English in European Commercial Cases, Vol. II, Part 6, July 1979 at p. 324).

45: For example, it is not possible to have one element of the board appointed by another, or one part alone being responsible for scrutiny of the auditors' report.

Takeovers, other offers for shares and Mergers

5.1.34 The interests of those with relationships with a company and of the wider community are often affected by proposals to transfer shares, and thus control of the company, or for a merger in some other form. The commercial case for such transactions is often dependent on cost savings in the form of redundancies, or plant closures, and may involve the transfer of corporate headquarters. Such changes may also be very unwelcome to the directors of the target company in question.

5.1.35 Under the present law and practice directors are prevented by the "proper purpose" principle, and, in the case of takeover offers for public companies resident in the UK, by the City Code on Takeovers and Mergers, from exercising their powers in a way which frustrates the bid[46]. This might be done, for example, by issuing shares to a friendly third party, establishing generous pension arrangements, or engaging in commercial transactions on behalf of the company which undermine the bidder's plans.

5.1.36 Directors are required under the Code to give shareholders sufficient advice and information to enable them to reach a properly informed decision about whether to accept a bid. The Code requires such advice properly to explain the impact of the proposal on the company, including on the continued employment of its employees[47]. This is entirely consistent with the present law. Shareholders in exercising their power of sale are free to take account, generally speaking, of any considerations and should be properly informed of the implications of their decisions.

5.1.37 The first issue in the context is what the meaning and implications are of the directors' fiduciary duty to the company to manage its affairs so as to serve the best interests of shareholders present and *future*. The problems of this formulation have been discussed above. See the second footnote to paragraph 5.1.18. If this is taken to mean, as we believe it should, the immediate and longer-term interests of the present shareholders, then the directors' duties are clear. They should run the company so as to maximise its value for present shareholders, bearing

46: See City Code on Takeovers and Mergers ("Code") General Principle 7 and Rule 21.

47: See Code, Rule 25.2 with Rule 24.1. See too General Principle 9.

in mind this will often require them to adopt a longer term perspective. Their duty to give advice is a separate matter, but should be performed in a way which is consistent with this. The advice should enable shareholders to decide whether or not, having regard to the prospects of the company under their control, it is in their interests to sell at the price, or on the terms, proposed. We believe that this is what happens in practice. Literal reference to the interests of future shareholders in this context is not helpful as the outcome of the decision in question will determine who they are to be.

5.1.38 The second issue is more problematic. For what purposes should the directors be regarded as free or obliged to exercise their powers in such circumstances, not in order to frustrate the bid, but to secure the best interests of the company? Under the enlightened shareholder interest approach it seems clear that directors should continue to conduct the business in a way which secures maximisation of shareholder wealth, but bearing in mind the reality of the offer, and leaving shareholders to decide whether or not to sell. Under a pluralistic approach, however, the issue arises of whether directors should be free, or even obliged, to consider the competing interests of employees, suppliers, and the local community. These may demand that steps should be taken, in the best interest of the company defined in an inclusive way, which have the effect of preventing, or inhibiting, the bid. This appears to be the effect of at least some of the American stakeholder statutes (see paragraph 4.14, above). It may be possible to adopt a pluralist appproach without allowing or requiring directors to intervene in this way, but perhaps at the price of consistency[48]. Arguably to prevent directors from serving wider interests in such circumstances would deprive the approach of its effect in the cases where it is needed most. The issues are not easy and we would value the views of consultees.

Further Work

5.1.39 To analyse the options in terms of a contrast between enlightened shareholder value and pluralism in company law may be to give a distorted picture. The objective is to provide the conditions for optimal co-operative relationships. Company law is only one means of achieving

48: It may be argued that there are powers under the Fair Trading Act 1973 and the Industry Act 1975 to prevent takeovers etc which are contrary to the public interest, but such powers can only be used in a small minority of cases and are of restricted application.

this – there is a range of other means which could be utilised or improved but which fall beyond our terms of reference. We propose to undertake further theoretical and empirical research into the options, and more widely, addressing, for example, the following questions, so far as it proves feasible to do so – What are the necessary preconditions for human capital or supply chain investment? To what extent are the wider objectives of 'inclusive', or enlightened shareholder interest, companies reflected in higher levels of commercial success? Do such companies generate an enhanced level of confidence in their suppliers, employees and others so as to enable optimal levels of firm-specific investment on their behalf, and if not, what further provision, in the form of information systems or otherwise, is necessary?

Social and Ethical Constraints

5.1.40 The argument that companies should respond to a range of demands beyond the interests of their members, and that company law should reflect this, goes wider than the need to ensure effective business relationships. There are also claims that corporate citizens should behave ethically and should have regard to a range of public interests. In the course of generating wealth companies may cause various kinds of external harm of which society disapproves – damage to health and safety, abusive employment or contracting practices, and environmental damage. The normal public policy response is specific legislation applying to all, not just companies; this imposes constraints but does not interfere with the profit maximisation motive as it operates subject to those constraints. Such targeted legislation is of prime importance, but there are limits to what it can achieve. It is slow to be introduced and adjusted, relies on minimum rather than aspirational standards and cannot adjust to specific circumstances.

5.1.41 Here again the two kinds of view are possible, based respectively on the enlightened shareholder value and pluralist approaches. The first is that companies which are properly managed and controlled by directors and members with long term vision and insight will in their own enlightened self interest ensure that they take proper account of these wider objectives. Increasing importance is now rightly attached by companies to their dependence on corporate reputation for commercial success; they are under increasing scrutiny from governments, regulators, the press, pressure groups and non-governmental organisations and the communities

in which they operate; employees and investors are increasingly aware of the risks and difficulties of involvement with companies which have an unacceptable reputation.

5.1.42 A more pluralist view would assert that to work properly such market mechanisms require a fuller system of disclosure than company law currently provides and that there should also be a readiness on the part of companies to sacrifice their own self-interest in appropriate cases. One response is therefore to increase accountability through greater transparency. A second response would be to adjust directors' duties. It is arguable that for practical purposes the latter is unnecessary. Adoption by directors of high ethical standards (for example the adoption of the highest standards in the employment or environment field) is unlikely to be held by the court to be beyond the range of permissible judgements about the optimal positioning of the company. It is in any case improbable that shareholders would seek to exercise their powers to castigate such practices. However, it may be argued that, as a matter of principle, the law should be changed to allow directors a discretion to sacrifice commercial advantage for ethical or public objectives. The American Law Institute has adopted a provision of this kind, conferring a discretion on directors to subordinate the interests of the shareholders to wider ethical considerations which may reasonably be regarded as appropriate to the responsible conduct of the business[49]. As an alternative the law could be expressed in mandatory language, though it would be impracticable and undesirable for such a provision to constitute an enforceable duty. The issues to which such an obligation would give rise are not ones easily resolved by the courts and the possibility of litigation could create damaging uncertainty. Nevertheless, we would welcome comments on whether a mandatory formulation would be of value in encouraging directors to take account of ethical considerations.

5.1.43 A related issue is company philanthropy and other forms of corporate community support. It seems likely that much of the activity currently found in this area has a commercial foundation, for example, because it may help build the company's positive reputation with customers and others. It is possible, however, that directors may currently engage in corporate generosity towards deserving causes which has little if any genuine relationship with the

49: American Law Institute, Principles of Corporate Governance, 1994, para. 2.01b(2). The American Law Institute is an association of American lawyers, academics and practitioners, which, inter alia, adopts codes and restatements of the law which are highly influential with US legislators and judges.

commercial interests of their companies. If this is considered desirable it should be properly authorised in law, subject to proper transparency or other safeguards. The American Law Institute Principles provide in this context that directors be permitted to expend a limited amount of company funds for philanthropic purposes, even though no benefit to the shareholders is likely to result[50]. It could, however, be argued that such a discretion would confer a power on directors to engage in largely unconstrained generosity, enhancing their personal reputation, or satisfying their personal predilections, at shareholders' expense without effective accountability[51]. Proper regard to the need to sustain and enhance the company's reputation, particularly if this is supplemented by greater transparency, may be sufficient to deal with the issue without creating such risks. We are not aware of pressure for wider discretion for directors in this field, but we would welcome comments on this.

The Relevance of Transparency and Public Accountability

5.1.44 We have already noted that in practice the fact that a company's accounts and reports must be published enables the public at large to evaluate its performance and bring pressure to bear on the company as a whole, both members and directors, so as to satisfy relational and wider social interests. Enhanced reporting obligations operating within a structure of enlightened shareholder value have the capacity in principle to achieve the objectives of a more pluralist approach, by ensuring that it is in the self-interest of members that such pressures should be satisfied. Effective reporting might also, by informing shareholders of the issues and their relevance, reduce short-term pressures by shareholders on directors. Such developments are better able than substantive prescription to cater for the diversity and flexibility referred to in paragraph 5.1.2 and 3 above; maximising wealth or shareholder value is, for example, best assessed qualitatively and in context. In general, effective reporting regimes can improve the climate of opinion on issues of acceptable and desirable corporate behaviour. This approach could avoid the difficulties which arise from adopting a more pluralist line, in terms of increased

50: American Law Institute, Principles of Corporate Governance, 1994, para. 2.01b(3).

51: Compare the Fifth Report of the Committee on Standards in Public Life (Cm 4057-1), Recommendation 35, which proposes that legislation should require shareholders' prior authority for political donations by companies.

directors' discretion and/or the creation of new stakeholder remedies and/or new structural requirements as to the composition of boards.

5.1.45 If wider, pluralist discretions are thought to be necessary for directors, but through permissive provisions, then reporting may still provide some discipline against abuse (though if members' powers are correspondingly diminished the reality of any such constraint will be debatable).

5.1.46 We have noted in Chapter 2 that company law reporting requirements at present pay little regard to the need to account for 'soft' assets and resources. These will include the level of skills and stability of the work force, established and stable trading relationships with suppliers, and the value of a company's reputation and brands, which are an important indicator of ongoing relationships of confidence with customers. In many of these areas, however, it is clear that adequate standards and benchmarks for reporting do not yet exist, capable of carrying the weight which is needed to establish effective pressures to ensure that there is an adequate response to this range of interests. There is also a danger, evident in some areas already, that reporting duties without real content will lead to perfunctory, 'boilerplate' compliance – costs without benefit.

5.1.47 There is however growing evidence of companies responding to such needs and of developing thought and practice, out of which standards may be expected to emerge. We attach great importance to the potential of company law to achieve a proper measure of corporate responsiveness to wider interests through transparency and accountability. We believe that this should include the wider environmental and social issues where the responsible exercise of corporate power has a major role to play. We intend to investigate the issues, and to make proposals if possible, as part of the next phase of our work.

Smaller Companies

5.1.48 Any change to the law will raise issues about coverage. In principle it seems that the purpose of company law is the same for all companies. In practice small companies may well often have a more equal bargaining relationship with their constituencies and be likely to be very conscious of the need to ensure that appropriate relationships are sustained. The objectives of

small or closely-held companies are often very much identified with those of their founders. Any case for a pluralist solution may therefore be weaker here. The individual impact of such companies on the environment and on other wider interests is also typically likely to be less, though in the aggregate it is substantial. Compliance costs in small companies tend to be disproportionately large.

5.1.49 We are inclined to think that any reframing of directors' duties which emerges should be of general application, but that any extensive reporting requirements or pluralist solutions should be restricted to larger, or perhaps listed, companies. However, this will need to be worked out in detail once we have developed concrete proposals in the light of this consultation. We would welcome views on these questions, which need to be addressed as an integral part of any proposal for major reform.

Questions for consultation

5.1.50 We would welcome comments generally on the analysis and views expressed above, but would be particularly grateful for responses on the following issues:

Question 1 **Should the present law requiring directors to have regard to the interests of shareholders as a whole remain in force:**

- **(a) without further clarification?**
- **(b) with some additional declaratory clarification to make it clear that directors, in determining the best interests of members, should take account of all relevant factors including the need, where the company depends on relationships with others, to take account of their interests?**

Question 2 **If such clarification is desirable, should it take the form of:**

- **(a) a statutory clarification of the position?**
- **(b) clarification by some non-statutory means, and if so what?**[52]

52: See the discussion in the Law Commissions' paper referred to in Chapter 7.

Question 3 **What (in the light, in particular, of the answers to the preceding questions) should be done about section 309?**

Question 4 **If the present law (with or without any clarification) is not to be retained, should:**

(a) some variant of the pluralist approach be adopted – ie conferring a power, or duty, on directors to have regard to the interests of those in relationships with the company, even at the expense of the interests of shareholders, where the directors believe the situation justifies it?

(b) is it agreed that it would not be desirable to make such a duty enforceable on behalf of those concerned?

(c) is an institutional solution (e.g. new board structures with representative directors) desirable to ensure proper exercise of any such power or duty, and, if so, should this be mandatory or optional and what form should it take?

(d) more generally (but bearing in mind the likely complexity of the law), should options be available so that more than one of the solutions considered in this part are available to be chosen by companies if they wish?

Question 5 **Should a power be conferred, or obligation imposed, on directors to have regard to wider social or ethical objectives, or to engage in philanthropic or community activity, at the expense of the interests of members, or does the present law already give appropriate powers in practice?**

Question 6 **(a) Should the present regime of accounting and reporting be modified in any way, with or without any of the substantive reforms mentioned in questions 1 to 5 above, in order better to secure that companies are operated to achieve their proper purposes, and if so how?**

(b) For example, are all or any of the following desirable for this purpose:

(i) a mandatory report on employee relations, supplier relations, customer relations, community relations, philanthropic activity and/or environmental performance?

(ii) more detailed changes to current reporting requirements, eg as to the disclosure of relationships and dependencies and of their value to the business?

Question 7 **If a pluralist approach is adopted, should directors be permitted, or required, in takeover and merger cases, to take action on behalf of the company to meet the interests of employees, suppliers and others above those of shareholders where they believe this is justified, even if this damages the prospects of the bid, or merger proposals?**

Question 8 **What parts of any such proposals, mentioned in questions 1 to 7, should be applied to small, closely-held or private companies and what additional requirements should be added for larger, public and listed companies and on what basis should the lines be drawn?**

The issue

5.2.1 A company may be regarded as small either because of its economic significance or because of the small number of its shareholders. In the latter case all the shareholders are often also involved in management, and such companies are frequently described as 'closely-held' or 'close' companies[53]. Most companies are small on both counts and we are concerned here with both aspects of the issue.

5.2.2 Small companies represent by far the greatest proportion, numerically, of the companies incorporated under the Act. Of all 3.7m businesses in the UK only 32,000, or less than 1%, have 50 or more employees (see Annex D, paragraphs 1–3). Small companies are also important in terms of economic activity. At the start of 1997 they accounted for 45% of non-Government employment and 40% of turnover, while at least 99% of businesses in all but a handful of industry sectors were small or medium sized companies.[54]

5.2.3 In general, the Act is structured around the needs of larger, publicly owned companies with a separation between the shareholders/investors and the directors who are in charge of, and accountable to shareholders for, day-to-day management[55]. Many provisions cater for this, imposing duties on directors and providing protection for shareholders against abuses of directors' powers.

5.2.4 However, over the years many detailed additions and adaptations have been made to the Acts to cater for the needs of private companies[56], single member companies[57], companies of

53: The Companies Act 1948 contained a detailed definition of an 'exempt private company', which was exempt from accounting obligations. The detailed structural definition led to evasion and was abolished by the Companies Act 1967 section 2, leaving all limited companies subject to full accounting disclosure; for current exemptions based on economic size see Annex D. The Act only distinguishes between companies by economic size for the purposes of those exemptions.

54: Small and Medium Enterprise (SME) Statistics for the United Kingdom, 1997, DTI, URN 98/92, July 1998.

55: The basic model was probably the start up railway company, as befits an Act with its origin in the decades of railway mania.

56: Defined in statute for the first time by section 37 of the Companies Act 1907, and exempted by that Act from various provisions including those on prospectuses (s 1(5)) and filing of accounts and directors' reports (sections 21 and 22).

57: Section 1(3A).

smaller economic size[58], and companies wishing to operate through written procedures between members, rather than meetings, or by dispensing with some key formalities[59]. The latter provisions (‘written resolution’ and ‘elective’ regime) apply to all private companies, but may be expected to be particularly useful for enabling closely-held companies to opt out of normal governance requirements. However, they appear to be little used, probably because the requirement for member unanimity, for what are structured as exceptional departures from the statutory norm, raises procedural and psychological barriers.

5.2.5 Many of the provisions of the Act do not apply to small private companies, either in law or in practice, and many which do are not well designed to cater for their real needs. Because of its structure, building on the large business model and then making detailed adaptations, the Act is opaque and inaccessible for small business users. To determine which parts of the Act actually apply to a small company requires a thorough knowledge of the whole Act, what exemptions or adaptations are available, and under what conditions.

5.2.6 Responses to the first Consultation Paper indicate that these problems are widely regarded as serious and requiring a remedy. The law should be accessible to those managing and advising small companies and relevant to their requirements.

5.2.7 There is also a concern that the ‘regulatory’ requirements laid down in the Act (broadly for the protection of the company’s creditors) are overly burdensome and fail to serve the purposes for which they were designed. These must take account of a number of delicate balances, for example of the scale of risks to creditors, the ability of the company to devote resources to compliance, and the amount of disclosure etc required to provide adequate protection.

5.2.8 A considerable amount of piecemeal work has been done on improved accounting approaches within the existing framework – eg the Financial Reporting Standard for Smaller

58: Accounting exemptions and modifications see Annex D.

59: Written resolution procedure, section 381A, ‘elective’ regime, section 379A

Entities (FRSSE), the Department's work on simplification of SME accounts and the preparation of a standard format for SME annual accounts[60].

The Wider Context

5.2.9 The special needs of the small company and the appropriate response are part of a wider set of issues, identified in our terms of reference, about the range of forms of business organisation, or 'vehicles', which the law provides.

5.2.10 Our approach is that there is a clear case for providing the most competitive legal form possible for the typical small commercial business seeking limited liability and transferable shares. It is that case that we are addressing here. Other forms are available including the unincorporated partnership with unlimited liability. The Law Commissions are carrying out a major review of partnership law, under a reference from the DTI, which may well lead in the longer term to a better unlimited liability vehicle for the needs of modern business. The Law Commissions intend to publish a series of discussion papers. In particular, the review is considering, in relation to both Scottish and English law, legal personality, the holding of property, continuity of business irrespective of changes in ownership, partners' liabilities and the dissolution of solvent partnerships. Their work therefore relates to and in some respects parallels the work outlined in this Chapter but is independent of this Review. We recognise that for some small businesses the Companies Act form, however improved, may be unduly burdensome as compared to the partnership approach and an improved partnership form may be particularly beneficial in that context. However, this does not of itself lessen the need to address the form of the limited liability company most appropriate for small businesses.

5.2.11 We intend that these wider questions about legal forms of organisation, including the whole range of corporate and unincorporated vehicles, for business and other non-commercial forms of collaborative activity, with and without limited liability, should be addressed in the next phase of our work. We hope that, subject to consideration of this document, the approach adopted

60: Financial Reporting Standard for Smaller Entities (effective March 1999), Accounting Standards Board, December 1998. The Companies Act 1985 (Accounts of Small and Medium-sized Companies and Minor Accounting Amendments) Regulations 1997. The standard format is in preparation and has not yet been published.

as a result of the proposals here on the small limited liability company can be developed as an integral part of that wider work (see Chapter 9).

5.2.12 There is another related issue, not addressed further here, about the potential for abuse, or disproportionate risk of insolvency, to which quick, simple and easy access to limited liability status may give rise. It is sometimes suggested that it should not be made too easy to incorporate, and that there should be higher hurdles, for example in relation to minimum capital, to discourage individuals from taking the step of incorporation without careful thought. We are not aware of evidence suggesting that ease of incorporation (which is cheaper and quicker here than almost anywhere in Europe) has led to unusually high levels of failure or abuse by the standards of international comparison[61]. But we have set in hand enquiries on this. Particular examples of abuse, such as the 'phoenix company' phenomenon (registration of substantially the same company after an insolvent winding up or dissolution) will, again, be addressed in the next phase of our work.

5.2.13 So the main problems which small companies find with the present law appear to be that it is opaque, unwieldy, unnecessarily complex and burdensome. These are general concerns, but smaller companies are precisely those which do not have the time or funds to devote to legal advice; their owners and managers cannot delegate and must focus on day-to-day survival and growth.

Possible solutions to the problem

Accounts

5.2.14 So far as accounting regulation is concerned, internal financial management is vital to ensuring the success of a business, but preparation of statutory annual accounts (although ultimately they will flow from proper management accounts) may well be seen by management as a low business priority and perhaps as of little value in terms of management information. In the minds of directors the main benefits of producing statutory annual accounts may be avoiding the consequent legal and financial penalties, and avoiding loss of reputation or credibility with

61: See ACCA Research Report 54, Business Start Up in Europe: Law and Practice, 1998.

potential creditors. In some surveys on small companies, directors have cited the production of statutory annual accounts as an important regulatory burden on their businesses[62], along with other issues such as VAT; clearly if statutory accounts are no better than a tiresome irrelevance for management attempts to make them more useful and/or less burdensome should be considered. However, it will be necessary to bear in mind the EU Company Law Directives[63].

5.2.15 So far as the interest of creditors in accounts is concerned, it has been suggested that the current level of public disclosure for companies designated as being small, which essentially requires an un-audited summary balance sheet published within 10 months of the end of the accounting period[64], is of little value to creditors and imposes some burdens on companies in terms of preparation and filing. There must be a question whether these requirements should be made more meaningful or replaced or supplemented by something of more value to creditors, for example an annual declaration of solvency[65]. In particular modern software employed by probably the great majority of even very small companies makes available up to date information at no incremental cost which might be much less burdensome to produce and of greater value to creditors than present financial statements. A related issue is the extent to which fiscal recording requirements could be used or adapted for determining company law requirements.[66]

5.2.16 We believe that accounts are a useful protection for members not immediately concerned in management, even in small companies, and we see value in the present

62: J. Freedman and M. Godwin, Legal Form, Tax and the Micro Business (Institute of Advanced Legal Studies 1991), J. Freedman, Small Businesses and the Corporate Form: Burden or Privilege? (1994 57 MLR, 555). A Hicks, R Drury and J Smallcombe, Alternative Company Structures for the Small Business (ACCA Research Report 42, 1995); J Freedman, The Quest for an Ideal Form for Small Businesses – A Misconceived Enterprise? (in B Rider and M Adenas (eds), Developments in European Company Law: the Quest for the Ideal Form for Small Businesses (1999)).

63: The Fourth Directive requires all limited companies to publish some accounts. Any replacement of the requirement would require a change in EU law. If such changes were proposed they would have to be longer term objectives and could only be enacted in the UK once a change in EU law had been achieved.

64: I.e. even timely published accounts are as much as 10 to 22 months out of date.

65: Companies Act accounts are used by small companies to inform management and are relied on by credit rating agencies and credit managers but the abbreviated form and absence of audit is criticised by external users – See Pratten, ‘The Uses of the Accounts of Small and Medium-sized Companies and the Effects of the Audit Exemption Regime’, ICAEW 1998.

66: In particular, we believe the great majority of commercial companies provide VAT returns. The question has been raised whether these could be deployed to meet the needs currently addressed by Companies Act accounts.

requirements. Improvements for creditors and for internal management purposes are likely also to be beneficial to members – we would welcome comments on this.

5.2.17 We propose that work on accounting and reporting issues in the next phase should consider the value of Companies Act accounts for internal and external purposes and possible substitutes or supplements. But we would also welcome comments on these questions, particularly in the context of the needs of small companies and those in relationships with them. (See Chapter 6 below, for further description of this and other issues on accounting)

5.2.18 For many companies (eg those where all members/shareholders are directors) issues about accounts largely concern external interests, for the most part creditors. They raise essentially simple questions about the balance of burden for economically small companies versus risk to outsiders, the extent of disclosure and the appropriate economic thresholds. For example, it is sometimes suggested that accounting exemptions have facilitated fraud, or alternatively that exemptions are of limited practical benefit since lenders such as banks will insist on seeing full accounts. The current solutions to these questions are clearly appropriate for further consideration as part of the work on reporting. As we have indicated, we would expect internal questions about accounting largely to fall into place once those have been resolved.

Governance Issues

5.2.19 A more troublesome set of issues is concerned with the mismatch between the current provisions about governance, ie the internal management and control of companies, and the needs of the closely-held company. Solutions need to address both the substance and the form of the current legislation.

5.2.20 Such solutions are however hard to devise, for two reasons. First, the character of small companies is very diverse and defining the limits of the closely-held company which is fit for special treatment is problematic, without producing possibilities of abuse on the one hand and without being unduly restrictive on the other. This may be called the ‘problem of definition’.

5.2.21 The second set of problems can be called 'problems of transition', and are of two forms:

- the structure of governance in small companies is liable to change, for example, as the business grows and the age of the founders increases. Therefore new structures of management, typically less closely held, come about, and it is important that the existence of different regimes should not impede such natural evolution: and
- the new regime needs to be acceptable to the business community as it is currently comprised. It must be sufficiently attractive, so that advisers will be willing to recommend its use to those setting up new businesses and significant numbers of existing businesses will wish to adopt it.

5.2.22 Problems of transition and problems of definition are obviously very closely related, the narrower and more closely framed the definition the greater the likely problems of transition. Small companies are unlikely to be aware when they cross transitional thresholds – the danger of legislative traps in the area of governance is therefore real and acute. On the other hand, the more lax the definitions are the greater the possibility of mismatch to needs and of abuse.

Two Broad Approaches

5.2.23 A wide variety of approaches is possible and various models have been proposed and adopted in other jurisdictions; some have been found wanting, here and abroad[67]. We have broken these down into two broad kinds of approach, which we shall call the 'free standing' and the 'integrated' approaches:

- the *free standing approach* involves creating a separate, free-standing, limited liability vehicle for small companies, probably involving separate legislation. Eligibility criteria would be based on the economically small, closely held, company where the shape of regulation could be tailored and would be relatively light when compared with the full

67: For example, see the Department's 1981 Green Paper 'A New Form of Incorporation for Small Firms', HMSO, Cmnd 8171 and the Australian experience, paragraph 4.9 above.

Companies Act provisions. Such companies would need to revert to the Companies Act regime should they develop beyond these limits. A number of corporate models have been studied under this approach to see if they would provide a vehicle around which a regime suitable for the British environment could be devised. These included the South African Close Corporation, the US Limited Liability Company and the Limited Liability Partnership (LLP), on which the Government is hoping to introduce legislation shortly.[68] These are described in greater detail in Annex E: and

- an *integrated approach*, within a single Companies Act regime. There are again a number of different options, ranging from effectively the *status quo* to a totally reformulated SME-centric Companies Act, perhaps based on the legislation recently introduced in New Zealand. (The New Zealand regime is described briefly at Annex E[69]).

Pros and Cons of Each Model

5.2.24 There are a number of pros and cons which can be argued for both of the broad models outlined above, and further arguments for and against can be presented for different possible variants of each.

5.2.25 The main advantage of a stand-alone small companies vehicle is said to be that it would be tailored more closely to the needs of those companies, unlike the existing Act. The legislation might be relatively concise and designed specifically for a limited class of users.

5.2.26 On the other hand, the consequence of being tailored in this way is that the legislation would not provide an integrated regime within which a company which ceased to satisfy the criteria could continue to operate. For example, clearly the conditions would need to lay down a limit on the number of members and perhaps that all members should participate in or be entitled to participate in management. But the levels at which these criteria would be set are, largely, arbitrary. Moreover such criteria would present major problems of transition.

68: See the Department's consultation document "Limited Liability Partnerships" (URN 98/874, September 1998)

69: See too Chapter 4, above.

5.2.27 Entirely normal and desirable stages in the development of closely-held companies are likely to involve the overstepping of such restrictions. Common examples are; i) the need for injection of external funds from a venture capitalist; ii) the involvement of a new professional manager who seeks special status; and iii) the retirement, or death, of a founder member causing the dispersal of his shareholding amongst his widow and/or children, some of whom are either not qualified or not inclined to participate in management. Such changes can be fundamental and are probably very diverse. To deal with such problems either detailed rules are required (probably impossible to devise in the abstract), member involvement in adaptation will be needed (probably re-registration with a new constitution under the main Act), or a sweeping discretionary power of court intervention will be necessary.[70]

5.2.28 The overall effect would be to make the transition from close to more broadly held status – a critical process to facilitate, in order to promote competitiveness – a complex, difficult or risky and uncertain process. This is particularly important because in small companies the need for appropriate transitional measures is less likely to be seen or anticipated by those concerned.

5.2.29 However well devised, a new regime is of no value unless it is attractive enough to be widely used. The novelty of the free standing approach, taken with the fact that the existing corporate form used by many thousands of small companies would need to continue (compulsory re-registration of such companies under the new regime would be very hard to justify) suggest that the new regime might be unlikely to be used on formation, and even more unlikely to be exploited by existing companies. Professional advisers are likely, even for new companies, to adhere to the tried and tested system they know, and for which they have invested in standard procedures. We are supported in these conclusions by the lukewarm response to Professor Gower's proposals for a new form of incorporation for Small Firms in 1981[71] and, more recently, the largely negative response to consultation about the value of a new incorporated limited liability structure for small businesses in 1994[72].

70: Compare the South African Close Corporations Act sections 36 (cessation of membership by order of the Courts), and 49 (unfairly prejudicial conduct – broader than our section 459).

71: See the footnote to paragraph 5.2.23.

72: The Law Applicable to Private Companies, DTI 1994 URN 94/529.

5.2.30 There seems therefore to be a strong case for adapting the existing regime better to meet the needs of small companies. This avoids the problem of novelty, provides an integrated mechanism for existing companies to exploit the new provisions if they choose and should enable smoother transitions to be achieved within a single regime, though there is no doubt that detailed problems will still remain.

5.2.31 But this is the approach which has been adopted already with little success. A different form of adaptation from those tried so far appears to be required.

5.2.32 We have been struck by the fact that many of the criticisms of the present Act which have been made on behalf of economically small and closely-held companies apply also to other private companies. Examples are the general complexity of the legislation and the fact that the law relating to private companies is bundled up with that relating to public ones, and some more specific problems which arise in relation to particular areas like par values, capital maintenance, directors' self dealing, and outmoded registration requirements. All these problems need addressing for private companies generally and do not require a separate novel regime for small companies. Moreover proposals for addressing some of them have already begun to emerge from the work of working groups reviewed elsewhere in this Chapter. In addition, the form of the existing opt-out provisions, which is thought to account for their limited use, can be addressed without the need for a radically different regime. They can continue to apply quite satisfactorily to private companies generally.

Provisional Conclusion

5.2.33 These considerations taken together lead us to favour a variant of the integrated approach, involving both changes in form and changes in substance to the existing legislation. Its main components would be the following:

- companies legislation should be reframed so that the basic model is the private company, and private company provisions should be presented as a single integrated whole. Provisions relating to public and listed companies should be drafted so that they are separated out and dealt with as an additional set, perhaps in a separate Act or part of

the Act. In that case the users of the legislation who are concerned only with private companies should have no need to consider them;

- small companies should benefit from changes that will be made to the law applying to private companies generally. The legislation will, we believe, be simplified and brought into line with current business needs as a result of other work conducted under the Review. As noted above, examples include reform of outmoded registration requirements and rules relating to capital maintenance:

- within the above framework, it should be possible on formation to opt for a company with special close company status, preferably by ticking a box. Such status should confer on the company at least all the exemptions from regulatory requirements that are currently available under the present elective regime. A new set of model articles to suit the needs of close companies should also be devised, for example, a special version of Table A designed for companies in which all the shareholders are involved in management: and

- consideration should also be given to whether it should be possible for private companies in general, or a more restricted class of closely-held companies, to adopt a form which is exempt from a wider range of Companies Act requirements (that is, whether the elective regime in this modified form should be extended), allowing them greater freedom to customise their constitutions to their individual needs. A similar possibility is a reformed written resolution procedure. This currently requires unanimity on the part of the shareholders for an opt in and notification of the auditors (if any). It could, however, be made possible for a private company, or one satisfying more restrictive criteria, by its articles to provide for written resolutions that require only the same majority as that for resolutions passed at a meeting, subject of course to proper notice to all members.

5.2.34 A preliminary survey of the complex questions just raised has been begun, but they lie outside the scope of this strategic document and will be considered further as part of the next stage of the Review. The work will need to take account also, for example, of the outcome of the

Law Commissions' review of Part X, in determining the most appropriate rules to control improper self dealing by directors of small companies. At this stage, however, we seek consultees' views on the desirability of extending the elective regime to cater further for the needs of companies in which the distinction between members and directors is absent or of diminished importance. At present the elective regime under section 379A requires a unanimous decision by members to opt out of certain usual protections – the annual general meeting, the laying of accounts before shareholders' meetings, the annual appointment of auditors (if applicable), the limited duration of the powers of directors to issue shares, and the majority required to authorise short notice of meetings. We have already suggested that adoption of this regime by a company on formation should be facilitated, but do consultees believe that this approach could be taken further, enabling opting out of other provisions? Similarly, does experience of the operation of the written resolution provisions, under section 381A to C, suggest that change is necessary, particularly in the direction of greater flexibility?

5.2.35 We are conscious that increasing the freedom of companies to opt out of provisions that are designed to act as safeguards for minority shareholders, unless undertaken carefully, may expose such shareholders to unacceptable risk. In particular, provision will need to be made to deal with transitional problems arising when a company formed as a close company undergoes changes in the size and structure of its shareholding, or in the degree of shareholder participation in management, which may make that regime no longer appropriate. The scale of transitional problems likely to arise will clearly depend on the scope that is allowed for adopting special provisions which exclude or modify statutory rules. What is the most suitable response will also depend greatly on the extent to which key thresholds are likely to be crossed in practice, and on what the detailed circumstances at the time of transition are likely to be. We propose to commission research on these questions but would also be grateful for comments. One possible approach would be to allow minorities to insist that any 'opt-outs' that adversely affect them be brought to an end. At present, termination of the elective regime requires a majority resolution of shareholders. Should the regime in its current form, or any extended version of it, provide for greater minority protection, perhaps by permitting a minority shareholder to insist that the company comply with provisions of the legislation that have been disapplied? Or would the ability to make an application to the court on grounds of unfair prejudice, by those harmed in a

situation in which the company's constitutional arrangements no longer match its shareholding structure, constitute a sufficient protection?[73]

5.2.36 We would welcome views on the following issues arising out of the analysis on this subject:

Question 9 **Is it agreed that the difficulties met by small and closely-held companies in operating within the Act are serious and worthy of remedy?**

Question 10 **(a) Is it agreed that it is not desirable to restrict access to limited liability?**

(b) if not, then what constraints should be considered?

Question 11 **(a) Should the current accounting exemptions for small and medium sized companies be removed or amended?**

(b) do current exempt accounts provide proportionate, or any, protection to creditors, bearing in mind the costs of their preparation?

(c) should such accounts be replaced by a different requirement, eg solvency certification?

(d) would there be value in aligning tax and company law reporting requirements?

Question 12 **Is the conclusion (paragraph 5.2.33) in favour of the 'integrated' approach to reforms in this field rather than the 'free standing' model supported?**

Question 13 **If a free-standing model is favoured, how should eligibility be defined, what should the character of the regime be and what provisions are necessary for regulating transition (voluntary or involuntary) out of the 'small company' status?**

73: Such problems can arise already with 'partnership companies' in transition – see section 459, which perhaps would need adaptation; and see Law Commission Report "Shareholder Remedies", Law Com No 246, Cm 3769, October 1997.

Question 14 **If the integrated approach is favoured, what detailed provisions would be desirable for small and closely-held companies:**

(a) an 'opt-out' on formation?

(b) a special 'Table A'?

(c) a broader elective regime and/or more flexible written resolution procedure?

(d) special minority protections in such cases?

(e) and how should the remaining problems of definition and transition be resolved in this context?

Chapter 5.3 Company Formation

Introduction

5.3.1 This section examines a number of issues arising on the formation of a company. These include the form and content of the company's constitution; the procedure for registering a new company; the control over the names under which new companies may register; and a related set of questions concerning the implications, particularly for third parties, of any limitations arising from the company's constitution on its capacity to act or on the authority of the directors and managers to enter into commitments in its name. These issues arise for both private and public companies; where special considerations apply for public companies, these are noted.

The Present Position

The Company's Constitution and Initial Registration

5.3.2 The first step in forming a new company is for one or more 'subscribers' (founder members) to prepare a Memorandum of Association for the company and sign it. This designation reflects a traditional view that the company is formed by an association between the subscribers. It is however negated by the provision permitting a single person to 'subscribe' the Memorandum of a private company; this was introduced in 1992 to implement the Twelfth EU Company Law Directive on Single Member Companies. (The requirement for two subscribers for a public company remains, though the case for its retention does not seem strong).

5.3.3 The Memorandum of Association, and the company's Articles of Association, together make up the company's constitution. Broadly, the **Memorandum** includes the information which the outside world needs to know and which may vary from company to company – the company's name, the jurisdiction of the registered office (whether England and Wales or Scotland), the objects of the company, and the amount of the (authorised)[74] share capital with which the company is to be registered and its division into shares of a fixed amount, together with the amount of that capital initially subscribed. (The registration of these details is prescribed

74: ie the maximum amount which the directors may issue without amendment to the memorandum. Additional conditions may apply under the Act or the Articles of Association.

by the First and Second Directives for all companies, except that details of the objects and the initial subscribed capital are only required for public ones). The **Articles** set out the internal aspects of the constitution – further details of share capital, arrangements for general meetings, delegation of powers to directors, payment of dividends etc. The Articles can be changed by special resolution; so can the company's objects though in this case there is provision for a minority to appeal to the court. Both the Memorandum and the Articles must be delivered to the Registrar and appear on the public register. But if the company opts to adopt the standard form of Articles (Table A) it needs only to register a Memorandum. This meets the requirement of the First Directive for disclosure of the company's 'instrument of constitution and statutes'.

5.3.4 To obtain registration of a new company, the following documents must be sent to the Registrar:

- the Memorandum and (where Table A is not adopted) Articles;
- a statement of who the first director(s) and the first secretary are to be. (This must be signed by the subscribers, and by the director(s) and secretary to confirm their willingness to act[75]);
- a statement of the intended address of its first registered office; and
- a statutory declaration by a director or secretary, or by a solicitor engaged in the formation of the company, that all the requirements of the Act in respect of registration and 'of matters precedent and incidental' to it have been complied with.

5.3.5 On receipt of these documents the Registrar must, if he is satisfied that the requirements for incorporation have been complied with, give a certificate of incorporation; in doing so he may rely on the statutory declaration as evidence of compliance. The certificate of incorporation is conclusive evidence of compliance – ie if defects are subsequently found in the procedure, this does not render the company and its acts null and void.

75: The Working Group considering these matters saw advantage in directors being provided with a simple statement of their duties and being required to declare that they have read and understood them. The Law Commissions are considering a similar proposal. We are inclined to agree with this, but the matter will be considered in more detail by Working Group E in the next stage – see chapter 8.

5.3.6 The statutory declaration must be attested by a Commissioner for Oaths[76]; anyone making a false declaration may be indicted for perjury. The person making the declaration confirms at least that the Memorandum and Articles accompany it; that they contain the required information; that the Memorandum is duly signed and witnessed, that the statement of first director(s) and first secretary also accompanies the declaration, and that this is duly signed by those named in it. It is less clear what 'matters incidental and precedent' are confirmed by the declaration; that the company is being formed for a lawful purpose is presumably one.

Company Names

5.3.7 The Registrar may not accept for registration a company name which is the same as an existing name; or, without the Secretary of State's authority, a name which implies that the company is connected with the government or with a local authority or which contains a word on a 'sensitive' list of words likely to give a false impression of the company's business or standing; or a name which is in the opinion of the Secretary of State offensive[77]. In addition, the Secretary of State may within twelve months of registration, order a company to change a name which is the same as, or 'too like' the name of another company.

The Company's Objects, its Capacity, and the Powers of the Directors to Bind the Company

5.3.8 The requirement that the Memorandum must state the company's objects has been a feature of company law from the last century. In the early days, many companies adopted objects which described fairly precisely the business the company had been set up to engage in – eg to build and operate a railway between London and Birmingham. An objects clause had a dual significance. It restricted the **capacity of the company**, so that transactions outside the objects were void ('ultra vires'). It also limited the authority of the directors (or anyone else) as agents of the company to bind the company as their principal; and the powers of the directors to bind the company, or authorise others to do so, might also be limited by, or under, the company's Articles.

76: Under the Statutory Declarations Act 1835.

77: Names the use of which is a criminal offence are also disallowed.

Furthermore, because the registration of the Memorandum and Articles had the effect of deeming everyone to be aware of such limitations ('deemed' or 'constructive notice') third parties were also treated as knowing of the defect in the company's capacity or the agents' authority. Breaches of such restrictions would also give rise to directors' liability to the company for misfeasance and agents' liability for breach of authority.

5.3.9 It became clear over time that this situation was unsatisfactory from the point of view both of the company, if it wanted to expand its activities into new areas (originally there was no means of changing the objects); and of third parties, who were at risk if a transaction with the company was outside its objects. Early on, the practice grew up of adopting long and complex objects clauses, giving the company capacity to engage in a vast range of activities, many of them remote from the original business. This devalued the objects clause as a means of informing the world of the company's business, without entirely removing the risk faced by third parties if the founders of the company had failed to think of everything. The result was that prudent third parties would need to study the objects clause carefully to ensure that they were not caught out by some trivial defect in the long and tortuous wording.

5.3.10 Recent changes in the law have attacked directly the doctrine of 'ultra vires', and the limitation on the authority of directors, as they affect third parties. Provisions in the European Communities Act 1972 implemented Article 9 of the First Directive which provides protection for third parties where acts are not within the company's objects, or beyond the directors' powers. A more comprehensive reform was undertaken in the Companies Act 1989, the main features of which are:

- a company may state in the memorandum that it is a 'general commercial company', in which case the object of the company is to carry on any trade or business whatsoever (section 3A). This was intended to avoid the need for long and complex objects clauses;
- the validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's memorandum (section 35). This was intended to give third parties full protection against 'ultra vires'. (The protection in the case of charitable companies is set out in charities legislation and is more limited);

- in favour of a person dealing with the company in good faith, the power of the board of directors to bind the company, or to authorise others to do so, shall be deemed to be free of any limitation under the company's constitution (Section 35A). This was intended to give third parties acting in good faith similar protection where directors have acted outside their authority deriving from the Memorandum or the Articles. It applies even where the person has actual knowledge of the fact that the act is beyond the powers of the directors (section 35A(2)(b)), provided that bad faith is not established. (This protection is qualified where the third party is a director of the company or a person connected to a director – section 322A – and is again more limited in the case of charities); and
- a party to a transaction with a company is not bound to enquire whether it is permitted by the company's memorandum or as to any limitation on the powers of the board of directors to bind the company or authorise others to do so (Section 35B). This was intended to do away with 'deemed notice' so far as the Memorandum and the powers of the board are concerned, and is not subject to the limitations which apply to section 35A. (Section 711A was intended to get rid of deemed notice in respect of all documents lodged with the registrar, but has, for extraneous reasons, not been brought into force).

Outstanding Problems and Possible Remedies

The Company's Constitution and Initial Registration

5.3.11 There is a case, in the interests of simplification, for ending the distinction between the Memorandum and the Articles, and providing instead for a single constitutional document as a number of other jurisdictions do. If we can do away with the requirement for a company to have objects and prevent any objects from having external effect[78], the special provision for the alteration of a company's objects can, arguably[79], fall.

78: see paragraph 5.3.18 below.

79: Objects clauses have become so prolix, or in the case of section 3A companies, so broad, that the provision has in practice lost much of its value in any event.

5.3.12 What would appear on the register is a separate issue. The company's name, the names of the founder shareholders, the jurisdiction of registered office, the amount of authorised and subscribed share capital, and the objects (if any), should be registered in all cases. All companies must have these but they vary from company to company. This basic information could be registered on a single, standard form, which could also include space for the other particulars which are required on initial formation relating to the directors and secretary and address of registered office. The need for what is now in the Articles to be on the public register is less clear cut. But the First Directive requires the registration of the company's constitution and we are not aware of any objections in practice to this requirement, which investors find useful.

5.3.13 The requirement for a statutory declaration ensures that the subscribers take the registration process seriously; the fact that the Registrar may rely on it also gives him comfort in granting the conclusive certificate of incorporation. We believe that companies and those dealing with them attach great importance to the conclusive character of the certificate, and would wish it to be retained. But we think that a formal statement of compliance by the subscribers, backed by penalties for the deliberate or reckless making of a false statement, could replace the statutory declaration. This alternative would also facilitate electronic registration (see paragraph 5.7.15).

5.3.14 We would welcome views on the following proposals for simplification:

Question 15 **(a) Should the distinction between a company's memorandum and articles be abolished?**

(b) instead of the requirement to submit for registration the memorandum, articles and separate statements of first director(s), secretary and registered office, should there be a requirement to submit a single standard form (as described in paragraph 5.3.12), together with the company's constitution in a single document?

c) should the statutory declaration, which now accompanies documents for registration, be replaced by a formal statement of compliance, signed by the founder shareholders?

Company Names

5.3.15 The operation of the present provisions have been criticised as unnecessarily strict, notably in leaving the Registrar no discretion. 'Sunny Bank Retirement Home Ltd' is unlikely to be thought a competitor of Barclays Bank plc, nor is Annie's Kitchen Ltd in Torquay likely to be confused with a company of the same name in Whitby. Taken to its logical conclusion, this argument would suggest that controls over the registration of the same or 'too like' names should be abandoned and companies uniquely identified by number only. Where a newly registered name threatened the interests of an existing company, the remedy would then be to take proceedings for 'passing off'. On the other hand, it has been suggested that controls do not go far enough (for example, names are accepted which can be confused with a trade mark owned by another company); and that the Registrar's duties should be extended to guard against this, perhaps through a link with the Trade Marks Register. The twelve month period during which a company can be directed to change a 'too like' name has also been criticised by some as too long, and by others as too short.

5.3.16 Our provisional assessment is that the present controls over company names, and the way in which the Registrar operates them, strike about the right balance. We would welcome views on the following question. In the light of such views, we will consider whether more detailed consultation is necessary.

Question 16 Is it agreed that the present rules on company names are satisfactory and, if not, what are the objections to them and how should they be changed?

The Company's Objects, its Capacity, and the Powers of the Directors to Bind the Company

5.3.17 The 1989 reform was welcomed as a great improvement, but it has not solved all the problems. In particular, the 'general commercial company' provision has not been widely adopted as an alternative to long and complex objects clauses, since it is feared that it may not cover everything the directors might legitimately wish the company to do – eg participate in community initiatives, or give a guarantee to another company in the same group; and objects

clauses are still relevant to determining the authority of directors when issues arise about ‘good faith’. More generally, the complexity of sections 35 and 35A, and the differences in wording between them, has induced a very cautious approach. We are aware for example that some banks still expend considerable resource on checking objects clauses. Once an objects clause has been read by, for example, an employee of a bank, the bank is arguably aware of any limitation in it for all time. While this is not enough to create bad faith and thus to invalidate transactions by the board or an agent authorised by the board it is not clear what is required in addition to such knowledge, which will, in any event, invalidate the acts of an agent who is not so authorised.

5.3.18 We are therefore attracted to a radical simplification on the following lines:

- it would be made explicit that, in all relations with third parties, a company was deemed to have the capacity to do anything which a legal person, (as opposed to a natural person), was capable of doing. This would be so regardless of anything in the company’s constitution;

- the requirement on companies on their formation to include an objects clause in their constitution would disappear;

- companies would continue to be free, if they so chose, to limit the authority of their directors to bind the company, as an inbuilt constraint on their freedom vis a vis the shareholders. This could be done either by the constitution (articles), or by a shareholder resolution made under it; but no such limitation would affect rights of an independent third party dealing with the board of a company or an agent authorised by the board in good faith, even if they were aware of it. A qualification on the lines of section 322A would remain. But any such limitation should continue to have effect on directors as against shareholders;

- existing companies could choose whether or not to retain their existing objects clauses. However, these should cease to have any effect to limit the authority of any agent of the company as against third parties, without prejudice to their limiting effect as against shareholders. Existing companies would continue to be free, like newly formed ones, to limit the authority of directors to bind the company by or under the constitution, with the same effects;

- the special minority protection in relation to resolutions to alter a company's objects would be abolished;
- the shareholders could, as now, bring proceedings to restrain the doing of an act by the directors, or a person authorised by them, which was beyond their powers as set out in the constitution or in a resolution; but this could not affect the validity of a commitment already entered into;
- the abolition of deemed notice would be implemented in full; and
- the companies legislation would be silent on the authority of officers or agents of the company, below board level and persons authorised by the board, which would thus be governed by the normal rules of agency law, subject to a provision for existing companies which removes any limitation on the authority of agents by virtue of the objects clause so far as third parties are concerned.

5.3.19 In the case of public companies, it is arguable that the Second Directive requirement that the objects of the company must be stated in its constitution still applies, even where the applicable law provides that the objects clause cannot prejudice third parties. That is because the purpose of the Directive is stated to be the protection of shareholders (and indeed 'any interested person'), and not only of persons such as creditors who are actually dealing with the company. However, this question could be investigated further, and the possibility of an amendment to the Directive explored. It could also be considered whether the current requirement that a company should state its current business annually in its directors' report (perhaps modified by proposals, yet to be considered, on reporting – see Chapter 6) is sufficient to fulfil the Directive requirement. If not, we would favour requiring public companies to state their objects on formation or registration as such; provision should be made that such objects can have no effect on third parties, thus ensuring that if there is to be any limitation on directors' authority in the company's constitution it has to be spelled out as such, either in the articles or by specific resolution. Since such a provision is likely to be exclusive, setting limits, rather than inclusive, setting out everything that might conceivably be needed, the problems of prolix objects clauses should disappear.

5.3.20 We would welcome views on the desirability and practicability of a simplification on the above lines, by reference to the following questions:

Question 17 **Should it be explicitly stated in law that companies have in their relations with third parties all the powers which any legal person is capable of exercising?**

Question 18 **Should the requirement to have an objects clause in a company's constitution on formation be abolished (subject to question 24, below)?**

Question 19 **Where companies exercise their power in their articles or by resolution to limit the authority of their directors or other agents should the position continue to be that, where the decision in question is taken by the board or a person authorised by the board it should be valid as against a third party acting in good faith, even if that party was aware of the limitation, but such provision should continue to have effect to limit the authority of directors as between them and the shareholders (and subject to the existing exceptions for charitable companies and cases where the third party was a director or connected with a director, ie as in section 35A)?**

Question 20 **Should existing companies be free to retain or remove their existing objects clause from their constitutions, but subject to provision making any continuing existing objects clauses of no effect in limiting the authority of the company's board or other agents as against third parties?**

Question 21 **Should the law continue to be that shareholders can, as now, bring proceedings to restrain the doing of an act by the directors or a person authorised by them which was beyond their powers as set out in the constitution or in a resolution, while not affecting the validity of a commitment entered into by the board or a person authorised by them?**

Question 22 **Should constructive notice and the duty to enquire as to limitations of authority in the company's constitution be abolished in full?**

Question 23 **Should companies legislation continue to be silent on the validity of transactions as between agents of a company other than the board and persons authorised by the board, and third parties, subject to the special provisions mentioned in questions 20 and 22 above?**

Question 24 **If it proves impossible to remove the requirement that public companies must have an objects clause in their constitutions, having regard to the Second Directive, should the residual objects clause be deprived of effect to limit the authority of the company's agents to bind the company as against third parties, without prejudice to its effect internally, as proposed for existing companies, as set out in question 20 above?**

Question 25 **Should the existing special minority protection in relation to amendments of objects clauses be abolished?**

Chapter 5.4 Capital Maintenance

Introduction

5.4.1 This section of the Document is entitled 'capital maintenance' because that is the traditional title given to the topic by company lawyers. However it is not about the broad issue of ensuring that companies are adequately capitalised, but about a narrower and more technical issue concerning the preservation of certain reserves which are currently designated as not normally distributable to members.

5.4.2 The principle of capital maintenance is at least as old as the limited liability company. The law gave the shareholder the privilege of limiting his liability, so that once he had paid, or promised to pay on call,[80] an amount equal to the nominal value of the shares he took up he had no further responsibility for the debts of the company. In order to protect members and creditors, however, a body of rules was erected; such rules were designed to prevent the capital so provided from being extracted or otherwise eroded, save as a result of trading or other business events[81]. The most important rules are those concerning reduction of capital, purchase by a company of its own shares, financial assistance by a company for a third party's acquisition of its shares and distribution of profits. Discussion of these rules requires consideration of accounting rules separating capital account from profits, and of no par value shares. It is also necessary to take account of the Second EU Company Law Directive, which harmonises provisions on the maintenance and alteration of the share capital of public companies.

5.4.3 Our limited enquiries tend to indicate that creditors and potential creditors do not any longer regard the amount of a company's issued share capital as a significant matter when

80: In the case of partly paid shares, the shareholder was liable for the unpaid part of the nominal value and the value of the reserve fund was of a different and in some ways more valuable character than paid up capital. Its preservation seems to have been one of the major objectives of the capital maintenance rules; but partly paid shares are now uncommon.

81: These rules were subsequently extended, to ensure that any 'premium' subscribed in excess of the nominal value was treated substantially in the same way as share capital proper (with its own separate undistributable reserve, subject to slightly different rules on its reduction), and to ensure that, if share capital, or this share premium account, was eroded by trading, the relevant reserves would have to be replenished before a distribution of assets to members could take place.

deciding whether or not to extend credit to it – this is particularly true in the case of the two thirds of registered companies which have a share capital of £100 or less. Whilst the existence of a substantial share capital may sometimes be regarded as a comfort, sophisticated creditors pay much more regard to the size of the company's total resources**,** including non-distributable reserves, and to its cash generation. This approach is reflected in the form of modern financial statements**.** We would welcome views from consultees on the following:

Question 26 What is the significance of the amount of a company's share capital (as opposed to its net assets or other features of its financial performance) for decisions on whether to extend credit to it?

Reduction of Capital

5.4.4 The Companies Act 1867 introduced provisions permitting companies to reduce their capital. The two specific requirements were a special resolution of shareholders and confirmation by the Court. The legislation included provisions under which the Court, prior to confirming the reduction, was to ensure that the interests of creditors were adequately safeguarded, but court approval was required even where there could be no conceivable real threat to creditors.

5.4.5 In essence the reduction process today remains the same as in 1867. Both the legislative provisions for the protection of creditors and their operation have become more flexible; nonetheless a company wishing to reduce capital may find that the court requires it to provide an expensive bank guarantee to cover present and future claims of its existing creditors, however financially sound the company may be, making creditors better protected than they would otherwise have been, at the expense of the company. We do not regard this rule as efficient.

5.4.6 The reduction of capital process is used to return capital to shareholders, to write off losses, and for many less obvious purposes – for example, in the past, to write off goodwill on consolidation and to produce a fund of profit which can be used to redeem or purchase shares.

5.4.7 We believe that the distinction between share capital (including share premium) and other funds should be retained. This is because, in brief, the distinction between capital contributions and other reserves from trading is an important one, in terms of historic disclosure

at least. However, reduction of capital should become a simpler and more efficient process. Our provisional view is that it would be preferable for companies to be permitted to reduce capital:

(a) with the sanction of a special resolution (ensuring the appropriate endorsement by shareholders of the change in status of funds which they envisaged as a contribution towards the trading capacity of the company[82]); and

(b) following the giving of a declaration of solvency by the directors (to ensure reasonable, but not excessive, protection of creditors from the risk of insolvency).

5.4.8 The declaration of solvency would be required to address the position of the company immediately following the reduction. We do not think that the declaration need take the form of a statutory declaration. We believe that directors should be required to make a proper enquiry and then to reach a reasonable judgement on solvency[83]. We would however expect that directors who make a declaration without having reasonable grounds for the opinion expressed will be liable to a fine and perhaps should be personally liable for any losses to creditors which result from a reduction made in circumstances which they should have known were likely to lead to insolvency. However it may be arguable that the law on directors' duties and insolvency law provides an adequate remedy already[84] and would be reinforced if the provisions on directors' fiduciary duties are clarified and strengthened.

5.4.9 We would welcome views on:

Question 27 **(a)** **Should the procedure for capital reductions, without court approval, but subject to shareholder approval and solvency certification, as proposed in paragraph 5.4.7, be adopted?**

(b) **if so, what is the appropriate sanction or sanctions for a defective certificate of solvency?**

82: In our view no special minority protections are required here because reductions discriminating between shareholders would amount to a change of class rights, requiring separate class meetings.

83: Along the lines of section 156(2).

84: Insolvency Act 1986 section 214.

(c) and what is the case for, or against, requiring an auditor's certificate in relation to such a certificate of solvency?

5.4.10 We are in principle in favour of extending provisions on these lines to all companies. But for public companies this would in most cases require an amendment to Article 32 of the Second Directive which sets out safeguards for creditors on a capital reduction. It seems clear under that Article that we must give creditors a right to obtain security for their claims or other 'adequate safeguards' or the assurance that the company's assets are sufficiently large to make such safeguards unnecessary. If creditors are not satisfied with what is offered by the company, they must be given the right to apply to the Court. We believe that such a regime puts unjustified power in the hands of creditors. Even an ability to delay a reduction of capital is something that should be avoided, for fear that it would be used for an improper purpose.

5.4.11 The current British regime goes even further, requiring an application to the Court in every case, whether or not any creditor could conceivably have good grounds to object. However, it would in our view be possible within the confines of the Directive to enable public companies to make capital reductions by special resolution and to issue declarations of solvency; and for the law to provide for creditors to be allowed to challenge the proposal in court on the ground that they had neither security, nor adequate safeguards, and that the state of the company's assets was not sufficient to make such safeguards unnecessary. To allow creditors a reasonable time to object, our preliminary view is that the reduction should be undertaken not less than four weeks after the passing of the special resolution (cf. section 158) and fair notice to the creditors of what is intended. The reduction would need to be suspended pending any such challenge. We believe that while this still enables creditors to hold up the carrying through of a capital reduction the transfer of the onus onto them to challenge (with express provision in the law for costs penalties if they fail) would be a useful change and that in many cases of capital reduction it would be obvious that the commercial position of creditors is not materially prejudiced, given the asset position of the company.

5.4.12 However, Article 32 of the Second Directive does not apply to certain kinds of share capital reductions, ie broadly speaking, those made to write off losses, or made by transfer to a separate reserve only to be used to write off losses, and involving, in either case, no distribution

to shareholders[85]. We believe that it would be useful to take advantage of this flexibility for public companies, on the assumption that Article 32 cannot be altered for the generality of cases, by providing that in the case of such capital reductions to write off losses the private company regime proposed above should apply.

5.4.13 We would welcome views from consultees on the following:

Question 28 (a) **If the Second Directive precludes the adoption of the same scheme for public companies, is it desirable to enable such reductions without prior court approval, but subject to the right of creditors to apply to the court to prevent the reduction on grounds that they are not secured, nor have adequate safeguards, and that the state of the company's assets is not sufficient to make such protection unnecessary?**

(b) **would there be value for public companies in adopting the scheme mentioned in question 27 in cases of capital reductions to write off losses, as permitted by Article 33 of the Second Directive?**

Question 29 If amendments to the Second Directive can be agreed to permit this should the scheme in question 27 be extended to public companies?

Purchase of Own Shares

5.4.14 It would be premature to make any recommendations on this topic, pending the completion of the DTI's consultation process on its proposal to permit companies which purchase their own shares to retain the shares in treasury, instead of, as now, being required to cancel them (URN 98/713, May 1998).

5.4.15 In any event since purchase of own shares is very similar to reduction of capital our view on this topic would be likely to follow a path equivalent to, and consistent with the one described above, subject, for public companies, to EU constraints, in particular Articles 19 and 22, Second Directive.

85: See Second Directive, Article 33, setting out the provision in greater detail.

Distribution Rules

5.4.16 A statutory regime for the determination of distributable profit has been part of our law since 1980. In part it was dictated by EU law and in part by a desire to modernise the existing common law rules and to introduce certainty and in some cases a checking mechanism on over-enthusiastic distribution.

5.4.17 Our general view is that these provisions have worked well and have introduced both certainty and some checks. There is clearly scope for some detailed redrafting but we should welcome consultees' views on whether they share our assessment that no major change is required.

5.4.18 We have considered, but are not attracted by, the idea that a distribution should not be made without a declaration of solvency by the directors. This has never been a requirement in the UK and experience with dividend-paying in the past does not indicate that the law has been abused significantly.

5.4.19 The question of what is a realised profit is a vexed one and we understand that the accountancy profession is considering an alternative approach to identify 'real' profits, although British legislation and the Fourth Directive set legal limits to the reinterpretation of realised profit. This is an area for detailed examination and consultation, and is also mentioned in the context of our review of high level accounting issues (see Chapter 6).

Financial Assistance

5.4.20 The provisions which, subject to exceptions, prohibit companies and their subsidiaries from giving financial assistance for the purpose of acquisition of shares of the company are normally regarded as part of the capital maintenance regime and are therefore addressed here.

5.4.21 Following various consultation steps effected by the DTI between 1993 and 1997, proposals to reform the law in this area have been announced but not yet implemented[86].

86: DTI circular letters of 21 November 1996 and 21 April 1997, available from the address at paragraph 1.20, above.

5.4.22 We are firmly of the view that changes to the existing law should be made in this area. We are aware that the relevant provisions are ones on which legal advice is sought very frequently; it has been estimated that the cost to companies of the provisions concerned is some £20M per annum.

5.4.23 Speaking generally, we do not regard the financial assistance provisions as strictly necessary for the maintenance of capital. Clearly there is in effect a partial reduction of capital where, for example, a company, having lent money on the security of its own shares, finds that the borrower is insolvent. But if the security is good the company is able to sell the shares and recoup any loss. It is only if the security is inadequate that the company will make a loss which might, because of its provenance, be regarded as an unauthorised reduction of capital. It could be argued that there need be no special prohibition other than that, when considering any loan or other financing of an acquisition of the company's shares, directors of a company should disregard the value, either then or at a future date, of the relevant shares.

5.4.24 We are inclined to think that this may be too radical, and our provisional preference is that private companies at least should be permitted to give all kinds of financial assistance if approved, in general meeting, by the members of the company other than any who have a special interest in the outcome, and preceded by a declaration of solvency covering the situation following the giving of the assistance. This is a more flexible provision in some respects, and less so in others, than the DTI's final proposals of April 1997, which envisaged freedom to engage in financial assistance financed out of distributable profits, without general meeting approval, where the assistance diminished net assets by less than 3%, and with general meeting approval, by special resolution. We believe that shareholder approval is appropriate in all cases, but that an ordinary resolution of disinterested members is sufficient and that it is appropriate for assistance to be permissible out of capital, so long as it is approved and creditors are protected. We agree with the Department's proposals for redefining assistance, that the exemptions should remain, for all cases, and that proper notice of resolutions is appropriate. However, we would welcome views on the rival merits of these two sets of proposals.

5.4.25 We consider that the arguments for such a relaxation apply on merit equally to private and public companies. But in the latter case a radical amendment to Article 23 of the Second

Directive would be needed; we hope that this possibility can be explored. If Article 23 must be accepted as it stands, we would favour implementation of the more modest reforms proposed by the DTI in 1997. We would welcome views on:

Question 30 (a) **Should private companies be permitted to provide financial assistance in connection with the acquisition of their shares subject to approval by disinterested shareholders and solvency certification?**

(b) **or are the Department's proposals for a de minimis provision and a special resolution 'whitewash' provisions a better way forward (see paragraph 5.4.24)?**

Question 31 (a) **If amendments to the Second Directive can be agreed, should the same regime be applied to public companies?**

(b) **if not, should the Department's proposals set out in its consultation document be adopted?**

No Par Value (NPV) Shares

5.4.26 The **nominal** value of the issued share capital was the traditional yardstick for the maintenance of capital, but this has now in effect been replaced by a measure corresponding to the total consideration (consisting of both nominal value and share premium) which is paid or payable on the shares. The question therefore arises whether the distinction between nominal value and share premium, or any similar distinction, needs to be retained.

5.4.27 We believe that the requirement that shares should have a nominal value has become an anachronism. There is no real distinction between share capital and share premium account, except that the latter may be applied in certain (very limited) ways in which share capital account may not. The existence of a nominal amount of share capital attributable to a share, which rapidly ceases to have any significance other than a historical one, tends to confuse the layman. The only real function of nominal value is to set a minimum price below which shares cannot be issued. But as long as all the proceeds of an issue are retained in an undistributable capital

account, there is no reason to impose any particular limit below which the issue price cannot fall. Thus arguments based on the need for a minimum issue price are in our view misconceived. New issues of shares can never damage creditors, indeed they will always be for their benefit. Members of a company issuing NPV shares are well aware of the commercial position on the price that can be charged for a new issue. For these reasons, we would favour the end, for public and private companies alike, of the requirement for shares to have a nominal or par value.

5.4.28 There is no formal requirement in the EU Company Law Directives for shares to have a nominal value. However, both the Second and the Fourth Directives require that shares have assigned to them, if not a nominal value, then at least a quantity called the 'accountable par' or 'accounting par value'. Furthermore, Article 8 of the Second Directive requires that NPV shares of public companies may not be issued below their 'accountable par'. The precise constraints imposed by this 'accountable par' regime are still being investigated: in particular, the question whether (unlike nominal value) the accountable par of a class of share can be adjusted for new issues, enabling shares to be issued at a lower accountable par to the previous issue. In any event, however, it seems clear that the Second Directive would not permit a true NPV regime, in which the issue price would be freely determined at the time of issue and all the proceeds of issue credited to a single capital account.

5.4.29 We understand that the Department will be exploring with the Commission the scope for modifying the requirements of the Second Directive relating to the nominal or 'accountable par' values of shares of public companies, and will be consulting on the options.

5.4.30 If this is not achievable, we recognise that to introduce NPV shares only for private companies would mean that when they go public they will need to convert into par value form. But we do not regard this as a major difficulty.

5.4.31 We also recognise that our proposal raises transitional questions:

- whether existing companies should be required to convert their existing share capital and register the conversion;

- or whether a system which merely deems existing nominal value shares to be NPV would be feasible[87];
- or whether it would be better to allow existing companies to choose between the two approaches.

5.4.32 We would suggest that the funds subscribed for NPV shares, less the amounts paid out in expenses and commission on the issue of those shares, should be treated as capital funds which could only be reduced as discussed above. But by contrast with the provisions of section 130(2) for application of share premium account, we would not include the expenses of an issue of debentures as an exception to the general rule on the ground that this is inconsistent with the principle that the reserve established on the issue of share capital should be at least equivalent to the net proceeds of the issue.

5.4.33 We would welcome the views of consultees on the following points:

Question 32 **Should both new public and new private companies cease to be permitted to assign nominal values to their shares?**

Question 33 **If the Second Directive continues to require that shares of public companies are assigned either a nominal or an ‘accountable par’ value (ie that the shares have attributed to them a fixed amount of the share capital reserve) is there value in taking advantage of the limited flexibility provided by the accountable par provisions of the Directive?**

Question 34 **If nominal shares are abolished for any class of new companies:**

(a) should existing companies be required to convert their existing share capital and register the conversion?

(b) or should existing shares merely be deemed to be of no par value with consequential effects on the balance sheet?

87: As has been done in New Zealand – see Chapter 4.

(c) or should existing companies be permitted to choose between having nominal value shares and no par shares?

Question 35 **In cases where no par value shares are adopted should the rules on the distributability of reserves be as proposed in paragraph 5.4.32 – ie there should be a single reserve for share capital equal to the net proceeds of the issue – ie with no right to write off the expenses of an issue of debentures against this reserve?**

Question 36 **If nominal value shares continue to be permitted, should the equivalent regime be applied to share capital and share premium accounts?**

Regulation and Boundaries of the Law

5.5.1 The main topics dealt with by the Act include the formation of companies of various types; shares and share capital; company disclosure, including accounts and audit; and company management, including the role of directors and of the general meeting, where auditors also have a role to play. But much of the regulation in these areas is not in the Act. A substantial body of secondary legislation has been made under the Act; accounts must, in most circumstances, be prepared in accordance with accounting standards; listed companies are bound by the Stock Exchange Rules; takeovers are conducted according to the City Code on Takeovers and Mergers; listed companies must, under the listing rules, indicate in their annual report compliance with the Combined Code on corporate governance. The nature of the obligation, and the consequences of breach, are different in each case. In some areas two or three layers of regulation are superimposed. The table at Annex F summarises the different rule-making and enforcement jurisdictions currently operating in company law and related areas[88].

5.5.2 The table illustrates a spectrum of techniques. At one end, there are statutory obligations set out in the Act itself, with criminal and/or civil sanctions for non-compliance. At the other are the provisions of the Combined Code on corporate governance, where the obligation is one of disclosure only, and the formal sanctions for non-disclosure are limited to those provided for in the Stock Exchange Rules. (In this case, as in some others, the most effective sanction in practice is loss of reputation and of shareholder support). In between are accounting standards, where the rule-making role has been conferred upon a qualified non-governmental body, while the rules themselves are accorded some statutory recognition[89]. The table is not fully comprehensive, notably for investment exchanges[90].

88: The definition of ‘related areas’ is somewhat arbitrary. We have excluded, for brevity, and as not directly within our terms of reference:- corporate insolvency; corporate forms other than limited and unlimited Companies Act companies, including building societies, friendly societies and open ended investment companies; and sector-specific regulation e.g. insurance, banking, charities, and investment business. However, we recognise that there may be ‘knock-on’ effects, of which we must take account, between any of these areas and company law as we have defined it.

89: Schedule 4, paragraph 36A requires company accounts to state whether they are prepared in accordance with accounting standards, and to explain departures (other than small and medium-sized companies, see Chapter 6.14-15 below).

90: The main Stock Exchange Listing Rules are included in the Annex, but the rules of the Exchange’s Alternative Investment Market (AIM) are not. Equities traded on AIM are unlisted, and must therefore produce a prospectus complying with the Public Offer of Securities Regulations (q.v.). Nor are the rules of Tradepoint – the only recognised UK investment exchange apart from the London Stock Exchange on which equities are traded – mentioned. These equities are officially listed and must comply with those of the Stock Exchange ‘Yellow Book’ provisions which implement Part IV of the Financial Services Act.

5.5.3 There are merits and drawbacks in these different forms of regulation. Regulation by, and enforcement under**,** statute has the merit of democratic legitimacy in the making of the rules and, in the company law field, the widest consultation beforehand. Enforcement through the courts is open and independent of rule making. Ministers are accountable publicly for the effective operation of the rules. But such statutory regulation also has drawbacks. In a field where commercial practice and, more recently, technology, is constantly evolving, it is often difficult to respond with appropriate changes in the law, unless the need to do so has been anticipated and secondary legislation powers provided[91]. In addition, the perceived need to foresee and provide for every eventuality has led to a level of complexity in the statute beyond the capacity of those without legal training to assimilate. Non-statutory regulation enables flexibility and dynamism in the development of rules and other guidance, while it tends to permit in appropriate contexts a higher level of generality or vagueness in expression, combined with more sensitive discretionary enforcement to meet the merits of varying cases. The drawbacks can include lack of precision; lack of transparency in both the rule making and the enforcement activities; and suspicion, well founded or not, that the authorities administering the rules may tend to favour their own members or clients, or wider commercial considerations. In the case of the Stock Exchange Listing Rules, for example, onerous prescription may lead firms to seek listing elsewhere. There may also be a tension between the role of non Governmental regulators which are commercial or professional organisations and their responsibilities for administering a widening range of rules, such as those on corporate governance, and some monitoring of these. Some of these drawbacks can be mitigated by, for example, wide consultation when rules are changed and introduction of an independent element into the competent bodies.

5.5.4 A number of issues arise in relation to the present distribution of functions, which is the outcome of ad hoc decisions rather than any grand design. What is the core competence of each regulator? Does the present distribution of functions make appropriate use of those competencies? Would any reallocation of functions improve the quality of regulation? More specifically, is there scope for simplifying the regulatory requirements facing companies, by

91: Secondary legislation has many of the characteristics of statute but can be much more responsive to change. The possibility of greater use of such legislation is highly relevant in the present context, but is discussed in the context of wider legislative issues in Chapter 8, below.

reducing the overlap between the provisions of the Act and the rules of other regulators. Is the present division of competence in accounting, where an independent body, the Accounting Standards Board (ASB), is responsible for standards (though with statutory backing for these and statutory provision for their enforcement), but the form and content of the main financial statements is laid down by the Act, the right one?[92]

5.5.5 We are inclined at this initial stage to believe that there may be scope for rationalising the present regulatory structure. However, we acknowledge that the present structure offers the benefit of familiarity even if it sometimes appears to lack logic, and that there needs to be substantial benefit to justify major change. We will examine the scope for this topic by topic in the next phase of our work. We believe that a distinction needs to be drawn between the form of legislation, in terms of precision, flexibility and sanctions, and the nature of the competent body and of the function which it performs, whether prescribing the rules or enforcing them or both. But we would expect the general trend to be away from prescriptive rules set out in the statute and enforced by criminal sanctions. These might in appropriate cases be replaced by more flexible rules in the form of codes of practice, expressed in sufficiently general terms to permit the exercise of judgement and common sense in their application to individual cases. The administration of such rules would be a public law function, and appropriate safeguards are required.[93] Responsibility for this could rest either with a public or a private body; the availability of effective sanctions would be a key factor in the decision.

5.5.6 At this stage we have not attempted to consider the implications of the questions raised by this Chapter in specific contexts, though one is mentioned in 6.8-10 below (see too paragraph 7.11 below on the Law Commissions' considerations). It will be important, in doing so, to consider the allocation of each of the following functions – rule-making, interpretation, enforcement and adjudication, as well as the extent to, and means by, which any non-governmental body is authorised or recognised by statute in performing its regulatory function.

92: The form and content of accounts are laid down in outline by the Fourth and Seventh Directives, but it would be quite possible for the ASB, or some other non-governmental body, to be directly responsible for the implementation of these as part of an integrated accounting regime. See too Chapter 6.4-10.

93: It is possible for similar flexible codes to be made and administered by bodies formed and governed by statute – the Financial Services Authority (formerly the Securities and Investments Board) is the leading example in the field of commercial regulation.

Other characteristics of the regulatory solution, which will need to vary according to the demands of the context, are the degree of lay participation in the governance of the bodies concerned and the weight of professional expertise to be deployed. We expect these issues to be considered in their specific context by the working groups during the next phase and recognise that the demands of the particular context should dictate the shape of the regulatory response (see Chapter 9). We would nevertheless welcome comments at this stage on the general approach, particularly on the following questions.

Question 37 **Is the broad analysis and approach in Chapter 5.5, and in particular the inclination to move more in the direction of "non-statutory regulation" (i.e. away from the rules being laid down by or under statute and enforced by criminal and/or civil sanctions) correct?**

Question 38 **How could the present arrangements for allocating jurisdiction between regulatory bodies as set out in Annex F be simplified while improving, or at least preserving, their efficacy?**

Question 39 **Are there specific areas where there is a case for changing the present allocation of roles and functions and/or the extent to which statutory recognition or support is conferred on non-governmental institutions?**

Purpose

5.6.1 In Chapter 2 we stressed the need to ensure that our company law provides a competitive infrastructure, which is attractive to internationally mobile businesses, ensures an efficient regime for our own companies in a fast integrating world economy, and ensures fair terms for all companies (including domestic ones) operating within Britain, regardless of origin.

5.6.2 In this section we therefore examine:

- the relative attractiveness of the British regime for business;
- the basis on which we assert jurisdiction and impose our company law rules on companies with an overseas character; and
- more specifically, our rules for regulating companies formed abroad and operating here, without incorporating under our law, and the relative impact of those rules as compared with rules we apply to companies which are incorporated here.

The British Regime – its Relative Attractions

5.6.3 Generally, the evidence suggests that company law is not a major consideration in the decision whether or not to locate business in the UK. The UK, without the benefit of unusual fiscal or aid incentives, successfully attracts far more than its 'fair share' of such investment[94]. However there is little doubt that the main considerations affecting such decisions are fiscal, operational and macro-economic. A very limited survey of inward investors, supplemented by the experience of our working group, establishes that our law has very considerable strengths – in particular relative certainty, efficiency of administration, and relative structural and institutional flexibility enabling it to respond effectively to business needs. British law is regarded as more business-friendly than other European systems, but less so than the law of some North American jurisdictions.

94: Recent UN figures (United Nations Conference on Trade and Development, World Investment Report, 1997) show the UK attracting 28% of EU inward investment; Germany, in second place, attracted slightly less than half as much to a substantially larger economy. Whether measured in terms of stocks or flows, the UK has higher ratios of inward and outward direct investment to GDP than any other major economy.

5.6.4 A significant list of 'irritants' which internationally operating companies wish to see corrected also emerged. Of these the most important was the detailed and highly technical capital maintenance regime[95]; the rules on directors' transactions (loans etc); the complexity and outmoded character of parts of the law (objects clauses and the ultra vires doctrine, par values for shares); the absence of a flexible solvent dissolution process or means to achieve mergers of solvent companies; the lack of an easy method for moving corporate domicile into and out of the British jurisdiction; the breadth and complexity of Part VI (on disclosure of interests in the shares of public companies); the requirements in the Act that certain new share issues should be authorised by the general meeting[96]; the requirements on the localisation of the register of members within Britain; the law ('illogical', 'ambiguous' and 'incomprehensible') on the registration of oversea companies with a presence in Britain (Part XXIII, see below). Reference was also made to the complexity of our system of multiple regulation of company law matters and to the absence of a cheap and simple method of forming a small limited liability business (comparisons were drawn with the US, for example). The last point may not be of much significance in an international context, but this may change.

5.6.5 We would not necessarily accept that all these 'irritants' represent weaknesses. Irritants to management may represent valuable and proportionate protections for creditors or members; however the majority of them have already been recognised as substantive issues in working groups. Proposals on some have been made above. All the others will be considered in later phases of our work (see Chapter 9, below).

5.6.6 Some of the stronger components of our company law which might be expected to cause concern, such as our system of company accounting and reporting, insolvency regime and the Department's inspection powers, were not mentioned by any of our interlocutors.

5.6.7 We sought views on changes which might, if adopted here, alter this relatively favourable view of the UK. The principal point to emerge was that international advisers would tend to avoid founding companies in countries such as Germany, with inflexible mandatory rules

95: Particularly the insistence on court approval for capital reconstructions and the financial assistance regime which has been described as an obscure trap.

96: Sections 121 and 159.

on capital structure and forms of employee participation and split boards, presenting major problems for companies unfamiliar with such systems. We have little doubt that extreme forms of 'stakeholder' governance would cause concern for inward investors and that this aspect needs to be borne in mind[97]. In spite of the importance of other factors German employee participation rules do tend to lead international company lawyers to prefer other jurisdictions.

5.6.8 Issues for consultation:

Question 40 **(a) Is it agreed that British company law is generally attractive to inward investors and that the list in paragraph 5.6.4 sets out the main irritants?**

(b) if not, what else should be included?

Question 41 **What proposals for change beyond those contemplated in this document are desirable in this context?**

Question 42 **Are there any models overseas, or particular kinds of reforms, which should be avoided in this perspective?**

Jurisdictional Rules and Applicable Law

5.6.9 Two related issues arise here – the circumstances in which our courts and regulators will intervene to assert their powers ('jurisdiction') and the extent to which we impose our law, or accept the operation of other laws, in matters with an international component. Both clearly bear on the effectiveness of our law in the international context and on its flexibility for foreign businesses.

5.6.10 Generally the national jurisdictions in the UK adopt a territorial approach to jurisdiction, particularly in relation to criminal matters (ie they claim power to govern events which take place within them). However, in company law this is modified by the recognition that

97: The German market, which is large and profitable, remains attractive to inward investors. Germany's economic success, which is part of the attraction, may itself be attributable to the relative inflexibility of its law and to employee participation institutions. But there can be little doubt that such innovations here would make investment less attractive.

issues about whether companies exist and about their internal operation need to be referred to the law under which they claim to be formed (law of incorporation). We do not insist on any connection with the country of incorporation, other than effective use of its law to achieve the relevant status.[98]

5.6.11 This means, in particular, that people operating in Great Britain may, if they choose, incorporate under a foreign law, and do business here with the benefit of that status, and that people from abroad may, so far as Great Britain is concerned, lawfully incorporate under British law and locate the whole of their activity overseas.

5.6.12 So British businesses can opt out of the whole of the internal rules of company law if they choose. This includes not only rules on internal governance, such as members' and directors' rights and duties, but also matters relating to creditor protection, such as capital maintenance or self-dealing by directors (company loans to directors, etc)[99]. We are aware of little concern at the resulting possibilities for evasion, perhaps because of the practical difficulty of operating an oversea company effectively in Britain. But this may be changing (see below). There have been occasions, however, when the use of foreign law became popular because of defects in our law[100]. Any decision to make our law more onerous would need to take this possibility into account, or would need to be accompanied by more stringent rules to prevent evasion, perhaps like those in Germany (see below).

5.6.13 There is a corresponding difficulty with oversea businesses operating abroad and opting for British corporate status. The absence of a real presence in Britain may lead to enforcement difficulties and ultimately to automatic 'striking off'(dissolution) by the Registrar. The confusion in the interim may be significant, particularly in the country of operation.

98: Different approaches are adopted by the Takeover Code (residence of target) and the Stock Exchange Listing Rules (see Rule 17), however.

99: Section 745(1) provides that the Act does not apply to non-British companies unless explicit provision is made to the contrary.

100: See 'Modern Company Law for a Competitive Economy', (DTI 1998) paras 4.5-6.

Alternative Approaches

5.6.14 Some countries address the alleged problem of companies operating under laws with which they have no real connection by insisting on a real connection between a company and its claimed place of incorporation. The most common approach is the so-called 'real seat' doctrine, which requires companies to have their centre of management control in the territory of formation. Thus if a UK limited company trading in Germany can be shown to be really controlled from Germany, or some third country, under German law the company does not exist to assert its claims (though it can apparently still be sued). German case law shows the strongly regulatory and 'protective' character of this approach[101].

5.6.15 However, so long as the real seat is located in the territory of claimed incorporation, German law will apply the law of incorporation approach, so that, for example an English private company controlled in England[102] can trade in Germany without a minimum capital, although German law would require an equivalent German company to have it.

5.6.16 California adopts a different approach. If a company incorporated elsewhere has more than 50% of its business and stockholders in California, and is not listed, Californian law will be applied to exclusion of the law of incorporation, leading to a possible contest between the law chosen by the founders and Californian law as to the rules regulating the internal affairs of the company[103] . Under Clause 13 of the draft Limited Liability Partnerships Bill contained in the Department's Consultation Paper[104] a power is conferred on the Secretary of State to apply domestic law to foreign limited liability partnerships with 'such connection' with Great Britain as he determines. This is a flexible power to adopt something like the Californian approach.

101: eg Re Expatriation of a German Company [1993] 2 CMLR 801

102: Whatever that may mean, precisely – the law does not seem clear.

103: California Corporations Code sections 2115 and 2116.

104: Limited Liability Partnerships, URN 98/874, September 1998.

5.6.17 The UK ‘freedom of contract’ approach means that generally UK company law is applied to all company law matters relating to UK companies wherever they carry on their activities (a loan to directors is illegal wherever advanced, for example)[105]. Similarly UK law will not be asserted against companies formed abroad.

5.6.18 There are two main exceptions to this approach which help to allay concern about its weaknesses. First, our insolvency law claims jurisdiction over companies world-wide ‘if there is sufficient connection between the company and England and there are persons who would benefit’[106]. In effect UK law is happy to let members look after themselves, but for creditors it asserts a ‘long arm’ jurisdiction. This ensures for example that directors are bound by the Insolvency Act version of the duty of care and skill for creditors[107].

5.6.19 The second exception is that foreign companies with a presence in Britain may be subject to the Oversea Companies rules (Part XXIII). These are intended to ensure appropriate disclosure by such companies, but are open to major criticism, discussed below.

5.6.20 The general law protecting third parties also applies to foreign companies, subjecting them, for example, to the normal rules on safety or consumer protection.

5.6.21 The ‘real seat’ doctrine is of questionable legality under EC law and the European Human Rights convention. It may be argued to be uncertain and arbitrary in its effects and, as the location of company control becomes more uncertain with electronic commerce, this may became a more serious problem. The Californian approach may be open to similar objections.

5.6.22 We would be grateful for views from consultees on:

Question 43 **(a) Is the present British approach on the law applicable to companies, based on the law of the place of formation, preferable to either the ‘real seat’ or the more subtle California type approach, and should it therefore be retained?**

105: For a discussion and endorsement see Law Commission paper 153, Scottish Law Commission 105, Company Directors (1998), paras 8.21-8.23.

106: Halsbury, Law of England 4th Ed. Vol 8(1) at para 991.

107: Insolvency Act 1986 section 214. The Directors’ Disqualification Act 1986 is similarly extraterritorial.

(b) or is there a case for taking a power enabling the Secretary of State to apply prescribed British company law rules to foreign companies with prescribed connections with Great Britain, analogous to clause 13 of the draft Limited Partnership Bill?

Oversea Companies (Part XXIII)

5.6.23 A company incorporated overseas may carry on business here:

- on a 'services' basis, ie by dealing with customers, suppliers etc without establishment of a presence of its own here, either by actually communicating across the frontier (increasingly possible with modern communications), or by employing an agent or other intermediary, but ensuring that the agent's place of business remains his, and not the company's. Company law does not regulate this activity in any way, though sectoral regulation may (eg financial services regulation of companies 'carrying on business' here); or

- by establishing a presence, or establishment, from which business is done, either in the form of a 'place of business' or in the form of a 'branch'. Such companies ('Oversea Companies') are governed by Part XXIII. The requirements are different according to whether the presence is a place of business or a branch. A 'place of business' encompasses both a presence less substantial than a branch and one where the central management and control of the company is here; or

- by establishing a subsidiary company – ie a company formed under our law and subject to the same rules as any domestic company, but owned or controlled by the foreign parent.

Statistics

5.6.24 The rest of this section of the Document is concerned with the rules which apply to Oversea Companies and their comparison with rules applying to others.

5.6.25 No statistics are available about subsidiaries of foreign companies operating here[108]. They probably hugely outnumber oversea companies. Nor are there statistics about such companies operating on a services basis, though we suspect their numbers may be rising. The statistical position on Oversea Companies is set out in Annex G. This sets out the Part XXIII registrations at Companies House at 31 March 1998.

Operation of Part XXIII

5.6.26 Part XXIII is very complex and the detail is beyond the scope of this paper[109]. There are two registration regimes, one for 'branches' introduced by the EC Eleventh Directive, and one for places of business which are not branches, the basis for requiring registration before the Directive regime was introduced; this latter regime continues to apply to places of business which are not branches:

- oversea companies which set up a 'branch' in Britain must register certain particulars at the companies registry. 'Branch' appears to be very loosely defined by European law, which we cannot, of course, change unilaterally; it means 'a place with the appearance of permanency ...' which '..has a management ...' and '... is equipped to negotiate business with third parties so that they do not transact business with the parent, though they know that if necessary there will be a legal link with the parent'. Registration is required of various details designed to enable creditors and others to identify the person to sue on behalf of the company and to obtain access to information about the company, including accounts. In the case of companies originating within the EC, registration of full, audited (where audit is required by the home Member State) country of origin

108:However, for an analysis of the largest 3,000 see Britain's Top Foreign Owned Companies (13th Ed) Jordans, 1998 (1,516 are identified with sales over £50 million).

109: There are 35 sections and 4 schedules in all, with special rules for banks, for example.

accounts is required relying on home country enforcement of EC law[110]. If the state of origin does not enforce the law nothing is filed and the UK authorities can do nothing. Oversea Companies formed outside the EU must file the same particulars and are required to file home state audited accounts, if any, but must otherwise file 'section 700' accounts, which need not be audited[111]. The UK is not, under EC law, permitted to impose more stringent requirements than those required by the Eleventh Directive, but the scope of this restriction is not clear and is currently subject to litigation[112]; and

- for oversea companies which establish a place of business which is not a branch, either because it falls short of the definition in terms of the nature of business carried on or because significant control is exercised from it, similar but not identical registration rules apply and they have to file section 700 accounts[113].

5.6.27 The obscurity and complexity of these rules and their other characteristics make them extremely difficult to enforce. The sanction is a criminal penalty to be enforced by the Registrar against 'officers or agents knowingly or willingly authorising or permitting the default'. Such people may be hard to trace and outside the UK's jurisdiction. Also, due dates for compliance are not self-evident. The requirements are also arguably lax in substance – accounts are not required to be audited, for example[114]. A number of responses to the March 1998 Consultation Paper suggested that these rules should be simplified, but there is very little evidence of hardship from their operation; the level of complaints is very low, both from companies and from third parties likely to be damaged by non-compliance.

110: Fourth and Seventh Company Law Directives on individual and group accounts. UK authorities have no powers to enforce these requirements.

111: No director's report is required, nor details of directors' emoluments, for example, and UK accounting standards do not apply in full. See too SI 1980/440.

112: See the footnote to paragraph 3.7

113: Complex provisions apply to companies which cease to have a branch but retain a place of business, or vice versa, and to the permutations of this between the different UK jurisdictions.

114: For example, where companies are required to publish accounts under home state law they are permitted to register them here in whatever form is required there, and the period in which they are allowed to do so is three months after they are first actually disclosed under home state law. This requirement is arguably lax, and clearly unenforceable against some thousands of overseas companies. (Schedule 21D paras 1-14). It means that even a company listed in London may be filing accounts under these provisions which are stale and highly defective by our standards.

5.6.28 The following points arise:

(a) the law could be much simplified by the removal of place of business registration and reliance solely on the branch regime. We would favour this for company law purposes but we are concerned that there may be wider implications. The definition of branch needs to be extended, probably in any event, to include the place of central management. But consultation with the European Commission (and possibly amendment of the Eleventh Directive) would be necessary on this;

(b) a very high proportion of registrations are by companies which originate in jurisdictions where the regimes are flexible and regulate little. For example about half of US registrations are from Wyoming companies which have minimal disclosure obligations. Many of these appear to be controlled from the UK and in many cases no accounts have ever been filed. We propose to carry out more research on this, but we would welcome comment on whether this causes problems in practice. The 11th Directive permits us to impose more stringent requirements on companies of third country origin, including requiring accounts for the branch;

(c) how can the exemption of Oversea Companies from the great majority of the creditor protection provisions in the Act be justified? It might be argued that creditors are on notice of the possible absence of the protections which apply to British companies – but this would be a reason for allowing British companies exemptions from such provisions provided that adequate publicity is given. On the other hand, we have noted that other countries too (for example, Germany in relation to minimum capital) are prepared to accept a laxer regime for foreign companies;

(d) there may be a case for a more effective sanction for the accounting and disclosure requirements of Part XXIII, for example the right for those dealing with such companies to assert the invalidity of transactions against them on the German model. There would need to be a possibility for Court relief in deserving cases and consideration would have to be given to the argument that the absence of a similar sanction for late filing of domestic company accounts would be discriminatory; and

(e) there is an argument that with the growth of electronic commerce it is becoming extremely easy to carry on business in Britain without establishing any physical presence, via an Internet website which is located overseas (to the extent that it is located anywhere). This looks a very easy means of avoiding Part XXIII.

5.6.29 We would welcome comments on the following questions in particular:

Question 44 **(a) Is it agreed that Part XXIII should be simplified?**

(b) if so, given that the branch registration regime is an EC requirement, should the rules be aligned on branch registration, or by applying the current regime for branches to all places of business?

(c) or should there be simplification in some other way?

(d) would anything of value be lost by abandonment of the place of business registration requirement?

Question 45 **If a regime based on branch registration were adopted would it be desirable to ensure that a place from which control was exercised was treated as a branch, with EC law amendment if necessary?**

Question 46 **(a) Are consultees aware of significant harm arising from compliance, or non-compliance, with Part XXIII rules, and**

(b) if so what, and what would they propose by way of legislative response?

Question 47 **(a) Does the growth of electronic commerce make Part XXIII outmoded, or suggest that it should be extended to ensure adequate disclosure by companies accessible by the Internet?**

(b) If the latter, what proposals should be considered for providing sanctions for non-compliance, given the absence of a physical presence within the jurisdiction?

Chapter 5.7 Information and Communications Technology

Introduction – nature of the issues

5.7.1 This section of the Document is concerned with the issues surrounding modern electronic means of communication and storage of information. These new technologies represent a major resource for competitive operation of companies with, we believe, exciting potential for greater efficiency and for greater provision of information about the operation of companies. It is a high and urgent priority to facilitate their exploitation. The law has only partly been adapted to enable them to be exploited and regulated. They also raise new problems and risks for which provision is needed.

5.7.2 These technologies enable all forms of information, text, sound, still and moving pictures and any combination of these, to be encoded, usually in digital form, and communicated, and/or held in a database. Access to such communications or data can be made available virtually instantaneously to anyone with access to an appropriate network, and the necessary equipment to decode it.

5.7.3 The key technologies include the familiar telephone and fax, simultaneous real time communications of images, by video telephony and video conferencing, similar communications with an element of delay, such as electronic mail, and the accumulation and making available of information of any kind on a computer data base and provision of access to it, including sometimes, the possibility to add to it or manipulate it, by means of a network.

5.7.4 The most important such network is currently the Internet, which enables anyone with a telephone line and a networked digital terminal (personal computer or interactive television) to access any database connected to the network, to add to or alter it if it is open to this (typical examples of such databases are electronic ‘bulletin boards’) to copy information for their own use, and to exchange text and other information by means of electronic mail.

Strengths and Weaknesses

5.7.5 The Internet is not yet as ubiquitous as the postal service, on which the law currently largely relies; while virtually all companies have telephone lines and the vast majority have

personal computers, only 90% of households have telephones and only 16% are connected to the Internet. However both statistics are increasing.

5.7.6 Nor is the Internet wholly reliable and in the case of non simultaneous communications there is no necessary indication of receipt. However, its use is typically far cheaper and quicker than the compilation of documents in hard copy form and use of the post, and, for those who have access, the receipt of material in digital form is also normally cheaper and more convenient. We believe that electronic mail's speed and reliability is already comparable with the postal service over short distances and hugely superior internationally.

5.7.7 Electronic material is capable of being corrupted, forged, lost or destroyed more easily than hard copy, or at least in different ways. Its location is immaterial if access is networked, and jurisdictional and enforcement problems may arise. Other considerations which bear on security are the absence of a complete equivalent to a personal signature and the new possibilities for interception of communications. On the other hand, the new technologies offer new, and in some respects significantly superior, means of providing for authentication, verification, monitoring and enforcement.

5.7.8 These technologies are volatile in the speed and direction of their development and in the development of their uses ('applications'), and abuses. At the very least new and unforeseen applications will develop, access will become more widely available and use will become cheaper and more convenient. But the continuing availability of the Internet, or a functional equivalent, can be relied upon.

General Relevance to Company Law

5.7.9 These media enable new methods of carrying out company operations for which the law makes provision. These include – communication between the key participants, members, directors, the registrar of companies and others; and the holding and making available for inspection of information on registers in the Companies registry, within companies, in out-sourced repositories run by third parties, such as company registrars, or elsewhere such as at the Stock Exchange; this may be done, for example, at a 'website' ie a database connected to the

network with access open to all or to an authorised class equipped with appropriate passwords or encrypted ‘keys’.

5.7.10 It also enables new forms of company related communications and disclosures, such as the holding of multi-location, or non-real time, ‘meetings’, the reporting of information through new media such as the Internet, and in new forms allowing selective access and interaction, for example, and remote voting.

Objectives

5.7.11 We believe the approach here should be based on the following general objectives:

- ensuring competitiveness by enabling the widest possible use of the new media by companies, reducing cost and ensuring ease of compliance;
- promoting greater efficiency and quality of service at the Registry of Companies;
- promoting transparency and availability of information; and
- promoting participation and higher standards of governance.

5.7.12 This leads us to favour an approach based on the following principles:

- in general participants should be enabled to exploit the new technologies on the basis of a facilitative and technology neutral approach;
- security is an important consideration, but a proportionate approach should be adopted, recognising that current systems are far from absolutely secure and that a balance should be maintained recognising that in some respects the new technologies are more secure than the old;
- legal changes should be in a flexible form, able to be readily adapted to changing applications and patterns of abuse;
- as far as companies are concerned, the permissive rather than prescriptive approach may also need to change over time – for example, more extensive, or different, reporting

requirements may be desirable for large companies, given the greater speed, lower cost, and increased targeting of audiences which the new technologies enable; and

- but the law should continue to ensure reasonable access to company information for individuals, recognising (for so long as this is the case) that domestic access to modern forms of communication, such as the Internet, is limited.

Current Provisions Dealing with These Technologies

5.7.13 A number of piecemeal attempts to address these issues have been made in the Act over the years.

5.7.14 So far as company records are concerned, the Act provides that any ‘register, index, minute book or accounting records’ may be kept either ‘in bound books’ (a Victorian security device) or ‘by recording .... in any other manner’, including in non-legible form, and for inspection to be available by the provision of a legible copy of the recording[115]; regulations may make certain appropriate adaptations to the substantive provisions[116], but problems remain[117].

5.7.15 So far as the Companies Registry is concerned, the Act allows the Registrar to receive material in non-legible form (but not to require this) and to lay down how it is to be presented and authenticated[118], and to maintain it and send it out in such form, as he approves. An initial scheme for receiving a limited amount of such material[119] is now in operation. However full electronic registration is not possible under these provisions[120]. The Act allows the form of

115: Sections 722-723A.

116: For example, allowing inspection of registers (e.g. of members or directors) at other than the statutorily prescribed place and providing for the manner of presentation and extraction of information, see SI1985/724, SI1991/1998.

117: For example, if minutes are kept in digital form how is the probative effect of a director’s signature to be achieved (see section 382)? Or what is the place of inspection of a register maintained on the Internet to be?

118: Sections 707-710A.

119: Annual returns and returns relating to changes of directors, secretaries or registered offices.

120: For example, the registration of a company requires a ‘statutory declaration’ (sworn, under an Act of 1835) – not achievable by electronic means; see section 12(3) and paragraphs 5.3.4-6, above.

presentation and distribution of information to be prescribed by the Secretary of State or approved by the Registrar, a practical, flexible provision.

5.7.16 Company accounting requirements are subject to an overriding power of amendment on the part of the Secretary of State, which would allow him to enable or prescribe distribution to members by electronic means[121]. This might even allow a company by consent to make its accounts available by 'posting' them at a website and informing members that they were available (a vastly less expensive and more convenient method than postal distribution, with considerable possibilities in terms of more effective disclosure – see Chapter 6, below). Finally if company accounts are available on the Internet there may well come a time when publication at Companies House is superfluous. It is sensible to anticipate this by conferring an appropriately flexible power to make provision for it and to resolve any doubts as to the scope of the existing power. Enforcement considerations, if such a solution were thought attractive at any stage, would of course require careful consideration.

Further Proposals

5.7.17 Generally, we believe that any information which is currently required to be sent to the Registrar, or maintained, in documentary form for the purposes of the Act should be permitted to be sent or maintained by electronic means and in electronic form. In particular, the statutory declaration should be replaced by a modern and flexible equivalent (see paragraph 5.3.14 above). An appropriate power to prescribe for authentication of electronic material should be conferred on the Secretary of State. The system for registration of charges should be examined with a view to enabling electronic registration. This may require substantive reform.

5.7.18 We are also inclined to suggest reforms in a number of general areas of the legislation as follows:

> **meetings of directors and members**. It should be expressly provided that a meeting is valid if all the participants have reasonable opportunity to participate whether or not

121: Section 257 (power to alter accounting requirements).

they are all in one place[122]. Whether it is appropriate to alter the requirements for members' meetings to permit, for example, 'virtual meetings', which might take a variety of forms, perhaps involving electronic voting, is a matter which should be considered in the next phase of the Review, when the wider policy issues surrounding the role and place of the general meeting of shareholders will be examined. Important issues of principle arise which are beyond the scope of this document;

communications between companies and members. At least with the consent of members it should be possible for a company to communicate any information electronically, including by informing members of its availability on the Internet. This should include notices calling meetings and related information and proxy forms[123]. Similarly it should be possible for members who wish to do so and where the company wishes to make the facility available, to communicate electronically with the company, for example by registering forms of proxy in digital form in advance of general meetings[124]. It might well be appropriate once this is clearly possible[125], to require larger public, or listed, companies to make this facility available. Similar arguments apply to publication of accounts[126];

information held at company offices. Various information is currently required to be held and available for inspection at company offices[127]. Careful examination is required of the extent to which electronic maintenance and inspection is currently permitted, though we are not aware of any difficulties in this regard. However much of this

122: See Re Equiticorp International plc [1989] 5BCC 599 (directors' meeting by telephone – valid) and Byng v London Life Assurance Ltd [1989] 2 WLR 738 (members' meeting in a number of rooms, linked audio-visually – valid)

123: Ancillary provisions will be required, for example as to length of notice and date of deemed delivery. Arguably these should be prescribed at least as default rules rather than left, where they can be, to company articles, to save transitional costs.

124: Such a facility should be useful in enabling nominee shareholders to communicate effectively with beneficial holders.

125: Sections 372 and 373 arguably require written documentary appointment of proxies.

126: Particular security considerations surround authenticating versions of a company's accounts as corresponding with the audited versions, but we believe that technical solutions to this problem do exist.

127: For example relating to members, directors, secretaries, company charges.

information is also required to be registered at the Companies Registry. Once Internet availability is effective, such dual registration may well in some cases become superfluous. Substantive examination of the relevant provisions in the next phase of the Review should consider the appropriate measures to deal efficiently with this possibility; and

information on business communications. The Act requires disclosure of various information on company documents and correspondence[128]. Electronic commerce now provides effective substitutes and modifications to the law to ensure equivalent protection appear desirable.

Form of Legislation

5.7.19 There are general arguments for a more flexible form for company law (see Chapter 8). But those arguments are particularly strong here. The nature of the needs is likely to change quite quickly and there appears to be a case for a flexible power to prescribe the necessary changes in substantive provisions to embrace the new technology, including a power to prescribe new protective measures for example in relation to audit of non-statutory reporting. This would suggest that, once the examination of substantive provisions suggested above is complete, consideration should be give to a broad secondary legislative power, subject to appropriate safeguards, to prescribe the necessary provisions.

5.7.20 We would be grateful for views generally on the issues raised and proposals set out in this Chapter. In particular:

Question 48 Are the material characteristics of the technologies and their relevance correctly described and assessed in paragraphs 5.7.1 to 10?

Question 49 Are the objectives and principles proposed in this context correct and complete (paragraphs 5.7.11 and 12)?

128: Sections 305, 349, 351.

Question 50 **Are the substantive proposals put forward in paragraphs 5.7.17 and 18 the right ones, ie that:**

- **any information required to be sent to the Registrar or maintained in documentary form should be permitted to be so in electronic form and by electronic means, with appropriate powers to prescribe for authentication;**
- **meetings via electronic means should be expressly declared to be valid so long as all participants have a reasonable opportunity to participate (subject to further consideration of 'virtual' meetings);**
- **companies should be free to communicate electronically with members for all purposes with their consent, including by notifying availability of information on the Internet; (information currently held at company offices in electronic form may duplicate information at the registry – this issue should be examined in the next phase – but comments on it would be welcome); and**
- **the rules on company information on business communications should be extended to equivalent electronic communications?**

Question 51 **Should a flexible power to deal with adaptations of the law to deal with electronic communications, their development and abuse, be conferred on the Secretary of State, as proposed in paragraph 5.7.19?**