

**MODERN COMPANY LAW FOR A  
COMPETITIVE ECONOMY: *THE  
STRATEGIC FRAMEWORK***

**RESPONSES TO THE CONSULTATION DOCUMENT  
PUBLISHED BY THE COMPANY LAW REVIEW  
STEERING GROUP, FEBRUARY 1999**

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## **1 Introduction**

1.1 The primary purpose of this document is to provide the key components of the Company Law Review - the Steering Group, the Consultative Committee and the Working Groups - with a guide to the views expressed by those who responded to the Consultation Document *Modern Company Law for a Competitive Economy: The Strategic Framework*, published in February 1999. This Consultation Document, the first major output from the Review, sought comments on the issues raised in it and, in particular, on the 58 separate questions posed throughout it and summarised in Chapter 10.

1.2 The Consultation Document requested that comments be submitted by 1 June 1999. The Review Team received responses from 137 individuals or organisations, the majority arriving around the time of the deadline. Of these, only those received by the end of July are covered by this summary. At Annex A is a list of responses in the order in which they were received, and at Annex B is an alphabetical list of respondents. At Annex E is a list of documents that were enclosed with responses but which are not covered by this summary.

1.3 Responses to the Consultation Document came both from those usually associated with company law issues - the professional bodies, law and accountancy firms, company law academics and the investing community - as well as from a range of organisations such as Amnesty International and the World Development Movement that are not regular commentators on company law matters. This latter group tended to focus on the scope of company law issue covered in Chapter 5.1 of the Consultation Document.

1.4 Given the size of the Consultation Document, the technical nature of some of its subject matter and the wide range of issues that it covered the Steering Group has been much encouraged by the large number of responses received and the effort and thought devoted to their development. Many of the responses were substantial documents in their own right, reflecting the great deal of thought and effort that had been devoted to addressing the issues raised in the Consultation Document. Equally, a good number of shorter responses focused on one or two areas of particular interest or concern to the respondents.

1.5 In order to be able to assess the information provided in the responses the Review Team scanned them so that they would be available in electronic form. A second stage in the exercise saw the comments of different respondents to the same question being grouped together (and some comments not specified by respondents as addressing a particular question were grouped under a question where this seemed preferable to do so for ease of reference, while some comments addressing a particular question have been assigned to a different question where that seemed appropriate). This process resulted in the creation of over 800 pages of text.

1.6 A statistical breakdown of the comments received by broad subject is at Annex C. This shows the preponderance of comment on the scope of company law issue (Chapter 5.1), together with the importance attached by respondents to issues surrounding small private companies (Chapter 5.2) and the interest aroused by the

Consultation Document's provisional proposals on reforming the capital maintenance regime (Chapter 5.4). A numerical analysis of respondents' views on particular questions is given at Annex D; while this is of some interest and value - especially where there is a preponderance of opinion in favour of a particular point of view - it should be borne in mind that this analysis takes no account either of the knowledge, experience or standing of respondents nor of the quality and extent of the arguments they put forward in support of a particular proposition.

1.7 The remainder of this document is devoted to a brief summary of the views expressed in the responses. Given the scale of the comments indicated in paragraph 1.5, this summary does no more than provide an overview of the comments received and, hopefully, acts as a signpost for those wishing to pursue particular areas of comment. It does not purport to record every comment made by every respondent, only those that seemed to add something to the debate or made points that the Review needed to be aware of. In addition, the summary has had to conflate and combine the views of respondents in order to keep itself to a reasonable size. A more detailed summary of respondents' views would have resulted in a document of more unmanageable length.

1.8 This document, in particular, is not intended as a substitute for reading the responses themselves and does not purport to do justice to the many full and well-argued responses the Consultation Document attracted. In accordance with paragraph 1.20 of the Consultation Document, the text of the responses is being made publicly available via the Department's Library, with the exception of those who indicated that they wished their views to remain confidential.

1.9 References in the summary to the Act are to the Companies Act 1985 and references to sections are references to sections of that Act.

## **2 General comments on the Consultation Document**

2.1 As well as commenting on the detailed issues raised in the Consultation Document and responding to the specific questions it posed, a number of respondents took the opportunity to comment generally on the Review. The vast majority of these welcomed the concept of the Review and were supportive of the Review's objectives (particularly the aim of improving competitiveness) and processes (especially the Review's adoption of a consultative and consensual approach) and the quality and coverage of the Consultation Document itself.

2.2 A number of commentators did, however, offer a more critical viewpoint. The issues they raised were:

- the potential confusion caused by some of the terminology used by the Consultation Document, particularly its use of "company" as if it were synonymous with "business", whereas the corporate form was used by many organisations that did not pursue business and profit-oriented objectives;

- the need for the Review to ask radical questions and propose radical solutions rather than become a technical tidying-up exercise; and
- the Review process was overlooking the special requirements of the capital markets and the needs of investors.

### **3 Comments on Chapter 1, Introduction and Background**

3.1 There were, understandably, relatively few comments on this part of the Consultation Document, which was intended merely to sketch out the background to the Review and to explain the intended consultation process. The reference in paragraph 1.11 to the themes that emerged from the Consultation Paper issued by the Department in March 1998 did, however, elicit some comment. One respondent expressed surprise at the doubts at the usefulness of the AGM, noted that his experience suggested that outside interest in a company improved governance and performance and attributed this to directors having to face shareholders once a year at the AGM (the AGM also figured prominently in the other issues raised by commentators; see paragraph 18.2 below). A second commented on the view that company law should make greater use of civil as opposed to criminal remedies, arguing that criminal or “civil penalty” provisions had much to commend them in the context of company law .

3.2 Further commentators picked up points arising from paragraph 1.15 on the relationship between the Review and other company law reform proposals. One urged the Department to implement its proposals to reform and enhance the share buyback regime, both in respect of “treasury shares” and investment trust company buybacks, ahead of the longer term Review, as the current provisions imposed an onerous burden on quoted companies, while another expressed the hope that the Review would be able to reconsider the conclusions reached by the Law Commission on shareholder remedies, and particularly the recommendations regarding a new derivative action, including the issue of the power to ratify wrongs.

### **4 Comments on Chapter 2, The Overall Approach**

4.1 This Chapter of the Consultation Document, which described the overall objectives of the Review, the guiding principles that it had adopted and the approach taken so far, attracted a range of comment at a general rather than a detailed level. In addition, a number of general points made by commentators without reference to a particular Chapter or question can be usefully dealt with here.

4.2 The comments made are recorded below in the order of the Chapter:

- **paragraph 2.3:** the overall objective of the Review should be to create a single, reordered Act, so that the core requirements for all companies, however small, were in one place with the additional requirements for larger companies added progressively, with greater flexibility in the administrative arrangements for small

companies, less Court involvement in capital reorganisations and a coherent approach to the respective powers, duties and responsibilities of directors, shareholders, auditors and company officers;

- **paragraphs 2.4/5:** three commentators focused their attention on the Review's predominant objective of modernising company law so as to promote the competitiveness of companies. One stressed the importance in the British company law model of the direct involvement of shareholders as effective monitors of management and the need to develop a framework that further promoted and enhanced such involvement. A second argued that successful companies were the major driver of growth in the economy and it was therefore critical that the Review retained this focus, and ensured that rules and regulations took full account of those which applied overseas so that Britain was not put at a competitive disadvantage. Finally, a third argued that company law *per se* could not be a major factor in improving competitiveness though it could facilitate actions by directors and managers that would do so. Consideration should thus be given to the way in which changes to the Act will help management to perform better and directors to make decisions that enabled managers to do so;
- **paragraphs 2.17/8:** one commentator picked up the points made in these paragraphs about the need for company law to reflect the growing importance of "soft" and intangible assets, arguing that this should be an issue for the Accounting Standards Board (ASB) rather than the DTI. This commentator also argued that the Review needed to recognise that accounting standards were moving away conceptually from some of the traditional areas enshrined in the Act, such as the focus on "realised profits", and should ensure that the law facilitated the development of new forms of financial and non-financial reporting. These issues are picked up in more detail in the comments made in response to question 52 - see part 14 of this document below;
- **paragraph 2.19:** another commentator picked up the reference in this paragraph to reflecting in a revised company law the predominance of small and closely-held companies, noting that a key difficulty in conducting the Review would be that a large majority of specialist company lawyers are experienced in the problems of large companies, and especially listed public companies, but have little experience of small and medium-sized enterprises;
- **paragraph 2.20:** the section of this Chapter that outlined the guiding principles that the Review intended to adopt attracted a number of commentators who suggested a revised or alternative list of principles that they considered should replace those listed here. Two of these contributed more expansive critiques of the philosophical approach adopted by the Review, substituting their own conceptual frameworks, one based on a range of alternative guiding principles and the second on the concept of self-governance as the only way to regulate the complexity of the modern community of companies. Space prevents these responses being dealt with in full. Other commentators suggested further principles that could usefully be added to those contained in the Consultation Document, such as the expectations of modern society on business, the principle that the law should not impose undue requirements on the majority in order to control the "rogue" behaviour of the few

and that there should be consistency between the approach adopted by the Review and that taken by other elements of the Government's economic reform programme;

- **paragraph 2.21:** some commentators focused on the points made in this paragraph on accountability and transparency, one noting that accountability should not be equated with transparency - rather, governance could be analysed by reference to five components: accountability, transparency, predictability, credibility and participation - and another arguing that in order to balance the interests of society and business there should be a more effective system of corporate accountability;
- **paragraph 2.23:** one commentator, picking up the comments made here about possible approaches to enforcement and sanctions recommended that a clear indication be given in the law of the consequences of non-compliance and the penalties that would apply. Such penalties should be significant enough to provide an effective deterrent, and some mechanism should be adopted to ensure that financial penalties kept pace with inflation;
- **paragraphs 2.24/5:** the points made in this part of the Consultation Document on the merits of greater accessibility and ease of use of company law attracted comment from a handful of respondents. These were generally supportive of the principle of greater certainty, clarity and simplicity. One pointed out that certainty was important for those dealing directly with the company; which set of rules applied to a company should be readily apparent, and those rules should be clear and easy to apply. It should also be obvious from a foreign company's constitution or papers issued by its registry, what the English Courts would regard as the jurisdiction whose laws controlled its activities. Another commentator, while supporting the modernisation of core company law so that it was drafted in clear, concise and unambiguous language which could be readily understood by those involved in business noted that considerable care would need to be exercised in carrying out this project. Many statutory provisions were familiar and had been clarified by case law over the years and there was a danger in change for change's sake. Adequate time and resources and a realistic budget would need to be allocated for the Review. Draft clauses of any new legislation should be exposed to full consultation at an early stage. Finally, another recommended that any revised legislation be written in plain English and that the focus of the Review should be clarity, as well as brevity;
- **paragraph 2.26:** one respondent argued that the proposition in this paragraph on regulatory bodies would need to have regard to different traditional company models; and
- **paragraph 2.33:** one commentator, in supporting the view expressed in this paragraph that a company's constitutional structure represented the most difficult, important and wide-ranging of the areas yet to be covered, argued that the establishment of a coherent interrelationship between a company's directors, both executive and non executive, its members, auditors and other officers was a vital aspect of the process of reform. If an appropriate balance between these

interrelationships could be achieved, many of the problems, such as those involving the issue of professional liability, might be alleviated.

## **5      Comments on Chapter 3, *The European Dimension***

5.1      This Chapter, which outlined the legal framework under European Union Law and the European Convention on Human Rights which constrain and shape the options open to the Review in certain areas, attracted only two comments. Both argued the case for change to the current EU framework, on the grounds that liberalisation would allow Member States to make more of their own laws and rules which were better attuned to each individual country's priorities, standards, situation and culture and because the relevant Directives were now becoming out of date. There was a need to keep them up to date if the European Union was to remain competitive and able to adapt to changing economic situations.

## **6      Comments on Chapter 4, *The Comparative Dimension***

6.1      Similarly, this Chapter, which explained the comparative work the Review had undertaken, attracted only two comments. The first of these suggested the Consultation Document would have benefited from a more detailed outline of specific issues of the law in other European countries, in order to communicate some of the interesting approaches taken in countries such as France and Germany (not least because these were very likely to influence any further European company law measures) rather than focus on the law in countries with a legal system closer to the British. The second warned that company law was designed to meet the particular circumstances of the jurisdiction for which it was designed and that in looking at changes made in other countries it was necessary to consider the geographical and economic circumstances which dictated those changes and be aware that changes that had been welcomed or successful in other countries would not necessarily be equally welcome or successful for Britain.

## **7      Comments On Chapter 5.1, *The Scope Of Company Law***

7.1      This part of the Consultation Document was concerned with identifying the proper scope of company law, i.e. whose interests it should be designed to serve and the legal means by which it should do so, recognising that the conclusion reached on this subject would have important implications for the approach to be taken by the Review across a whole range of issues and subjects. The Consultation Document drew a distinction between the “enlightened shareholder value” approach, which asserts that company managers should have regard, where appropriate, to the need to ensure productive relationships with a range of interested parties - often termed “stakeholders” - and have regard to the longer term, but with shareholders’ interests retaining primacy, and the “pluralist” approach, which asserts that co-operative and productive relationships will only be optimised where directors are permitted, (or required) to balance shareholders’ interests with those of others committed to the company.

7.2 This part of the Consultation Document attracted by far the most comment from those who responded (see Annex C). What follows represent only a brief summary of the many long comments that we received on this topic.

7.3 **Question 1(a)** asked whether the present law requiring directors to have regard to the interests of members as a whole should remain in force without further clarification. **Question 1(b)** went on to ask whether the present law should remain in force with some additional declaratory clarification 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. The responses to these two related questions are considered together. Of those commentators who addressed these questions a slight majority favoured the addition of some clarification that directors should take account of all relevant factors in determining the best interests of the company. These figures, however, mask the position somewhat. Some of those who argued in favour of additional clarification did so on the basis that the current law applying to directors' duties was confused and confusing, spread between statute and common law and not easily accessible to the majority of company directors, while others did so on the basis that it would effect a material change in directors' duties, i.e. by ensuring that they considered interests other than shareholders'.

7.4 Points made by respondents in supporting the proposition that the current law remain in force without further clarification were as follows:

- a director could serve only one master (which should be the members) and, if honest, could be put in a difficult position if under a specific obligation to weigh the interests of others. If dishonest, he might be able to use those interests to cloud his duty to the members;
- the current requirement, under case law, equating the company with its shareholders, current and future, already introduced a diffused responsibility to current shareholders. Even if directors were only considering the interests of shareholders, these would vary between types of shareholder (e.g. private, institutional, those requiring capital growth, those requiring income) and there was no consensus between shareholders on how to measure 'shareholder value'. In practice therefore, directors had considerable discretion to act as 'umpires' between different groups of shareholders or others. Widening the scope of directors' duties to include other interests than simply the shareholders would cause greater confusion;
- a move to make directors statutorily accountable to groups other than shareholders would create difficulties in identifying the full range of stakeholders and deciding on the nature, priorities and extent of the director's duties to each interest group;
- widening directors duties in the way suggested would not aid decisive management decision making but would place additional unnecessary burdens of time and resources on the board, particularly for small companies. It could also lead to a significant growth in litigation with interested groups taking direct action against a

company's directors to hold them to account for failure to exercise their extended duty of care. This could lead to less people being willing to take on the role of a director of a company;

- directors stood in a fiduciary relationships with the members as a whole. This was consistent with investment in commercial companies for commercial benefit in the shape of dividends and capital growth, within a framework of provisions designed to protect creditors. It was consistent with the fact that directors were appointed by the shareholders, either directly or by approving appointments made by the directors and could be removed by the shareholders. Any dilution of this principle would give rise to serious conflicts of interest;
- there would be problems of enforcement. If there were a duty to have regard to the interests of others to the detriment of the interests of shareholders, any such duty would be illusory without giving those other groups some machinery for enforcement and without machinery for resolving conflicts of interest ;
- accountability to shareholders was currently clear and this was fundamental to the operation of the free market in a competitive economy. A dilution or dispersion of this accountability would risk making Britain less attractive to foreign capital and British companies less competitive. The successful capital markets of the world were strongly focused on their accountability of management to shareholders and there was evidence that international investors shied away from jurisdictions which imposed a mixed economy model;
- the effective management of a company in the interests of shareholders will generally require management to take account of the effect of their action on other parties with whom the company has a relationship. This would require management to foster close, stable, harmonious, long term relationships with those parties. These requirements arise as a corollary of the duty of directors to manage the affairs of a company in the interests of all its members, present and future. There is no need for any modification of company law to attain this end;
- company law defines and protects the position of creditors and owners (members), and establishes a framework within which other parties can establish contractual relationships with the company. The company's non-contractual obligations, to employees and to the wider community, are addressed elsewhere, by other laws. This model works, and should not be interfered with;
- the limited company form has also been outstandingly successful in attracting investment because its clear, primary purpose is to further the interests of its investors. The pluralist approach to stakeholding undermines this basic proposition: it makes investment unattractive by requiring that the directors try to serve the interests of other parties, which may be diametrically opposed to the interests of investors;
- it was correct that directors should manage all relationships - with customers, employees, suppliers, government, the local community and indeed members - for

the long-term benefit of the members. However, this was essentially a question of capable management, and it applied no more, and no less, than the need for directors to properly manage all other long-term company investments in tangible and intangible assets;

- in practice most boards of directors do (whether formally or not and without being required to do so by the companies constitution) in considering what course of action is in the best interests of the company, identify, assess and take into account the interests of all relevant stakeholder groups. Arguably this may be their duty in any event, as to fail to do so might ultimately prejudice the interests of the shareholders;
- although the present law carried with it uncertainty as to the precise nature and extent of the duties of a director, it did have the benefit of flexibility, allowing the Courts to consider all the facts surrounding a particular situation and to decide in those circumstances what was the fair and appropriate solution. The fact that the Courts did not at present seek to substitute their own judgement on business decisions for that of the directors was an indication that the benefits of enlightened shareholder principles were recognised in practice and that directors were already able to take into account the interests of other stakeholder groups where this was ultimately, in their opinion, in the best interests of the company;
- it was unrealistic to expect the typical shareholder/director of a close company to address his mind to the question of what hat he was wearing at any particular time, or to the identity of the persons to whom he owed a duty. Many such directors have no concept of legal personality, or of the difference between the shareholders individually and collectively, and it was a mistake to over-estimate their capacity to grasp the concepts involved.

7.5 Those in favour of the proposition that the current law required additional statutory clarification made the following comments:

- an Institute of Directors (IoD) survey of its members, *Company Law Review - the Stakeholder Debate*, undertaken in December 1998, found that many respondents perceived difficulties with the present law on directors' duties. Just over a third of respondents considered the law concerning their duties to be insufficiently flexible to allow them to take account of all relevant stakeholders. Moreover, three-quarters were of the opinion that directors' duties are difficult to understand because of the variety of legal sources involved;
- companies ultimately derived their licence to operate from stakeholders and this licence must be balanced by duties on the company with regard to the interests of these stakeholders. Companies do impact on others and they should accept the responsibility for this impact;
- one commentator focused on the point made in paragraph 5.1.10 that it was "*no longer necessarily the case that shareholders are the sole repositories of financial risk which can not be diversified away*", arguing that there were countless examples of companies earning abnormally high profits through the externalisation

of the economic costs of their operation . This resulted in the pollution of the natural environment, the over-exploitation of renewable resources and the mistreatment of civil society. These externalities present financial costs and opportunity costs to existing generations and future generations alike, compromising their ability to meet their own needs. This meant that maximum financial value to shareholders did not secure maximum overall welfare;

- stakeholders had interests in their own right, not merely to the extent that benefits flow to the company. It was legitimate for stakeholders to expect the company to take these interests into account. There was now an evolving body of international agreements and standards that form part of the framework within which society expects companies to operate, which reflect the interests of many of stakeholders, and which leading companies are acknowledging. Company law should provide a framework that supports the implementation of these agreements and standards;
- one commentator argued that although the fiduciary duties of the directors required them to manage the undertaking for the benefit of the company there was a risk that directors would be under pressure from shareholders to take a short term approach which would prevent them from acting in the long term interests of the company. This could be because longer term benefits of effective stakeholder management were often intangible. The law should therefore be amended to ensure that stakeholder interests (beyond those of shareholders and employees) should be taken into account if this was in the best interests of the company;
- if clarification was to include a declaration of relevant factors that directors should consider, this should be in a form that could be changed without the need for primary legislation in order to adapt to changing circumstances over time;
- another commentator - interested in company law as its powers could be extended to the commercial activities of firms incorporated in Britain, who either operate, trade or invest in developing countries - noted that in the context of a common interest in promoting sustainable development in the poorest countries, people working in the business sector were as moved by the moral argument as were those working in government, NGOs and international development organisations. However, the assumption that moral duties and business interests were in conflict was now demonstrably false and there was growing recognition that managing stakeholder relationships were therefore a key factor in the long term success of a company. It supported the concept of 'enlightened shareholder value', while at the same time recognising that in practice many shareholders and indeed directors still needed to become enlightened of these benefits. Against this background therefore, the Review provided an opportunity to establish an enabling legal framework for directors to develop and improve their management of stakeholder relationships.

7.6 **Question 2** asked, if any clarification to the law relating to the interests to which directors must have regard was desirable, whether such clarification should be in statutory form or non-statutory form. In purely numerical terms, there was an equal division between commentators arguing in favour of statutory clarification and those arguing for non-statutory clarification.

7.7 Those in favour of statutory clarification argued that there was no point in anything other than statutory codes and that to have non statutory classification would only create more confusion and uncertainty whereas a statutory regime would introduce certainty. The duties of directors need to be clear in all respects and their accountability to shareholders assured. Duties under the law need to be enforceable. Other points made by those arguing in favour of statutory clarification were:

- a new Act should incorporate the range of existing international conventions and agreements which serve as a global, impartial set of benchmarks on social and environmental performance. These include the UN Convention on Human Rights, the Convention on the Rights of the Child, and the core ILO labour conventions;
- while the very broad duties of a director should be statutory, they should be underpinned by guidance. The principal duty of directors, namely to act with due care and skill in the interests of long-term shareholders, should be stated in legal form. Detailed explanation of how this duty was to be carried out in a more practical sense could be set out in a Code of Best Practice, appended to the London Stock Exchange's listing requirements;
- there was support for the approach proposed in the Law Commission discussion paper *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* for, first, a simple statutory statement of the directors' duties and, second, for those duties to be codified in a quasi-statutory form rather than spread around a number of relatively inaccessible case law judgements;
- the further extension of company law by means of non-statutory codes was not desirable. Companies were creatures of statute and should, to the greatest extent possible, be regulated by statute or statutory instrument;
- the question of directors' duties was central to corporate responsibility and accountability and must be dealt with in statute. This would be in line with the principle of accessibility already identified in the Review.

7.8 Turning to those who agreed with the proposition that any clarification to the law should be by non-statutory means, points made by this group were:

- additional statutory clarification would complicate the legislation for little gain and would not further the competitive economy. Legislation on individual areas relating to a director's duties was too restrictive and would deter enterprise and risk taking which were essential ingredients to a company's success;
- a non-statutory approach would help to develop standards while retaining a flexibility to adapt to changing practices - this flexibility would be lost by a statutory approach. To enshrine today's best practices in legislation as a means of encouraging other companies to adopt them would restrict the flexibility required to cope with the needs of tomorrow and lead to British practice becoming outdated;

- a statutory approach would have many unwelcome ramifications, including: the danger that the law would become extended rather than clarified; that it was unlikely that every element of directors' duties could be expressed in statute; and the necessity for judges to interpret legislation which might create as much uncertainty as at present;
- statutory clarification was inappropriate in that the task of identifying and balancing the relevant considerations could be very complex;
- any attempt in legislation to set out the principles to be considered by directors might simply lead to directors considering it sufficient to abide by the letter of the law, rather than its spirit.

7.9 Other commentators went further in considering how clarification to the law could be made by non-statutory means. The points they made were as follows:

- if it were necessary for directors to be reminded of their duties and responsibilities to those groups with whom the enterprise has relationships, this could be achieved by issuing all newly appointed directors of companies with a booklet containing a brief summary of duties and obligations;
- additional clarification could be best provided by means such as the statement of directors' duties suggested by the Law Commission's discussion paper. Non-compliance with such a statement would be prima facie evidence that a director had not acted with due skill, care and attention and had failed to fulfil his fiduciary duty;
- it could take the form of a basic statement in a model constitution (for example, in Table A) which companies could then adopt or modify. Non-statutory corporate governance requirements might then provide timely guidance on best practice for companies in this area;
- any clarification to the law should be by way of the Highway Code model;
- one commentator suggested the use of codes of best practice and standards of business conduct designed to highlight examples of how, by having regard to and balancing the interests of various stakeholder groups at different stages in a company's life, greater wealth might be created in the longer term for all concerned with the company; better use of the existing documents sent to companies on incorporation; and the introduction of documents similar to the Australian "Directors' Survival Kit". It noted recent best practice statements contained in the Combined Code on corporate governance relating to the need for directors to receive training might also present an opportunity for informing directors of the results of research as to the benefits of taking account of the interests of various stakeholder groups and the ways in which this could be achieved within the present law;
- another commentator - largely focusing on the content rather than the form of clarification - argued that the best way would not be to focus on the need to take

account of all relationships that bear on achievement of the corporate objectives, but rather to clarify the meaning of the 'company' to which directors owed a fiduciary responsibility. This could be done by stating explicitly that the 'interest of members past and future' referred to 'an interest in the value of the enterprise as a revenue generating entity in the future.

7.10 **Question 3** asked what - in the light, in particular, of the answers to the preceding questions - should be done about section 309 which contains a statutory definition of a director's core duties. A significant majority of those commenting on this question were in favour of repeal or revision of the provision on the basis that it was ineffective or unclear as to its intent.

7.11 A number of respondents merely called for the repeal or revision of section 309 without explaining what, if anything, should replace it. In particular, one commentator noted that in the context of a close company it was completely irrelevant. The great majority of directors would be unaware that the duty even existed, and would regard it as a somewhat odd provision in the context of a company law statute. A key theoretical reason behind s.309 is to give directors a defence against allegations by shareholders that the directors are not entitled to take the interests of employees into account, but this was of no practical importance to such firms. In many cases the directors were themselves employees. Those who offered more positive comments fell into two broad camps, those that favoured a revision of the section so as to make it clear that a director owed his duties to the shareholders only and those that favoured a wider or more inclusive approach. Focusing on the first group, points to be made included:

- it should be replaced either by a non-statutory statement of directors' duties on the basis that, in its present form, it achieves little, if anything, or by the new clarificatory statements discussed in the Consultation Document, or by non-statutory best practice guidance;
- the section could be rephrased to give directors protection from personal liability provided it could be deemed that the average public company shareholder in Britain would have approved of their actions;
- section 309 needed to be replaced by a single code which clarified the duties owed by directors to the company's shareholders and sets out subsidiary recommended standards of good practice in relation to employees, creditors which should at all times be secondary to the duties to shareholders.

7.12 Turning to points made by those commentators that wished to see the scope of section 309 extended, these included the following:

- it should be revised to make explicit the power of directors to consider all stakeholders' interests, including not only employees but also customers, suppliers, and the community. The force of this section should then be to empower directors to act in favour of any or all stakeholders, even where this was perceived to be contrary to the interests of shareholders alone;
- if the company concerned remained a capital-oriented operation, section 309 seemed appropriate. If, however, other forms of corporate structure were to be introduced there might have to be an equivalent form of parliamentary expression of the wider ethical position for companies with other orientations;
- section 309 required to be changed by deleting Clause 2 and extending Clause 1 to include the public interest, consumers and suppliers. This section need apply only to public companies;
- section 309 should be redrafted (or subsumed within some other declaration of relevant factors) so as to make it clear that directors were not required to act in the interests of employees and that it did not restrict shareholder power to ratify misconduct;
- section 309 should be amended to make clear the ability of directors to be *entitled* to take into account stakeholder interests when acting in the company's best interests;
- any amendment in favour of a wider duty to have regard to the interests of stakeholders should sit alongside a reporting requirement to show how the interests of the various parties have been managed and promoted;
- section 309 should be redrafted to incorporate a much clearer statement of directors' responsibilities in relation to employees and the general public. This would include environmental and other matters in which a conflict of interest between shareholders and others is likely to arise.

7.13 There were few points to record from those that favoured the retention of the provision in its current form, although one commentator did point out that where employees were also substantial shareholders or pension fund investors in the company, the duty to consider their interests was already present. If the shareholders were mere employees with employment law rights to redundancy and protection against unfair dismissal, no change was necessary or desirable while a second thought that the provision should be strengthened in terms of its enforcement.

7.14 **Question 4(a)** asked, if the present law (with or without the clarifications referred to in questions 1 and 2) were not to be retained, whether some variant of the pluralist approach should be adopted, i.e. 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 members, where the directors believe the situation justifies it. This was a central question in the Consultation Document, the response to which would have significant implications both for the future direction of the Review and the nature of British company law. The question attracted a good deal of comment,

including a range of well-developed arguments from both sides of the issue (and including a number of possible variants). There was, however, a clear majority of opinion against the adoption of a pluralist approach.

7.15 Points made by those advocating the pluralist approach were:

- an ability to focus on stakeholders would enhance the quality of management and therefore the competitiveness of British companies. The exposition of the enlightened shareholder value vs. pluralist approach debate failed to consider for instance the link between the consistently superior performance of the German and Japanese economies and their stakeholder oriented corporate culture. The evidence seemed to suggest that the strengthening of the international competitiveness of the British economy may very well require the adoption of a pluralist approach to corporate governance;
- it would also allow the wider public interest to be considered in company decision-making. In an economy where corporations had very real power, this was of real importance;
- it would reflect companies' responsibilities to a wider range of stakeholders, including customers, employees (both directly employed and in supplier companies) and to the communities in which they operate;
- it would reflect the international nature of business - where the reach of companies was international, stakeholders should have the same rights as stakeholders at home. One particular concern related to the developing world. Many people in the developing world contributed significantly, by their labour and in other ways, to the success of British companies. They were stakeholders in those companies as much as are British stakeholders;
- it would reflect the fact that stakeholders, particularly those not perceived as being necessary for the company's success but who are undoubtedly affected by the company, often did not possess sufficient information or legitimacy in the company's eyes to enable them to assert their interests. The disproportionate risk borne by employees and suppliers in exposure to company downturn remained unchanged;
- it would encourage the adoption of a longer-term view. Directors often tend to take an overly narrow or short-term view of their functions. Since the silence of the law on the issue of time horizon consistently led to an undesirable outcome, there was a clear need to make explicit the requirement for adopting a longer-term view;
- the law as it stands does not reflect the reality of modern companies and their role in society;
- a voluntary enlightened shareholder value approach would not induce directors to take proper account of their responsibilities to stakeholders. If maximising shareholder returns remained the prime aim for company directors, they would only

consider stakeholder interests if they believed there was a clear economic case for doing so. While the economic case for developing long-term committed relationships with stakeholders, especially key stakeholders, was overwhelming, for a significant proportion of British companies economic self-interest had not been sufficient to date to induce them to follow this course. The argument that shareholder value led to good practice towards other stakeholders was demonstrably untrue in practice. History clearly showed that the interests of employees, the protection of the physical environment, and responsibility for companies' impact on human rights, had to be fought for, even in the best companies, by agencies outside the company, with damage to corporate reputation being a significant factor in leading to change. Only shareholder interest had been consistently fought for from within the company, with the law providing a shelter for directors who lacked the foresight to see the need to balance the requirements of their various stakeholders. The concept of enlightened shareholder value did nothing to change this;

- protecting shareholder value remained a condition of success; but it could not be a purpose. What was required was a law that enforced a company's accountability for its stakeholders while maintaining accountability to its owners. Transparency and disclosure were crucial to allowing the market to work. So too was measurement of corporate investment in the human resource, of corporate impact on the social and physical environment, which would provide the market with measures additional to money on which to judge performance. Given an increasingly critical consumer society, and a growing demand for companies' operations to be consistent with the values of society, it was important that the law should reinforce, rather than hinder, companies' ability to retain their "licence to operate" in the 21st century;

7.16 A number of common themes emerged from the large number of respondents arguing that a pluralist approach should not be adopted:

- actions by companies that were in shareholders' interests would be in the interests of many or all stakeholders as well, either directly or indirectly. A healthy economy was a prerequisite to the well-being of the nation. In part, the long-term interests of employees could only be protected so long as directors were successful in looking after the interests of the company and its shareholders;
- to empower or require directors through the 'pluralist' approach to have regard to other stakeholder interests at the company's expense would potentially open the company to lawsuits from many directions. Imposing such a vaguely-defined power or duty on directors would be simply unworkable. On what basis were directors supposed to decide when 'the situation justifies' acting against the interests of the members? And when they did so, how could a Court of law determine whether they have acted in dereliction of their duty to the members?;
- far from creating wider accountability, pluralism would likely result in accountability so blurred as to be meaningless;

- pluralism could undermine the very concept of the company as the vehicle for the provision of risk (equity) capital which underpins the private sector economy;
- pluralism called into question both the ownership and the control of businesses funded by their members. At worst, it would be highly damaging to shareholders and to the economy, and, at best, it would achieve little in practical terms;
- the current company model works, and should not be interfered with. Stakeholding proposals could not achieve consensus because they were profoundly damaging to the interests of shareholders;
- balancing the relative importance of the interests of each Stakeholder group would be an extremely difficult task and would encompass a wide range of issues, not merely financial, and determining whether directors had actually acted in accordance with their legal duties would be almost impossible;
- it was essential that British company law fully protected shareholders' interests. This should be its primary focus. The interests of other groups were already protected by a range of legal instruments with which those running all businesses must comply;
- incorporation in Britain would become less attractive and businesses would elect to incorporate elsewhere;
- the pluralist approach would impose more regulation on business, which was already calling upon the DTI to remove the many existing burdens. Under a pluralist approach to company law, management activity would be diverted from what should be its main focus - driving the enterprise forward for long-term success;
- the creation of a statutory requirement for directors to take account of relevant external requirements in making decisions would be too intrusive. Directors were engaged to employ their commercial judgement. Attempting to prescribe factors which must be taken into account in all circumstances would be fettering the exercise of a director's skill;
- there was nothing in company law that prohibited those who favour the pluralist approach from incorporating more onerous responsibilities into their constitution;
- introducing a duty to take into account the whole pluralist constituency would have the significant disadvantage of allowing directors to justify any controversial decision as being in the best interests of a particular stakeholder group;
- while it was in the interests of society that business be conducted on an ethical basis, taking account of various interest groups affecting, directly or indirectly, the company, social engineering was not a valid purpose for company law;

- it was inconsistent to require company directors to adopt a 'pluralist' approach in isolation from all other types of business organisation. It could be said to amount to discriminatory social engineering in that the directors of limited companies would be entitled by law to subordinate the company's interest while other major or minor institutions (friendly and building societies, pension funds etc) would not be so affected and would retain an unqualified obligation to their beneficiary;
- pluralism would amount to an infringement of the right to enjoyment of property. It would result in a one off but open-ended transfer of wealth from shareholders to other stakeholders. The effects of such a redistribution of wealth were comparable to a redistributive tax on a massive scale. The redistribution was likely, other factors being equal, to be reflected in a significant drop in stock exchange valuations of all listed companies, particularly those most affected by the transfer of wealth;
- an effective pluralist approach would need a radical restructuring of company law involving reconsideration of the position of shareholders as the group that appoints and removes the board, authorises the directors to act otherwise than in accordance with their general duties, ratifies misconduct, and winds up the company;
- the attractiveness of Britain as a country for inward investment by overseas and multinational companies would be significantly diminished. The stability of the legal framework and its long tradition of respect for shareholder rights was one of the main factors attracting overseas capital investment. Indeed, the long term effect of any legal reform which damaged shareholder rights, but stopped short of restricting freedom of capital flows, would be to encourage British companies to relocate some of their British operating subsidiaries to more investor friendly countries;
- some stakeholders had no interest in competitiveness or wealth creation at all and curtailment of a project or even the demise of the company may be their true objective;
- the use of company law to implement social and cultural changes which were not required by European Union law might restrict Britain's flexibility in future to respond to further developments on a European level;
- any such change to a shareholder's legal rights resulting in a shift in "value" should only take place with the prior fully informed consent of the existing shareholders. However, there could be difficulties/confusion in having a mixture of companies, some pluralist, others not.

7.17 The next **question, 4(b)**, addressed the proposition that it would not be desirable to make a duty on directors to have regard to the interests of those in relationships with the company - even at the expense of the interests of the shareholders, where the directors believed the situation justified it - enforceable on behalf of those concerned. A large majority of those commentators that responded to

this question agreed that such a duty should not be made enforceable. Points made in support were:

- Court cases on these sorts of issues would not be a good use of time of any of the participants, nor would policing through the Courts necessarily promote good practice and wise decision making;
- it could only promote expensive, unnecessary litigation and discourage people from acting as directors;
- if directors have acted in good faith, they should be protected in law. If shareholders took a different view, they would be in a position to remove them, or to sell their shares. The market would provide corrective action if directors were not perceived to be acting in the long term interests of the company;
- the effect would be to risk opening any significant business decision to challenge in the Court on the grounds that some or other interest had been neglected. In such a challenge, existing interests would be represented but "future interests" (that is to say, those that would have come into being, had the decision been effected and carried through unopposed) would not be. This is likely to have the effect of hindering business change, and in particular, long-term capital accumulation. Therefore it is likely to introduce an element of short-termism;
- this would create a litigation minefield for directors. How would a Court of law determine whether the directors have 'had regard to' the interests of, for example, a supplier whose contract with the company had been properly terminated? How would directors prove that they have fulfilled such an vaguely-defined obligation?;
- there were significant risks to competitiveness and economic growth in giving third parties enforceable rights beyond those which they currently enjoy, by contract or otherwise.

7.18 One respondent, in addressing this particular question, identified a range of legal and practical problems that would be caused by giving stakeholder groups the power to take enforcement action against directors: identifying those who should have the status to bring enforcement action; identifying other stakeholders who should be given notice of any proceedings, as persons who could be influenced by any decision of the Court; identifying which members of the particular stakeholder group should participate in any action and how all the members of that stakeholder group should take decisions in relation to, or fund, the proceedings; assessing the remedies to be available. If financial remedies were to be awarded, should these be paid by the directors personally (in which case, which of the directors?) or by the company (and, therefore, by other stakeholders)? This commentator went on to note that if directors were at risk of actions in the Courts every time a particular stakeholder or stakeholder group felt aggrieved by a decision, or likely decision, it would make management of the business almost impossible (for example, due to the risk of injunctions issued by minority interest groups) and add hugely to the cost (both in terms of finance and time) of administration of the company's affairs.

7.19 Only a handful of commentators supported the concept of making a pluralist version of directors' duties legally enforceable. Points made by those taking this view were:

- if there were to be no sanction or penalty there would be no change in companies' behaviour and a duty that was not legally enforceable could not fulfil the intended purpose of the requirement;
- because of the difficulty of covering every risk of damage caused by the action of companies by legislation, the present general law needed to be reinforced to provide that persons who suffered injury, whether financial or otherwise, by the actions of a company, should have the right to force the company to cease or modify such activity and, if appropriate, to pay damages;
- while transparency and accountability on corporate activity, including environmental and social aspects, was indeed of importance, reporting was no substitute for the obligation to take account of different interests in decision-making. Reporting took place after the event when major decisions were irreversible - if the commercial benefits were likely to be substantial, company management would often be willing to risk a certain amount of damage to reputation or other adverse effects resulting from acting to the detriment of the interests of various stakeholders. Such behaviour could only be prevented by adopting a pluralist approach combined with enforceability.

7.20 The majority of the commentators who responded to **question 4(c)** - as to whether an institutional solution (e.g. new board structures with representative directors) was desirable to ensure proper exercise of any power or duty on directors to have regard to the interests of those in relationship with the company, and, if so, should this be mandatory or optional and what form should it take - were against the adoption of institutional solutions. Points made in rejecting the proposition were:

- there were real advantages in the unitary board approach. It provided boards of directors with the necessary collegiate approach which meant that the directors as a whole were enabled to focus and act in the overall best interests of the company. The unitary board structure also ensured that all directors, including non-executive directors, were concerned not only with the governance of the company, but with its strategy and enterprise;
- for a board to work effectively there had to be freedom to discuss sensitive issues openly and, where it was necessary, for there to be robust independence. It was equally necessary that there be commonality of purpose combined with trust and respect between all directors. The present British system where, in practice, directors appoint (subject to shareholder approval) their colleagues on the board according to the skills and experience required to manage the company effectively, enabled this balance to operate. Shareholders did, however, retain an ability to remove and appoint directors if they considered that the board was taking the company in the wrong direction or had become ineffective. If this structure were to

be altered to enable special interest groups or stakeholders to appoint their own representatives to the board, the nature of the board would change fundamentally;

- the adoption of an institutional solution would further complicate Part X of the Companies Act 1985, contrary to the Review's objective of simplifying company law;
- current company law was sufficiently flexible to accommodate the requirements of different organisations through their own Constitutions. Rigid legislation could actually be counterproductive;
- even if the stakeholders could be limited to a manageable number, the identity of the stakeholder groups would not necessarily be the same for all corporate businesses, far less for all corporations. Any mandatory institutional arrangement was therefore more likely to be a problem than a solution;
- the change suggested would lead to more complicated administration which would be off-putting to those who wish to incorporate and those considering inward investment in Britain;
- the size of boards of most companies would have to increase to allow for all stakeholders to be represented, making the decision-taking process more cumbersome and costly;
- the present system permitted companies to establish a variety of board/management structures. A company, by its Articles, could at present require certain interests to be represented on the board and preserve the rights of various stakeholders. Even without this, boards could elect representatives of special stakeholder interest groups to the board if they wished. Some creditors (such as banks) were reluctant to participate at board level due to concerns about responsibility and liability and suppliers rarely had the time, as individuals, or the cohesion as a group to be able to take such a role. There would be no point in changing the law if there were insufficient suitable candidates willing and able to perform the role.

7.21 A number of correspondents did argue for mandatory institutional change to reflect a power or duty to take an inclusive approach at the expense of shareholders, making the following points:

- the Consultative Document appeared to equate changes in board composition with a removal of the ultimate control of the shareholders. An extension of board membership to directors representing various stakeholder interests did not necessarily mean a loss of shareholder control, and therefore property rights concerns were misplaced;
- in order for a pluralist approach to be made meaningful, there would have to be institutional changes, and these had to be across the board for all companies. There might, though, be a choice as to the type of institutional solution;

- mandatory attendance and advisory rights should be accorded to representatives of major stakeholder groups at all board meetings;
- both the European Union's Eco-Management and Audit Scheme and the International Standards Organisation's approach to Environmental Management Systems (EMAS and ISO 14001 respectively) included the requirement to nominate a board level director with responsibility for environmental issues;
- new board structures should ensure that employees' interests were properly considered. This might be achieved by a two tier board structure as in Germany, or by a unitary board with some worker non-executive directors. This commentator recognised that direct employee representatives on the board might discourage overseas companies from establishing businesses in Britain and thought that any compulsory provision for employee participation might best be achieved by councils outside the board.

7.22 Other commentators argued for an optional approach, making the following points:

- while it was not necessary to prescribe specific structures in the law, it was desirable to empower companies to adopt innovative approaches to corporate governance into their structure;
- already a number of companies, particularly those resulting from European mergers, have adopted quasi two-tier boards to take account of different traditions. Board structures encompassing representative directors would provide one way of ensuring that stakeholder interests are considered at board level;
- supervisory boards with employee representation worked well in other countries such as Germany and the Netherlands and enabling board representation could provide considerable benefits for employees by providing a direct voice into decision making at board level. This would ensure that employee interests were considered by managers and would change the culture of the board room, facilitating the creation of a climate in which relationships with stakeholders were recognised as a key asset of the company;
- the arguments for allowing a representative director to join the board were strengthened by the likelihood that the European Company Statute would be adopted in the foreseeable future. It was clear that the establishment of a European Company would provide the opportunity for employees and managers to negotiate a form of workers' participation appropriate for their needs;
- while the unitary board was a good model, and continental two-tier models resulted from different historical circumstances, there was no economic reason why companies should not be allowed to use different models which were internationally respected. Shareholders would make their own judgements on their investment policies towards companies adopting new ideas. The law should not unnecessarily close off any options;

- employees' commitment and willing contribution reflected the people management practices adopted by companies, rather than their governance structure. However, if such practices could be applied more effectively were companies to adopt alternative board structures which were not open to them under existing companies legislation, there should be no objection to such alternative structures being available *on a permissive basis*.

7.23 **Question 4(d)** asked whether options should be available so that more than one of the solutions considered in this part of the Consultation Document could be chosen by companies if they wished. The majority of those addressing this question were against making such options available.

7.24 Some respondents rejected the proposition outright while others gave a more reasoned response, making the following points:

- the existing law as to company Memorandum and Articles of Association was already sufficiently flexible to accommodate alternative solutions;
- whereas it might be practicable to have a range of model forms of company structure available for businesses to select, research should be undertaken to identify the extent to which these would, in practice, be adopted. It would normally be the providers of the finance who ultimately selected the form of vehicle to be adopted, as it was this group which established the vehicle in the first place and which effectively provided the opportunity for other stakeholders to participate. Suitable protections for minority interests prejudiced by any such change would also be required. There was, under present law, an infinite variety of models of business structure, limited only by the desire and imagination of shareholders and directors, by commercial inertia and by the requirements of those who provided finance that companies be operated in a particular way. If a range of model options were to be developed they should not restrict this general freedom and flexibility;
- the more options that were built into legislation the more complicated that legislation, and its operation, became. The Review should concentrate on the stated objective of producing a regime which would lead to a more competitive economy and thus should aim to simplify not increase complexity;

7.25 A number of respondents did, however, take a wider view on the availability to companies of the options considered in the Chapter. Those that argued in support of this approach focused on the following points:

- while accepting the strong case against pluralism, companies might recognise that the pluralist approach may provide commercial advantages and there was no reason why a company could not include in its constitution a declaration by shareholders as to the achievement of social, cultural or environmental objectives, whether permissive or prescriptive. The law should not unnecessarily close off structural options, nor discourage innovation. British business needed to be adaptable to a global economy and global societal change;

- a company should be free to insert any such provision in its Memorandum or Articles of Association;
- if such an approach could be accommodated and director's duties etc. clearly articulated, this could be a useful method of allowing a more pluralist approach for those that wish to follow that route.

7.26 Other commentators, while not explicitly supporting the concept of change to the current law, made the relevant points that any legislation would need to be very widely drawn, as different solutions may be appropriate to different companies, and that if companies were to be forced into such a regime, flexibility of approach and implementation was desirable; and that any options should be clearly defined in statute, limited in number and wherever possible the rules underpinning their exercise should be appropriate to the type of company.

7.27 **Question 5** addressed the issue of whether a power should be conferred, or an 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 whether the present law already gives appropriate powers in practice. Amongst those addressing this question there was a substantial majority against the concept of conferring such a power or imposing such an obligation on company directors.

7.28 A large number of commentators offered their views as to why such a change should not be adopted. Many made the point that existing law provided adequate powers to allow directors to consider wider social and ethical objectives, though only where they considered it to be in the interests of the company to do so. Other points made by this latter group were:

- although the potential social benefit which might be derived from permitting directors to use company resources to make charitable donations or engage in other philanthropic activity without any benefit to the company was superficially attractive, it was difficult to see how in commercial terms or in legal principle, it could be justified;
- the approach suggested would give rise to litigation on behalf of members contending that they had not been treated properly;
- employment law, health and safety and environmental laws and regulations were the proper place for requirements dealing with those aspects of conduct. There was no need to complicate company law further by introducing into it or retaining obligations on the lines of those in section 309;
- if any wider powers were thought desirable, it would be open to a company to take such powers in its constitution;

- the legal power or obligation referred to in the question might, in fact, have the opposite effect to that intended as the complexity of regulations could deter companies from contributing to community projects;
- the approach would serve to lower the value of members' interests, and make Britain a less attractive place in which to incorporate or indeed conduct any operation that depended on the existence of private property;
- if such a power were to be introduced, careful limits would need to be imposed on the board's power to authorise charitable donations or other philanthropic acts. These could include regulating the identity of recipients of gifts (e.g. should they be registered charities) as well as their size;
- such an obligation would appear to be completely unworkable in practice, highly dangerous in principle and totally alien to the British system of justice;
- there was doubt as to how such powers could be enforced and the extent to which they could be enforced by persons who were not members. A better solution might be to introduce non-statutory obligations or a code of best practice which could influence directors' decision making but not obscure their primary economic obligation to the company;
- conferring such powers on directors might encourage the possibility of shareholder funds being used for personal motives;
- to place wider social objectives ahead of the interests of members would inevitably create a conflict with the efficient running of the company, and would be a potential handicap to productivity and competitiveness;
- to require companies to engage in philanthropic activities at the expense of their members is simply another form of tax.

7.29 Some respondents did, however, support the contention that such powers should be made available to companies, contending that whether or not the present law already allowed directors to place social or ethical considerations ahead of the interests of shareholders, it was not always perceived to do so and no legal excuse should remain for directors to ignore such wider interests. They should also be required to demonstrate *how* they take into account such wider interests. Other points made in support of the inclusions of such a power or obligation were that directors should adopt high ethical standards in the conduct of their business, and the law should explicitly acknowledge and encourage this. The Review should have reference in this regard to the wider framework of international standards in, for example, human rights, health and safety, and environmental protection and should recommend a mandatory requirement for companies to have regard to the desirability of complying with internationally recognised standards in these areas. Several commentators referred to the discretion conferred on US directors by a provision of the American Law Institute to subordinate the interests of shareholders to wider ethical

considerations which may reasonably be regarded as appropriate to the responsible conduct of the business.

7.30 One commentator, while not generally offering support for the granting of wider powers to directors to consider ethical and social interests ahead of the interests of shareholders, agreed that if the present law were to be amended to permit such activities without any benefit for the company, strict rules would need to be laid down to avoid abuse. Donations should only be made with shareholder approval (subject to appropriate creditor protection) or be subject to the existing law requiring there to be a benefit to the company. Shareholders should always (except in situations where insolvency intervenes) have the ultimate authority to decide the policy for the company and, therefore, be able to elect to restrict or cancel any such statutory authority by ordinary resolution. Within these limits and subject to there being adequate safeguards against directors deriving personal benefits from such activities, there would be no objection to the rule that charitable/good cause donations should be for the benefit of the company being removed. Such a change might not, in itself, result in greater giving but it would enable this and remove the need for sometimes rather artificial justifications.

7.31 **Question 6(a)** asked whether the present regime of accounting and reporting should 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. The views of those who commented on this question were divided almost equally between those advocating and those resisting such change in the accounting and reporting regime. Many of the issues raised by commentators on this question reoccurred in the responses to question 52 (see section 14 of this document below).

7.32 Those commentators that favoured no change to the regime deployed the following arguments:

- The three major recent reports on corporate governance had already led to substantial increases in reporting requirements. The costs of these requirements was ultimately met at the expense of members. Additional reports would add to the cost of management and administration and would encourage "box ticking";
- for the kind of corporate structure that most companies required, the present regime of accounting and reporting did not need to be modified to ensure that they achieved their chosen purpose. Any additional reporting requirements should not be a matter for company law and should be left to evolve in practice according to the needs of the time or should be left to accounting standards rather than statutory control. This would enable necessary modifications to be made far more quickly and easily than would be possible under legislation. The increasing transparency in recent years, as best practice had developed with the help of the Hampel, Greenbury and, most recently, Turnbull reports, had shown clearly that peer pressure had a marked effect;

- further mandatory reporting would make documents such as the Report and Accounts so long that one could question the value of producing so much paper that was only used by a small number of people;
- accounts were the main vehicle for directors to inform shareholders and creditors about the affairs of the company and it was important to ensure that the financial information in company accounts was accurate and complete. Increasing the level of responsibility of directors for the information in the accounts or extending the categories of people entitled to rely on them would be counterproductive;
- market would lead to those changes in accounting and reporting for which there was a demand;
- prescribing mandatory reports on various matters might well not add much to genuine understanding by users of accounts nor be the best way of encouraging meaningful disclosure. Reporting on relationships was, by its very nature, likely to be subjective;
- to impose reporting requirements on the disclosure of relationships with other businesses and dependencies might act to reduce the competitiveness of the company, as competitors and suppliers took advantage of the information to the disadvantage of the company;
- greater disclosure did not necessarily lead to improved standards of practice. For example, the current requirement to report on employee involvement was fulfilled by many companies with a one-line insertion in company reports which was useless in terms of information provision, and did not act as a spur to best practice. There was wide agreement that the disclosure recommendations of the Greenbury Report have tended to boost, not reduce, directors' earnings.

7.33 Those respondents who supported the concept of change to the accounting and reporting regime in the way outlined in the question made the following points in support of their view:

- reporting on stakeholder relationships and environmental performance would be a very effective way of monitoring directors in the context of a non-enforceable pluralist approach. Greater disclosure would help participants assess how far directors' actions had been reasonable and could provide material which they could use to lobby on behalf of their interests. Access to information about stakeholder relationships could assist stakeholders in asserting their rights and ensuring that their interests were considered. It was also valuable for investors, as the quality of stakeholder relationships might provide an important indication of future value while financial indicators could only ever measure past performance. And in a democratic society of which companies were a part, the wider public had a right to information on corporate standards and the social and environmental impact of companies;

- reporting on stakeholder relationships would provide an important means of establishing new methods of valuation for businesses. These would aid competitiveness and performance by enabling a more accurate assessment of a company's prospects. Just as the quality, comprehensiveness and transparency of financial reporting contributed to the attractiveness of a market for listing, once the value of non-financial statements was understood by the market, they too could contribute to a more vibrant market and enhance Britain's stock market position;
- in addition to strong arguments for statutory disclosure of certain non-financial information that was now widely recognised as contributing to shareholder value (e.g. on certain aspects of environmental performance), civil society expected companies to account for their actions as a matter of principle. Business (and public) opinion was likely to be increasingly in favour of the introduction of mandatory social and ethical accounting, auditing and reporting standards, at least for publicly quoted companies;
- statutory requirements to report on particular matters not only provided potentially helpful information to users of a company's accounts but also acted as an encouragement to companies to compare their performance with industry benchmarks and, thereby, to seek to improve their own performance in the area concerned. A broad consensus had now developed among Government, the business community and the professions with respect to the wider social importance of how a business impacted on the environment. This consensus was mirrored in other developed countries. It was also the case that individual companies were recognising the benefits, for their own internal management and their own marketing, of devising comprehensive strategies for identifying and responding to environmental risks. The introduction of reasonable environmental disclosure requirements in the Companies Act would thus be in the public interest. Statutory recognition of environment-related activity also had the potential to assist individual companies to take appropriate and effective action in this area in their own operational interests;
- optional governance audits could be introduced, designed specifically to determine the extent to which a company's structures and systems, procedures and policies were actually directed at achieving the constitutional corporate objectives chosen by the shareholders. Properly structured, such governance audits could enable shareholders to evaluate the performance of directors, and enable directors to assess the conduct of other stakeholders;
- traditional British accounting practices had encouraged a limited managerial outlook, counting employees only as a 'cost', placing no value on the company's intellectual capital e.g. networks of connections with customers and suppliers, and disregarding the social and environmental cost of the organisation's activities. A change in company law requirements could point the way to a more performance-based, progressive and 'holistic' managerial approach, to the benefit of the whole British economy. In order to advance the stakeholder dialogue and transparency this commentator suggested a list of 12 candidate 'key indicators' to be considered for inclusion in a revised version of the directors' report. Each key indicator provided

information which was of relevance to stakeholders, including existing shareholders and investment advisers.

7.34 **Question 6(b)** sought views as to whether a range of specific modifications should be made to the accounting and reporting regime for the purpose of better securing that companies are operated to achieve their proper purposes, e.g. by requiring a mandatory report on employee relations, supplier relations, customer relations, community relations, philanthropic activity and/or environmental performance, or by making more detailed changes to current reporting requirements, such as to the disclosure of relationships and dependencies and of their value to the business. Commentators responding to this question were largely against the introduction of such changes. In addressing this question, many commentators, especially those arguing against the suggested changes, rehearsed many of the “in principle” points made in respect of the previous question. The following paragraphs attempt to pick out the more specific issues on which views were sought in the question.

7.35 Points made by those supporting the introduction of such changes were:

- the law should require companies to account for their relationships with the full range of their stakeholders. The format of such accounts should be left to non-statutory bodies to define, with the definition of the set of stakeholders which should be taken into account not determined by statute, but with the presumption that ‘stakeholders’ included *at least* shareholders, employees, customers, suppliers, local communities and the environment;
- as well as an obligation for limited companies to assume reporting obligations in respect of their impact on the environment, then, given wider share ownership, enhanced consumer awareness and a recognition on the part of many businesses that they should be prepared to present themselves to their markets as socially responsible organisations, company disclosure rules should be extended to cover other areas which have the potential to influence corporate reputations. Among the individual areas that might be covered in new reporting rules are equal opportunity records, health and safety performance, policies regarding child labour, fraud and corruption policies, dealings with oppressive regimes, genetically modified foods, animal testing of consumer products;
- the reporting requirements on companies should be amended to reinforce and make more visible employers' commitment to employees. Effective reporting arrangements would however require a significant improvement in companies' current arrangements for measuring the effectiveness of their people management processes;
- there were three ways in which legislation to increase disclosure should be taken forward: to require companies to report systematically on their social, ethical and environmental performance, to require companies to report, not on the full relationship with each stakeholder but only on the policies which they have for dealing with them, and to require companies to disclose only to which standards they adhered in their operations;

- there was a shareholder-centred case for larger, quoted companies including reports on their employee relations and environmental performance where such information may be of interest to potential shareholders and may influence investment decisions.

7.36 Respondents offered a number of arguments against the suggestions outlined in the question:

- while there was potential value in a requirement to disclose relationships and dependencies and their value to the business, in practice current accounting standards were insufficient to support this. It was difficult to see how the value of these relationships and dependencies to the company could be quantified and measured. They were also prone to rapid change and it would therefore be additionally difficult to verify the accuracy of a company's reporting at any one time;
- many companies choose to provide this information to shareholders as a matter of course, and there was sufficient pressure from shareholders to extend the scope of information provided in the report and accounts to encourage companies to extend the scope and content of their reporting in these areas;
- to impose changes to reporting requirements in order to oblige a company to disclose its relationships and dependencies would even further increase costs and might erode a company's market advantage and competitiveness where it was forced to reveal the extent of such relationships;
- directors were already required to provide a number of mandatory reports to shareholders. Some of these had been criticised in recent years for encouraging a boilerplate format. The type of reports suggested would almost certainly lend themselves to this kind of unhelpful response;
- it was not clear how any such requirements would be enforced. Civil remedies would be inappropriate while it would be excessive to introduce criminal penalties or a risk of disqualification. Without adequate powers of enforcement, the requirements would be ineffective. In addition, a mechanism would have to be devised to ensure that such reports did not become a matter purely of standard wording which is uninformative and of no benefit, while annual reports could easily become documents that were too large and cumbersome to be of practical use and with excessive production costs. Any new requirements for disclosure or for additional reports on a mandatory basis should be restricted to what were considered the most important areas, with other matters being left for good practice;
- there should be no mandatory disclosure in relation to specific relationships and dependencies and their value to the business, not least because this would raise issues of confidentiality/business secrecy and could be damaging competitively, for both the company making the disclosure and for the parties who were referred to (often without prior discussion as to the wording of any such disclosure).

7.37 **Question 7** addressed the issue of whether, if a pluralist approach were to be adopted, directors should 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 it is justified, even if this damaged the prospects of the bid or merger proposals. The majority of commentators focusing on this question took the view that directors should not be permitted or required to act in this way. A range of points were made in support of this view:

- it might be possible to distinguish between the investor shareholder (who would probably include employees) and the traders who might have bought shares within the last year or so with the object of profiting by a takeover. There was no case for considering non-shareholder interests;
- while directors should not be permitted or required to favour the interests of any group other than those of the owners, there might be a need to examine whether the present law was being properly applied in takeover and merger cases and, if not, whether any clarification was necessary;
- directors should not be put into a position where duties conflict, particularly fiduciary duties. In a bid or merger situation, where commercial interests must be paramount, it would be wrong to permit, still more so to require, a board to put the result in jeopardy in the interests of employees or suppliers. The conflicts of interest would be extreme. Disputes would be insoluble and protracted. Courts would not be well qualified to balance the issues. While present employees might suffer, there might be long term benefits for future employees and general prosperity. The interests of present employees could better be dealt with in the field of employment law governing consultation and redundancy;
- to allow directors in some way to frustrate a bid in order to prevent a factory closure or other impact on employees or a local community for example would enable them substantially to impede the market for corporate control. It would also adversely affect members' legitimate property rights in their shares. Resulting litigation as to whether any such blocking action were properly motivated or self-serving would be no solution as litigation could be used strategically and such issues are hardly justiciable;
- the directors, in advising on a bid, should give the shareholders sufficient information to enable them, if they so wish, to take account of wider interests such as the community in their decision whether to sell;
- takeovers were an essential mechanism for removing companies from the control of ineffective or self-serving directors. The approach outlined in the question would allow directors to protect their own positions at the expense of members. At best, incumbent directors with their own interests to consider would not be best placed to make complex and inevitably subjective economic value judgements as to the economic merits of the bid on a range of interested parties;

- a takeover situation, particularly if contested, imposed heavy burdens on directors and their advisors. The introduction of pluralist duties would undoubtedly make their position more difficult;
- if other stakeholder groups were to obtain new rights as a result of adopting a pluralist approach, these would have to be limited so as to make it clear that one stakeholder group did not owe any duty to another. Otherwise, for instance, a shareholder who accepted a takeover offer against the recommendation of the board and in the knowledge that acceptance would have an adverse consequence for another stakeholder group (for example employees or suppliers) could be exposed to claims by such other stakeholders.

7.38 Some respondents did, however, take a different line arguing that:

- it was essential that directors should be required to take action to protect the interests of stakeholders, particularly those of employees and suppliers, in takeover and merger cases. Mergers and takeovers provided one of the starkest examples of the ‘winner takes all’ side of the current company law regime. The decision in mergers and takeovers rested entirely with shareholders; yet employees in both the bidding and the target company were nearly always greatly affected by the merger. Repeated studies on the economic effects of takeovers had shown that they have little or no beneficial impact on performance. Some people might gain, principally shareholders in the target firm. But this was at the expense of other stakeholders, especially employees, rather than as a result of greater efficiency - the cake was divided differently rather than enlarged. This supported the argument that takeovers were fuelled partly by incentives for directors, who generally gained considerable sums when a deal was done;
- there was evidence that decisions about mergers and takeovers often pay inadequate attention to the people management implications, and this could have a highly damaging effect on subsequent business performance. Companies involved in a proposed merger or takeover could be required to publish a statement outlining the employment strategy they would intend to adopt towards the merged or acquired company. This would help companies explain the business case for the merger/takeover to a wider audience;
- where directors would usually inform the shareholders of the prospective bids received, and the advantages of each, they should be required to provide shareholders of the likely impact of such decisions on other stakeholders.

7.39 The responses to **question 8** - which asked which parts of any of the 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 - fell into three distinct groups: those that advocated a “one company law for all” approach, those that took the view while some aspects of the proposals - such as a revised set of directors’ duties - should be applicable to all companies, other aspects - primarily the revised reporting and accounting arrangements should not - and, finally, a group that argued that a fundamentally different approach should be adopted for small and private companies.

The number of commentators supporting each of the three approaches was roughly equal.

7.40 Addressing first the comments of those that favoured a “one company law for all” approach, the following were the main points to arise:

- all companies shared a similar legal status and character, which involved protection of their members from the unmet financial commitments of their company, a protection which had the potential to cause loss to creditors, employees and the state. The basic law should therefore be applied uniformly to all companies;
- there need be no variation in the fundamentals when dealing with small closely-held or private companies. As suggested in paragraph 5.1.49 of the Consultation Document, the reframing of directors’ duties should be of general application;
- there was no difference between large and small companies. In both cases directors exercised their powers for the benefit of the company in furtherance of its commercial interests;
- the proposals referred to in question 6(a) did not imply onerous reporting obligations for companies, and should be applied across the broad spectrum of companies;
- any proposals should be applicable to all companies regardless of size. Whilst they would have greater implications for larger companies and groups which had a more significant impact on society and the environment, the standards should apply to all companies to prevent smaller, less scrupulous companies undercutting the ethical standards that larger companies were setting;
- if duties were to be imposed on companies or businesses generally in respect of parties other than just the owners, then the cost to the business needed to be compared to the benefit to the other party. For example, there may be instances where smaller entities were the “worse offenders” than larger entities because (for example) the latter were more susceptible to adverse publicity.

7.41 Turning to those who took the view that some, but not all, of the measures discussed under questions 1-7 should be applied to small private companies, the following were the main points to arise:

- of the areas discussed in questions 1-7, only the proposals for change to accounting and reporting requirements needed to be modified to take into account the particular concerns of small and closely-held companies;
- to impose new board structures with representative directors seemed less likely to be effective in an owner managed business than in a large public corporation. Given that the vast majority of companies were owner managed, it was impractical to impose such requirements on businesses when they brought little or no benefit but considerable additional costs;

- while a statutory requirement to report on stakeholder relationships and environmental performance could apply to all firms, it might be appropriate to have more comprehensive standards for reporting for larger, public and listed companies and lighter disclosure standards for small, closely-held and private companies;

7.42 Finally, addressing those responses that saw the benefits of a differential approach first, some commentators argued that the adoption of the pluralist approach and additional accounting and reporting regimes would be of little benefit to small private companies and would simply add to the administrative burden for such enterprises. If the employees of the company were to receive some formal recognition and representation in the company structure, this should apply only to private companies employing more than a minimum number (with appropriate measures to prevent evasions, e.g. so that group structures are not used to escape any obligation). One respondent provided a fuller account of its approach in support of this view. Subject to the point that smaller companies represented a large proportion of the employers and of business activity in Britain and, therefore, to exclude them from any of the contemplated reforms would reduce the impact of such reforms, it argued that smaller companies should be allowed to operate with a minimum of administrative burden. To do otherwise would simply result in the corporate vehicle falling into disuse in the small business sector. Were a full pluralist approach to be adopted, it would not be practical for it to apply to very small business operations due to the complexities and conflicts that would arise. The issue was how, and at what point, a company would be considered to be of such a size that it should embrace the pluralist approach, a major transition which could carry a significant cost. A wide range of avoidance tactics and artificial arrangements might be developed in order to preserve "small" status, whatever test were applied as the trigger for transition.

7.43 Not surprisingly, given the fundamental and somewhat philosophical nature of the subject matter of this Chapter, a number of respondents took the opportunity to comment at length on the broad approach they took to the purpose and scope of company law as well as (or instead of) addressing the specific questions posed by the Consultative Document. It is not possible to do justice to these responses here. It is, however, worth mentioning some of them very briefly:

- a) one commentator expressed support for the enlightened shareholder approach on the basis that it should be linked to a view of the company as an institution with its own distinct personality which outlived any particular generation of managers, shareholders or other stakeholders. This commentator went on to formulate a "clear and modern concept" of the company, its obligations, and the conditions for its sustainable success, based on two essential principles: the entrepreneurial principle which stated that a company was a wealth-creating organism accountable to its shareholders; and the interdependence principle, which stated that, however international, however virtual and whatever its size, the company was also a social institution, subordinate to and dependent on the society which fed it and which provided the education, the infrastructure and the law and order on which it depended. All companies had a licence to operate from societies, and the amount of freedom that governments gave them would depend on the levels of public acceptance and trust that companies commanded.

- b) another commentator noted that the document highlighted the two models of 'enlightened shareholder value' and 'pluralism'. While the two models provided a framework for debate, there were considerable variations and tensions within each model which came to the fore in different circumstances. It would be helpful if the Review considered in more detail different practical models drawn from Britain and other countries. There were particular contradictions within the enlightened shareholder value model which needed to be addressed, such as the fact that while in law directors' duties were to the company (defined as the current and future shareholders), in practice on a day-to-day basis, directors were considering a wide variety of interests when taking strategic and operational decisions. In addition, shareholder value was a term open to a multiplicity of interpretations. Shareholders were not a homogenous group and required different types of return over varying timescales. They also measured 'value' in a variety of ways according to changing accounting and analytical conventions. If shareholder interests are to be paramount, their diversity should be acknowledged
- c) one focused on the point that potential conflict between a shareholder-oriented approach and a stakeholder-oriented approach could easily be overemphasised. The ultimate beneficiaries of pension funds and insurance companies (the holders of a majority of the shares in British companies) were stakeholders in other ways either as employees of listed companies, consumers, or simply members of communities affected by corporate activity. Institutional shareholders shared wider society's interest in a flourishing economy, a sustainable environment and a stable society, but under the current legal system, they did not always act to pursue these interests through short term financial pressures or failure to take a broad view of responsibilities. The challenge for the enlightened shareholder value approach was to find ways to remove the contradictions within the current system which lead to directors and shareholders pursuing perverse strategies which ran counter to the common interest
- d) finally, another commentator argued that the key question was "Does the concept of shareholder value assist in producing a competitive economy or would a different approach be of more assistance?" [in improving competitiveness]. This required consideration of the commercial practices adopted in achieving shareholder value rather than the theoretical possibilities. This commentator also argued that shareholder value, enlightened or not, might prove in one major respect the 1990s' equivalent of "creative accounting" in that they both produced an unrealistic and over-optimistic view of management performance. This could, in turn, delude observers into believing that the British economy was more competitive than it was, while the fundamentals for creating a really competitive economy were not being tackled, except by a limited number of world-ranking companies. It saw the fundamental problem as short-termism. This was much more prevalent in the UK than in other developed economies, even the USA, due to the unique control by City institutions of a large majority of quoted shares. They in turn were subject to pressures for immediate results owing in part to the manner in which their products were marketed and assessed. It was against this background that the key question of whether shareholder value or some more pluralistic approach was the appropriate basis for determining directors' duties should be assessed.

## **8 Comments on Chapter 5.2, The Needs Of Small And Closely Held Companies**

8.1 This part of the Consultation Document addressed the needs of small and closely held companies, examining the merits of new free-standing legislation for such companies, as opposed to an integrated revision of existing law. A provisional preference was expressed for the latter, re-writing the legislation on a “think small first” basis, with appropriate flexibility to suit the needs of such companies, while retaining integrated legislation which provided for all.

8.2 The first question posed in this part of the Consultation Document - **question 9** - asked whether it was agreed that the difficulties met by small and closely held companies in operating within the Act were serious and worthy of remedy. The overwhelming majority of those who responded to this particular question supported the proposition. Many felt that the present law was opaque, unwieldy, unnecessarily complex and burdensome and therefore ripe for review. One commentator in particular noted that the law for small companies should be no longer than necessary and that there was no logic in the current position that small businesses must comply, with certain exceptions, with the same requirements as larger companies. The costs involved in meeting these requirements were an unnecessary burden on small businesses. Many of the post-war additions to the Act had been developed in order to counter perceived abuses. These well-documented cases had mainly concerned the public and larger company and had led to increases in the amount of material in the Act which was of little or no relevance to the small closely held company. A number of commentators were in favour of an approach based on a starting point of minimum regulation for small and privately-held companies, with additional requirements for larger businesses, rather than the current regime, which provided a vast bulk of rules with a large number of specific, and often complex, relaxations for private companies. The principle in formulating such a regime should be that it was as simple as possible consistent with the proper protection for creditors and for minority shareholders. A further point made in this context was that investment in such companies should be made as attractive as possible in order to widen the range of investors. A model that started with a typical small private company and progressively built on requirements for larger and public interest companies, with each additional requirement fully justified, was widely advocated.

8.3 Another, closely-related, model which drew support was an approach that sought to stratify legislation, so that directors and owners could easily ascertain the requirements relating to their business. One commentator argued, in this context, that there were in fact a range of two categories of small company, including those small by economic significance and those with a small number of shareholders, and it may well be that various categories merited some but not necessarily the same exemptions from mainstream requirements. Finally, one commentator expressed the view that there had to be a more radical solution to the application of company law to the small and closely-held company - and it was concerned that based on the discussion in the Consultation Document the law as enacted following the Review would still be of excessive length and complexity so that it would be inaccessible to many small

company directors. Its view was that it would be better to have 100% compliance with 20 sections rather than 20% compliance with 100 sections of company law.

8.4 Two additional points made by commentators in the context of this particular question were that the level of ignorance of small private company company secretaries and directors of their obligations, responsibilities and liabilities was very high, and that a small businessman's problems related more seriously to issues concerning employment, taxation, social security and general regulatory requirements - company law problems featured well down the list of priorities.

8.5 In responding to this particular question, some commentators offered their own solution to the right approach of company law to small and closely held companies. One proposed a new category of propriety company which should be formed for non-regulated, non-public interest, owner-managed companies. Businesses would only be eligible to register as propriety companies if all the shareholders were directors. These companies could be relieved from all the requirements of companies legislation relating to shareholder protection. This would represent significant deregulation for a large number of companies while retaining appropriate creditor protection provisions. Another commentator advocated a similar approach, with a special regime for companies that were owner-managed. Such entities were fundamentally different from ones where management and ownership were separated. If this were recognised, a working definition of owner-managed companies could be devised. As soon as a company grew beyond this simple scenario, for whatever reason, it would enter a more rigorous regime. This definition should apply however, whatever the size of the company. Finally, one commentator argued that it would be appropriate to have a distinct legal form for sole member or owner-member companies with no employees which conferred the benefits of limited liability but without requiring such businesses to register as a company. This would remove the difficulties of engaging with company law for a significant group of people for whom these provisions had little relevance. There might also be a case for creating a special category for "micro" businesses with up to nine employees which combined the benefits of limited liability with a light legislative regime appropriate to the scale of their operations.

8.6 Of those who responded to this particular question, only a handful thought that the difficulties met by small and closely held companies in operating with the Act were not serious and worthy of remedy. As one commentator put it, such companies were, after all, limited companies and that there must be some legal and procedural consequences in incorporation, however small the company, to distinguish it from sole traders or partnerships. Another noted that while there were problems for small companies operating within the Act, some of these had been tackled, for example through the written resolution procedure and the adoption of the elective regime. These processes substantially decreased the procedural burden on small companies. In this context, the real challenge was to encourage smaller companies to use these procedures.

8.7 Finally, in responding to this question, one commentator noted that charitable companies should be treated as special cases with regulations designed to meet and be appropriate to their special status.

8.8 Similarly, a significant majority of those who responded to **question 10(a)** took the view that it was not desirable to restrict access to limited liability. A number argued that limited liability status acted as a spur to entrepreneurship and innovation. As one put it, limited liability status had played a key role in creating a dynamic private sector since its inception and its benefits should be open to all those who wished to set up a legitimate going concern. Other points made in support of not imposing restrictions on access to limited liability status were: that the protection essentially benefited shareholders, whereas the vast majority of small companies were owner-managed; that the limited liability vehicle in itself caused few problems, even when used by those with limited appreciation of the consequences of incorporation, as compared to the problems caused by businesses which operate as informal partnerships without proper documentation; that businesses should be able to choose between incorporation and other business forms on the basis of commercial criteria and not because of externally imposed restrictions; and that the Review should leave the simplicity of the incorporation system intact and should focus rather on directors and ensure that they were aware of and acted upon their responsibilities. Another argument put forward was that easy access to limited liability was not itself the key issue, despite abuses such as “phoenix” companies. The real problem lay in the behaviour of the directors of such companies who had found they were able to create phoenix companies unchecked. The solution to abuses of the system was not to make incorporation more difficult, but rather closer monitoring of, and the imposition of restrictions or penalties on, the individuals concerned.

8.9 Other commentators, while supporting the principle of not restricting access to limited liability status, sounded a slightly more cautious note. More than one expressed the view that there was a regulatory “price” to balance the benefit of limited liability, i.e. the imposition of enforceable duties and responsibilities on the owners and directors of a company. It was often assumed that the regulatory burden should be minimised in order to relieve the many small businesses which had been incorporated. However, it was also necessary to recognise that small businesses had incorporated with limited liability in order to achieve a formal “off the peg” corporate structure, even though this might not be ideal for them.

8.10 Only a handful of those who responded to this question argued that access to limited liability status should be restricted. One commentator thought that many limited companies were so small and under-resourced that they did not have the capacity to cope with the administrative requirements which company law imposed, leading them to claim that they were overwhelmed by unnecessary “red tape”. Pointing to the pressure to reform section 459, which had been caused in large measure by the large number of family or partnership-based companies whose directors fell out and consequently entered into prolonged legal actions, it was argued that it was inconsistent for company status to be so easily and cheaply available when directors’ duties were so onerous and directors and their companies capable of causing so much financial damage to those with whom they dealt. Another noted that many small businesses incorporate for what, in retrospect, appeared to be inappropriate reasons, and barriers that encouraged greater consideration prior to incorporation might be beneficial (although entrepreneurs should not be discouraged from adopting whatever form of business vehicle was most appropriate to their circumstances). Finally, another commentator argued that access to limited liability status was in

practice already restricted by, for example, the Company Directors Disqualification Act 1996, and there seemed no reason in principle that these restrictions should not be tightened up, for example, by requiring a minimum age and imposing other qualifications for directorship.

8.11 Amongst those who addressed **question 10(b)**, which sought suggestions on the constraints that should be considered were it to be decided that it was desirable to restrict access to limited liability, by far the most popular suggestion involved the introduction of a minimum capital threshold for businesses that sought to incorporate. This was seen as a practical and useful measure, causing proprietors of small businesses in particular to consider whether they needed to be incorporated, the responsibilities which they as directors would assume and also the financial commitment which they would have to make. A small minimum capital would be no disincentive to those genuinely seeking limited liability. In practice, most companies with a £2 paid up share capital had significantly larger sums injected by the shareholders/directors in the form of directors' loans while the directors of many small limited liability companies gave personal guarantees to large creditors, thus effectively negating the limitation of liability. This group of commentators accepted that a compulsory minimum capital would be of limited value in protecting creditors as assets might be quickly dissipated in trading - the intention was to encourage the smallest business to think twice before choosing a company form and so assist the most insubstantial in making the better choice. Others thought that under-capitalisation was one of the main causes of insolvent closure, however viable the venture may be, and argued that setting a significant threshold for limited liability, by requiring a meaningful contribution of capital, would encourage greater use of unlimited liability for those businesses that would otherwise incorporate. Sums of between £500 and £10,000 were offered as suggested minimum levels of capital while one respondent suggested that provision be made to enable the Secretary of State to adjust the appropriate sum of fully paid up capital that should be required before a limited company was allowed to function.

8.12 A number of other measures were suggested by commentators as appropriate forms of constraint on access to limited liability status:

- the imposition of minimum working capital requirements (rather than equity capital constraints). Potential creditors could be forewarned if a company was trading with current liabilities in excess of its assets;
- the restriction of access to limited liability to owner-managers who possessed a basic financial acumen, e.g. by requiring that at least one director had a degree of financial competence;
- requiring new companies to have a business-plan, completed by a qualified accountant;
- increasing the incorporation fee;
- confining the privilege of limited liability to true non-executive shareholders (i.e. pure investors) in order to avoid the widespread abuse of limited liability status by

shareholder/directors of close companies, which were little more than incorporated partnerships or sole traders. Owner-managers and directors of close companies should be regarded as principals, i.e. that in relation to those individuals the veil of incorporation should be lifted. The fundamental principle underlying this proposed reform was that someone, who as a matter of economic substance, assumed the role of a sole trader or active partner should be treated accordingly, and should not be allowed to hide behind limited liability status. True investors, with no executive involvement, would be allowed to continue under the protection of limited liability;

- the provision, as part of the incorporation process, of greater factual information about directors, such as proof of their identity and a facility to check their basic financial integrity, for which they would be charged a nominal fee. This would be linked to closer vetting of applications for, and the people behind, company registrations, and closer checks on individuals after incorporation;
- the introduction of compulsory indemnity insurance for directors, on a phased basis, i.e. for listed or public company directors first and extending to other companies subsequently; and
- the adoption of a formal procedure for the appointment of directors, whereby new directors either took a standard format solemn oath that they understood and accepted the duties and responsibilities of a company director, or took a test of their understanding of their duties and responsibilities.

8.13 One commentator, however, argued that the optimum solution to the problem of irresponsible incorporation lay in the introduction of an alternative incorporated form, a registered unlimited partnership which would have all the advantages of the limited company except limited liability and none of its disadvantages. Such an unlimited liability incorporated form would offer small businesses an off-the-peg corporate vehicle containing minimum regulation - as members would be personally liable for the business debts, all of the creditor protection requirements that made up much of company law would fall away. Small businesses should thus be given the choice between an unlimited registered corporation or the traditional limited company which came with greater regulatory responsibilities and obligations. Such a choice would reduce pressures to deregulate limited liability companies beyond the point that was desirable and would encourage more reasonable risk-taking by the smallest businesses, reducing the exposure of creditors to the “rogue director” who exploited limited liability to his advantage.

8.14 The vast majority of commentators who addressed **question 11(a)** which asked whether the current accounting exemptions for small and medium-sized companies should be removed or amended, took the view that some change to the current regime was necessary. There was, however, a wide divergence of opinion on the nature of the change that was desirable. For instance, some commentators took the view that there was no reason why a small private company should not be completely exempt from the preparation and filing of accounts if all its shareholders so agreed. As far as the other interest groups were concerned, especially creditors, they had the option of not doing business with the company if it did not prepare accounts and companies that wished to satisfy creditors would be able to produce audited accounts on a voluntary basis.

Echoing comments made by a range of others, this commentator argued that in any event the usefulness of filed accounts, which often consisted of historic information, up to 10 months old, was not significant - similar considerations would apply to an historic certificate of solvency. The view was that, in practice, few creditors looked at the accounts anyway, and those who were undertaking substantial transactions with a company often sought guarantees of security, disregarding the accounts.

8.15 A larger group of commentators had positive suggestions to make in respect of improvements to the regulations concerning the accounts to be provided by small and medium-sized companies. These included:

- the current permitted filing deadline of 10 months from the accounting year end meant that information on file was of little practical value to a user, especially if the abbreviated accounts were filed. A significant number of commentators supported a substantial reduction in the current 10 month filing period for private companies;
- abbreviated accounts provided too limited information to be of any use, whilst preparing separate abbreviated accounts for filing and full accounts for shareholders represented a burden to small companies. The information provided could be in a standardised form which met the requirements of the Inland Revenue and Customs and Excise;
- the role of small company accounts should be replaced with alternative forms of financial information, for example, cashflow statements, ratios or graphical presentations;
- many smaller companies were using computers with proprietary software to produce management accounts that were incomplete, inaccurate and erroneous. The financial accounting packages had not been recommended or installed by qualified accountants or other competent professionals and the staff operating them were not trained in their use. A reduction in statutory compliance would enable accountants to offer their clients more valuable service which could involve advice on IT;
- a number of commentators addressed the issue of the current accounting thresholds for small and medium-sized companies. One at least thought that the thresholds below which companies could opt to file abbreviated accounts were too high, arguing that they needed to be redefined in the light of the growth of the service sector in the economy. Others thought that the limits that determined the exemption should be raised given that the accounting requirements represented a burdensome process for small firms;
- the current reporting regime for small companies was too complex and should be simplified. Rather than focus on exemptions, the starting point should be ensuring that the core provisions of company law were made to apply to small owner managed companies with add-ons for larger companies and public companies. Under this framework small limited liability companies should be required to send their shareholders full audited accounts, comprising a balance sheet and profit and

loss account and supporting notes. Such companies should also be required to file their accounts or abbreviated accounts on the public record within seven months of the year end. Such a new financial reporting regime would not be onerous for small companies, but would provide the basic company and financial information to users on a more timely basis;

- financial statements to shareholders of small companies should be accompanied by a cashflow forecast statement and a break-even analysis, though these need not be filed at Companies House. The Annual Return filed at Companies House should be extended to include a box to be ticked by directors to confirm that these had been prepared within, say, 3 months of filing the annual return;
- given that accounting information was valuable to creditors, customers and suppliers, there was a view that small company accounting rules should be amended so that more information was available rather than less.

8.16 A number of other commentators took a different approach to this issue, arguing that small and medium-sized companies should provide the same range of financial information as larger companies. The points they made in support of this case were as follows:

- the fact that small companies no longer needed to file a profit and loss account if they chose to file abbreviated accounts, meant that it was more difficult for credit guarantors to assess their creditworthiness and it was often necessary to ask a company to furnish up to date accounts before finance could be extended. The information provided under the current regime was worse than useless to creditors as it could lure someone intending to deal with the company into a false sense of security. Further relaxation, e.g. of the audit requirements, would serve to restrict access to credit for small and medium-sized companies. At present, a large proportion of those entitled to file abbreviated accounts did not do so, partly because it would be detrimental to a company's credit rating;
- no de-regulatory benefit was achieved by reducing the level of accounting information published, e.g. in abbreviated accounts, since full accounts had to be prepared for shareholders and for taxation purposes, and the abbreviated accounts were derived from the those full accounts. Since the introduction of the exemptions, the fact that accounts were usually prepared on computer had reduced the burden on the small corporate body;
- the disclosure of financial information was a duty that could properly be expected of organisations which enjoyed the privilege of limited liability;
- as accounts had to be prepared in greater detail for the Inland Revenue, there was no extra cost in filing those accounts in Companies House. Indeed, it cost little more to provide a second set of accounts in a different format, while one of the common reasons that accounts were rejected by Companies House was because of arithmetical errors arising from simplification;

- preparing and filing full accounts provided an important element of accountability for the directors of a company at whatever level, which was a good discipline for the future as the company grew. The accounts were a very important in-house document for company directors, particularly those who were not shareholders. It was a document about the performance of the company and could be used to instil pride and care for the company;
- differentiation already occurred in accounting standards for small companies through the FRSSE. The exemption that permitted the filing of abbreviated accounts should therefore be abolished.

8.17 Only a small number of respondents argued against changing the current accounting and reporting regime as it applied to small and medium-sized companies. Those that did tended to emphasise that continuing regulation through the accounting requirements offered a much more effective influence for proper practice than the disqualification regime and argued that a major strength of the British system was that all companies were required to file certain information on an annual basis. Current filing requirements should thus be kept for all company financial statements, with transparency as a main price for limited liability. Without the filing requirements for all companies, Britain would attract more criminal activity, including fraud and money laundering and the black market economy would probably increase significantly. Arguments that there were cost burdens to making filings were largely spurious. Companies needed to prepare financial statements for tax purposes, to satisfy bankers and financiers and to enable suppliers and customers to understand the circumstances of the company with which they were dealing. The incremental cost in making a filing was insubstantial, while the benefit to the public was great.

8.18 **Question 11(b)** asked whether current exempt accounts provided proportionate, or any, protection to creditors, bearing in mind the costs of their preparation - a point that had already been touched on by some commentators in addressing question 11(a). The overwhelming majority of those who responded to this question took the view that abbreviated accounts filed by small and medium-sized enterprises provided little or no protection to creditors. As one commentator put it, such accounts told one nothing useful beyond the basic details, which were also to be found in the annual return. In addition, the information was only a snapshot in time and was soon out of date. Those wishing to establish a complete picture of the company, either had to apply for a full set of accounts from the company or use other sources to acquire the relevant data. Despite the fact that the additional costs of preparation of full accounts were minimal, the exemptions seriously reduced the usefulness of the published accounts to third parties. This was particularly true of companies which, while qualified to file abbreviated accounts, did in fact have substantial operations - it was also possible for a small company to form part of a complex group of related companies. Other commentators thought that creditors were unlikely to examine accounts at Companies House before extending credit. Suppliers, for instance, required trade or bank references before granting credit or sought pre-payment while banks were able to demand a range of financial information from their smaller company clients and were able to verify unaudited statements by reference to movements in the customer's account. Large creditors protected their

exposure by taking a fixed or floating charge over a company's assets or by requiring a personal guarantee from the director or other guarantors.

8.19 In responding to this question, a few respondents expressed the view that even full accounts were of only limited value to creditors, especially as they were often not filed until 10 months after the financial year end. No set of accounts could provide complete protection and creditors needed to be aware of the limitations of the financial information provided.

8.20 Very few commentators took the view that current exempt accounts did provide a level of creditor protection. One did argue that although the current accounting exemptions resulted in less information being available to creditors, creditors did take comfort from the presence of accounts on the public file. While this protection was limited it was difficult to see how the position could be improved without placing onerous accounting requirements on companies with limited resources.

8.21 The commentators who addressed **question 11(c)**, which asked whether exempt accounts should be replaced by a different requirement, e.g. solvency certification, were largely against the introduction of such a change. Only a handful of commentators supported the concept, arguing that it would retain for small companies a measure of commercial confidentiality, while at the same time providing creditors with a meaningful financial statement. It was also thought that a solvency certificate would force directors to address the solvency issue seriously and, in aid of transparency, could be displayed on companies' websites and on the Companies House website.

8.22 The greater weight of comment, however, was against the adoption of the solvency certificate approach. The following were the main points to be made by commentators who argued against it:

- it would not be well-regarded by creditors. Lenders would not extend credit on the basis of a solvency certificate;
- there would be significant practical difficulties, for example, in determining a time limit for its publication or in determining the amount of financial information, if any, to be included. It would be difficult for a solvency certificate to provide anything other than a solvent or insolvent status report without also providing supporting financial information. For such a certificate to have any credibility, it might also need some form of approval by auditors, which would represent an additional cost. A barely solvent company could potentially publish a solvent certificate which would not then alert creditors to the potential risk in the company. It would also be difficult for a company to provide anything other than a solvency certificate without financial collapse;
- as all companies would need to produce accounts, regardless of the disclosure requirements and concessions, and an annual declaration of solvency would have to be based on a set of accounts, it would not be a less onerous option. In fact, it could be a much more onerous document to produce than the current filing because

of the potential liabilities that could be attached. Such a regime would place unfair burdens on directors and auditors;

- solvency certification would be too dependent on directors' ability to forecast and therefore fraught with uncertainty.

8.23 In responding to this question, one commentator did offer an alternative way forward. It proposed that, where a small company's shareholders were also the managers, the necessity for annual accounts that were really only of use to the Inland Revenue and creditors should be discontinued. Instead, the company should be obliged to join a credit rating agency and registration would be a requirement before trading. This type of system would be of more use to creditors and potential creditors than historical accounting information.

8.24 **Question 11(d)** asked whether there would be value in aligning tax and company law reporting requirements. A clear majority of respondents addressing this question supported the proposition, generally on the basis that it would reduce the burden on business by removing the time spent producing similar information for separate requirements. Some argued that at present accounts were produced predominantly in order to comply with tax requirements, so aligning tax and company law reporting requirements would be beneficial and reduce confusion. Amongst those who supported the concept there was concern at the potential difficulties in aligning the two regimes in terms of the timing of submissions, the type of information required and the accounting definitions to be used. Other concerns expressed by those that supported the proposition were that public disclosure of the same level of detail as was required by the Inland Revenue might not be welcome. One commentator, in particular, thought that the alignment of the tax reporting requirements with company law reporting requirements would be welcome, although the reverse would create problems.

8.25 There were, however, a number of commentators who saw fundamental problems in attempting to achieve the objective. They noted that, even for a small company, there was potentially a wider user group, with a wider range of information needs, than simply the tax authorities. Accounts for tax purposes and for public reporting served different needs, and if they were aligned, short-term tax pressures could distort accounts drawn up for public reporting purposes. The differences between the two regimes, many of which were likely to be of relevance, even to smallish enterprises, were significant, such as the difference between accounting and tax depreciation.

8.26 The overwhelming majority of those who responded to **question 12** supported the contention that an "integrated" approach be taken to reforming company law rather than a "free-standing" model. There was, in particular, a good deal of support for an approach that saw the basic rules in company law being those that applied to the most basic company, with additional rules included for larger, more complex, companies on a building block approach. Points made by those arguing in favour of the integrated approach were:

- small companies became large ones and the legislation needed to cater for such transitions. Creating separate legislation brought difficulty in providing a cut-off point for which the small company was no longer small. Legislation should not be a barrier to transition from one category to the next, and the risk in adopting a free-standing approach would be that companies might seek to avoid the transition if it was felt that the regime for a larger company involved a radical, detrimental change in the applicable legislation;
- any new regime should reflect as appropriate the different types and sizes of company - public and private, large and small, owner-managed and diversified - and should be accessible to those managing and advising such small companies;
- under the present arrangement of the Act, provisions relating to small private companies had to be identified amongst a mass of provisions, some of which applied only to the largest public companies. The core provisions should be complemented by requirements relating to medium-sized, to large, and to listed, companies;
- the character of small companies was too diverse for a reliable boundary to be drawn between small companies and other companies. A closely held family company may manage a large business;
- an integrated approach should be truly integrated. The limited liability partnership should be incorporated into any new legislation, ensuring the law related to the formation of corporate bodies could be found in one place. The legislation should enable re-registration from a limited partnership to limited company and vice versa.

8.27 Only a small number of commentators supported the free-standing approach to company law for the small and privately owned company. Those that did argued that stand-alone legislation would be more easily understood by small companies and could thus greatly reduce the burden on them. From a practical viewpoint, it was essential that close companies, and those advising them, should have one relatively simple code to consider. They should not have to address hundreds of irrelevant provisions. In fact, one commentator, while supporting the integrated approach suggested that it might be necessary to adopt the free-standing approach if the integrated approach imposed on small companies a great deal of legislation which would not be required by the free-standing model.

8.28 **Question 13** asked, if a free-standing model was favoured, how should eligibility be defined, what should be the character of the regime and what provisions were necessary for regulating transition (voluntary or involuntary) out of the small company status. This particular question attracted a relatively small number of responses and those that did respond tended to focus on the eligibility criteria that should be adopted in a free-standing regime. These comments identified the shareholding structure of such companies, i.e. the number of shareholders and whether the shareholders were involved as directors and the degree to which any shareholders did not have day to day knowledge of the business. The thought was that eligibility should be defined by reference to the concept of a close company. If the purpose of creating a free-standing model was to cater for closely held and private companies, where there was no need for company law to regulate the relationship between

directors and external members, it followed that companies whose shares were traded on a recognised exchange would need to be excluded. One commentator, however, noted that regulations restricting status to participation in management would be difficult to define and even more difficult to achieve and should be combined with a turnover criterion.

8.29 Finally, in reference to this question, one commentator thought that all small companies should have the right to commence life as, or to transfer, to a standard private company at any time. Transfer from standard private company to small company status should be voluntary and only permitted if the number of members and the turnover criteria were fulfilled.

8.30 A clear majority of those respondents who focused on **question 14(a)**, which asked, if the integrated approach was favoured, whether an “opt in” on formation, was desirable for small and closely-held companies, supported the concept. One commentator did, however, point out that it would be necessary to allow existing private companies which met the defined criteria to opt in in a similar way. Another argued that it might be necessary for the founders of a company to be required to give a certification of its closely held status if, for instance, close company status afforded tax concessions. A number of commentators did, however, argue that if a bottom-up building block approach was taken, there would be no need for an opt in provision. The small basic private company would represent the automatic default. At each level above this basic model, the legislation would set out additional requirements. Others thought that having an opt-in regime would create problems in terms of amending the various aspects of the Act if further changes - to the accounting and disclosure requirements, for instance - were thought necessary. A further difficulty of the opt-in on formation approach flowed from the fact that companies were often established speculatively and held on the shelf while the size and trading status of new companies could vary greatly even in the early months following incorporation.

8.31 Similarly, a significant majority of those who responded to **question 14(b)** were in favour of the suggestion that a special Table A be adopted for small and closely held companies in the context of an integrated company law. The provision of a standard form of Articles would represent a valuable saving for small businesses and would break the conservative mould of traditional Articles. The provision of at least two sets of efficient private company Articles, one with a conventional broad structure, the other for the owner-managed closed company was seen as being of importance in modernising company law for a competitive small business sector. At present, the standard Table A was heavily altered by the majority of lawyers and company formation agents and it was clear that in its full form it was too cumbersome for smaller, owner-managed or private companies. One commentator thought that special Tables along the lines of Table A for varying sizes of company were a good idea. They could be drafted for owner-managed, small, medium, large and public, companies and could be tailored to suit specific circumstances. One commentator in particular thought that a new Table A for small owner managed businesses would need to include provisions covering: the use of information technology, including virtual meetings, electronic voting and record keeping; and provisions focusing on small, family owned companies which would allow for pre-emption procedures in relation to transfer of

shares should a management/shareholder leave the company and “drag along” provisions should the majority of shareholders wish to accept an offer for their shares.

8.32 A number of commentators did, however, express doubts about developing a special Table A for the small owner managed company. Some pointed out that with a building block approach to company law, the Articles for the basic small company would be the foundation block, but one which would form the core of the Articles for larger and public interest companies also. Additional Articles, to be applied as appropriate, would recognise that as subsequent generations of owners assumed control, an element of remoteness and separation of shareholders from management would inevitably be introduced. One commentator thought that if a standard Table A were focused initially on the small owner managed company, then there would be no need for such businesses to adopt a special Table A and larger, publicly quoted companies could adopt comprehensive, tailored Articles of Association. Finally, other commentators thought that small closely held companies should be left to adopt their own set of Articles and that an enabling approach, like that of the Partnership Act, should be the guide if one was needed.

8.33 A significant majority of commentators also supported the suggestion - posed by **question 14(c)** - that a broader elective regime and a more flexible written resolution procedure should be developed for small and closely held companies. One noted that the current written resolution procedure and elective regime were cumbersome and unclear and there appeared to be no reason in principle why a closely held company should be obliged to hold an annual general meeting at all, unless 75% of its members voted to do so. This principle could apply equally to the laying of accounts before shareholder meetings, the annual appointment of auditors (if applicable), the limitation and duration of powers of directors to issue shares, and the provisions which related to the majority required to authorise short notice of meetings. Where all members of a company participate in its management such arrangements were unnecessarily complex. The requirement to notify auditors of written resolutions (under section 381A) also appeared unnecessary.

8.34 Other commentators focusing on this question concentrated on the written resolution procedures, pointing out that it was illogical that a written resolution should require a greater majority than the 75% required to make changes by special resolution. One commentator did not fully accept the argument that it was only at a meeting that dissenting shareholders could argue their case. The written resolution procedure was generally used by owner managed companies, including subsidiaries, or closely held companies, where there tended to be close communication between shareholders anyway. If, however, a 75% majority was not considered acceptable, the requirement for unanimous consent could still be relaxed to the extent that the resolution could have effect if signed by that number or proportion of members required to consent to short notice had the resolution been considered in general meeting rather than in written form.

8.35 A number of commentators offered a slightly different perspective. One, while supporting the focus of an elective regime on owner managed businesses, expressed concern at how this would work in practice. In its view, it would simplify matters to replace the majority opt-out approach with a majority opt-in approach. Companies

could then opt back in either on incorporation, by including in their constitution the requirement to hold an AGM for example, or by subsequently amending their constitution. Another thought that the elective regime was of little value. It could only work where there were few shareholders and if there were only a few it was probably as easy to hold the meeting as to adopt the elective regime. Finally under this question, one commentator argued that it was unnecessary to prescribe a broad elective regime and more flexible resolution procedure. A company could adopt its own provisions. The present law that an informal consent of all members bound a company, and the power to ratify a decision reached after consultation with a majority provided sufficient flexibility. Prescribing rules were likely to ossify the position and lead to conflict.

8.36 Again, the majority of those commentators who focused on **question 14(d)** agreed that, if the integrated approach were favoured, special minority protection should be included amongst the detailed provisions desirable for small and closely held companies. One commentator pointed out that, compared with continental law, English company law was weak on the rights of minority shareholders to information. For example, members of a private company had no access to details of board proceedings nor to current accounting information. They were only entitled to the formal annual accounts and, possibly, attendance at the AGM. While owner managers in close companies would presumably have full access to information, the protection of minorities through enhanced shareholder information needed to be considered as part of the Review. Another thought that the current section 459 should be broadened to bring within its ambit not only unfairly prejudicial conduct but also disputes within the small company which did not amount to unfairly prejudicial conduct. At the same time, a more streamlined and user friendly procedure should be introduced for this purpose. One commentator suggested that there should be arrangements which allowed minority shareholders to insist that the full membership consider and opt in to some or all of the provisions removed by a broader elective regime. In this context, members constituting up to 10% of the issued share capital of a company could be regarded as sufficient to require the members to consider the opt-in arrangements, provided that such proposals did not allow scope for disaffected minority shareholders to bring vexatious or frivolous requests.

8.37 A number of commentators did, however, argue against the inclusion of special minority protection for small and closely held companies. They argued that the width of the equitable doctrine under section 459 might be cut down if the rules were to be prescribed. Nor would it be right to confer on a minority the right to be bought out simply because there was disagreement - this would be in breach of the contract in the Memorandum and Articles of Association embodying the principle of majority rule. It would also encourage damaging disputes. But it might be desirable to reverse the burden of proof where a minority shareholder complained of unfair prejudicial conduct - this would be likely to make the majority more open to compromise. This in turn might reduce the number of contested cases, in a field where litigation was often protracted beyond what was reasonable considering the amounts involved and the likely costs.

8.38 The commentators who addressed **question 14(e)** acknowledged both the importance of, and the difficulties involved in, suitably defining small and closely held companies within an integrated company law approach and the need for transitional

problems to be resolved. A range of useful suggestions and relevant points were made in this context. These included:

- one commentator offered a set of criteria for small company status (self-selection by the company, no corporate members, and no more than 10 members, excluding nominee members) while another commentator suggested that the pre-1967 rules for the exempt private company had worked admirably and could be revived;
- another commentator referred to the practice in German law which provided for three stages in a company's growth. Between the small GmbH and the large AG, there was a point at which the Germans recognised that a company had grown to the extent where its demise would be of greater concern to the community. It was therefore provided that once a company had 500 employees, it must have a certain kind of broad structure, irrespective of whether it was quoted or not. The thinking behind this arrangement - that size required self-discipline - had some relevance for Britain. There was a case for requiring the bigger unquoted companies to have to apply the kind of corporate governance principles that quoted companies were now obliged to follow. 500 employees was only a measure of size and rough and ready at that, but would do as well as most others;
- size was the most appropriate or obvious basis to differentiate between companies for regulation. Some small companies might have characteristics of being in the public interest due to a disparate or large shareholder base, or because they held or collected monies from the public. A better differentiation would be one based on owner managed, non-public interest businesses and those with a public interest;
- opt-outs from regulatory requirements should, potentially, be available to all private companies. The transition issue could be addressed by objection rights for new members;
- the only criteria for small company status should be a limit on the number of shareholders and on turnover not exceeding a specific figure. The latter could be conveniently tied to the compulsory threshold for VAT registration and if this were adopted it would not be an administrative burden to check the status annually, though this would mean that only the very smallest companies would fall within the criteria;
- in order to increase the precision of the relevant definitions, the amount of the share capital or the number of members offered the most likely grounds for distinction. Criteria such as net assets or turnover were too variable;
- the problems of transition would be more easily solved via an integrated regime rather than a free standing regime. If the act was built up from a foundation of a basic small private company to a public company there should be fewer problems of definition or transition;
- no single criterion should be used to establish the definition and transition of companies. A combination along existing lines of turnover, number of employees,

balance sheet total and perhaps number and/or type of shareholders would need to be considered. A combination of criteria would capture most companies enabling them to be placed within the most appropriate category. Special consideration would need to be given to subsidiary and group companies;

- to focus only on the smallest entities, or on private companies, would represent a missed opportunity. Many of the widely publicised problems relating to small private companies applied equally to smaller quoted companies with a market capitalisation of sometimes up to £100 million. While there was clear merit in addressing the issues for smaller or private companies any new regime should avoid the creation of a gulf between those and other types of company. Were this to have the effect of making quoted or listed company status any less attractive than it currently was, it would be damaging to both companies and the economy. Any actual or perceived barrier to companies becoming quoted or listed could restrict the development of growth of successful private companies and may, ultimately, restrict the competitiveness which the Review was seeking to foster. This was not to say that effective deregulation could not be achieved but rather that it should be applied as part of a tiered framework, the benefits of which should be more far reaching than just the very smallest companies;
- it would be important to give the Secretary of State the power to change the categories, in relation to size, status etc that determined into which category each company fell;
- in defining a small company and the point at which it passed thresholds to become a medium-sized, and subsequently a large enterprise, the following points needed to be taken into account: the number of members of the company and their relationship to each other; the nature of the membership of the company, i.e. were any of the members venture capitalists, corporate venturists or other institutional investors; the number of employees; the turnover, profitability and net asset value of the company; the issued share capital of the company; and whether the company was part of a larger group of companies.

## **9 Comments on Chapter 5.3, Company Formation**

9.1 This part of the Consultation Document examined a number of issues arising from the formation of a company, including the content of a company's constitution, the procedure for registering a new company, control over the names under which new companies may register and related 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.

9.2 **Question 15(a)** asked whether the distinction between a company's Memorandum and Articles should be abolished. This suggestion received overwhelming support from the wide range of respondents who commented on the question. A number made the point that the original distinction between the Memorandum and the Articles of Association had become of less significance over

time, that their combination into one document would aid the process of simplification and that a single constitutional document, standardised as far as possible across all companies, would be of assistance to third parties in dealing with companies. One commentator indicated that in a recent survey of its members almost three-quarters of respondents had agreed with the proposition of removing the distinction between the Memorandum and the Articles of Association.

9.3 Some commentators, while supporting the proposal that the distinction be abolished, offered comments on the detail:

- subsequent changes to the information contained in the initial registration document, such as the registered office, would need to be easily recorded without having to amend and refile the whole document;
- transitional provisions would require careful consideration. It would be undesirable to require all existing companies to change from a twin to a single constitutional model. There would thus need to be a long transitional period during which many and probably the majority of companies would continue to have Memorandum and Articles of Association;
- while a single constitutional document would suffice, the form of registration should be divided into two parts or headings, company legal status and powers and internal matters, to ensure that the existing distinction remained between the company's legal status and powers in respect of external third parties and the internal regulation of the company;
- the objective of simplifying the registration procedure would only be achieved if other reforms suggested (such as the abolition of objects clauses) were implemented.

9.4 Only a relatively small number of respondents expressed reservations about the proposal to remove the distinction between a company's Memorandum of Association and Articles of Association. The points made by this group of respondents included:

- one argument in favour of maintaining the present division between the two documents was that of visibility, i.e. it was easier to identify where certain matters were contained;
- the problems with the current system lay in understanding the documents owing to the legal terms used. This could be overcome and the current system left in place;
- there was a real distinction between the Memorandum - which was a mandate for the company and the directors to follow - and the Articles of Association - which were a contract between the members and the company, and under which either could take legal proceedings against the other for infringement. There seemed little advantage to be gained from amalgamating the two into one document.

9.5 Finally under this question, one commentator suggested that the Review should approach the issue of a company's Articles of Association and Memorandum of Association by adopting the New Zealand model. Rather than obliging businesses who wanted to become limited companies to devise bureaucratic and often complicated rules and methods of governance and organisation, which acted as a barrier to entry, company law should merely stipulate three minimum requirements: the name of the company, the country in which it was situated and the signature of the subscribers forming the company.

9.6 The suggestion, in **question 15(b)**, that instead of the requirement to submit for registration the Memorandum, Articles and separate statements of first directors, secretary and registered office, there should be a requirement to submit a single standard form, together with the company's constitution in a single document, also received overwhelming support. A number of commentators agreed that such a process would be simpler and easier to understand for those registering as limited liability companies and would leave less scope for any misunderstanding. One pointed out that as well as being more user friendly, it would offer the scope for easy registration by electronic means, while another argued that the current system was expensive and had become largely irrelevant to today's business environment. Two commentators agreed that while there should be a requirement to submit a single standard form on registration rather than the collection of separate documents submitted at present, there was merit in keeping the company's constitution itself in a separate document, as this was less likely to change subsequently than other information that would be contained in the form, such as details of directors or of the registered office address.

9.7 Only a handful of commentators argued against this particular proposal. The points they made included the following:

- combining the documents that currently have to be filed with Companies House would make a single standard form a document of unmanageable length;
- the information that was contained in the Articles of Association could have a profound bearing on corporate governance and could therefore affect the extent to which the company could be attractive or indeed an acceptable investment for potential investors, and should thus be kept separate;
- the different documents to be filed with Companies House on registration served different purposes and some, such as those which relate only to the incorporation of the company, could not be combined with those which relate to the ongoing life of the company.

9.8 **Question 15(c)** asked whether the statutory declaration, which now accompanies documents for registration, should be replaced with a formal statement of compliance, signed by the founder shareholders. Respondents were again much in favour of this proposition, although a number did emphasise the point that filing documents for company registration represented a serious matter and that there should therefore be corresponding sanctions for fraudulent or frivolous registrations. The conclusive character of the certificate of incorporation, upon which lenders and other

third parties should be able to rely, was also a point drawn out by several commentators. The thought was that the conclusive nature of the certificate should be retained, otherwise impractical problems relating to defective incorporation could arise. Another point raised by one commentator was that a revised process of incorporation would need to be checked for compliance with the terms of the First Directive, especially Articles 10 and 11.

9.9 Although a majority of those respondents who addressed this issue agreed with the thought in **question 16**, that the present rules on company names was satisfactory, there was a significant minority that argued the case for change to the rules, for instance for the register of business names to cover all businesses, whether corporate or unincorporated. One respondent commented that the restrictions on company names represented a major cause of discontent and found it difficult to believe that they were at all necessary. Even amongst those who supported the proposition that the current rules were satisfactory, there were a good number who suggested change in their implementation or their extension, for instance, by obliging the registrar to liaise with the trademarks registry to ensure that company names could not be accepted on the register which could be confused with a trademark owned by another business.

9.10 A large majority of respondents also supported the proposition in **question 17**, that it should 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, i.e. the removal of the ultra vires doctrine. Some commentators, however, while supporting the proposal did query the usefulness and accuracy of the definition of the powers of a legal person and at least one commentator thought that it would be useful for the law to explicitly state the legal powers of companies in dealing with third parties. Others pointed to the special problems created by charities and other not-for-profit organisations in the context of the removal of the ultra vires doctrine. Only a small handful of commentators argued that the existing law should be retained, one at least on the grounds that it protected shareholders from having their money spent on matters of a different nature than they had intended. More than one commentator expressed the view that an element of good faith in the existing law should be retained.

9.11 There was a similar majority in favour of the proposition put forward in **question 18**, that the requirement to have an objects clause in a company's constitution on formation should be abolished (subject to question 24 - see paragraph 9.17 below). A number of respondents thought however, that companies should be permitted to impose in their constitutions explicit restrictions on the carrying out of activities if they so wished. At least one commentator, while supporting the proposition, thought that there was a case for requiring companies to indicate at the time of their formation some statement of their intended activity analogous to that in the annual return. There were also a substantial number of respondents who thought that the requirement to have an objects clause in a company's constitution should remain, in view of the important control on the activities of directors, as a useful governance tool, that it provided.

9.12 **Question 19** asked whether, where companies exercise their power in their Articles or by resolution to limit the authority of their directors or other agents, the

position should continue to be that, where the decision in question was 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 the director or connected with the director, i.e. as in section 35A). A substantial majority of those who responded to the question were in support of the proposition. However, a number of commentators did suggest that there was a need to clarify the law, especially the question of whether a third party who was aware of a limitation was acting in good faith, and to raise awareness of its implications. Others argued that there should be an obligation on companies to notify the registrar of the fact of any limitation and its scope in full, and referred to the importance of the relevant EU law (Article 9 of the First Directive). One commentator explained that the focus of the reform should be on the security of transactions between a third party and the company and that this should involve an analysis of the powers of all organs or agents of the company. Dealing only with directors or agents authorised by directors to act on behalf of the company would result in any reform being incomplete in its coverage. A further commentator suggested that a third party acting in good faith should be protected, even if aware of the constitutional position, where the decision in question appeared to be taken by the board or a person apparently authorised by the board. Third parties might be expected to check a company's constitution, but they could not be expected to verify all the internal authorisations that may or may not have taken place under the terms of the constitution. Only a relatively small number of commentators argued against the proposition. One thought that the good faith limitation in the Act had little value because of the difficulties in establishing bad faith and that there was a case for its removal, while a second questioned whether third parties transacting with directors whom they know are acting ultra vires could possibly be acting in good faith and preferred to see any new legislation defining such situations more closely.

9.13 A large majority of those commenting also supported the proposal, suggested in **question 20**, that existing companies should be free to retain or remove their existing objects clauses from their constitutions, subject to a 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. In supporting this proposition, some commentators emphasised that a company's freedom to remove an existing objects clause should not diminish the protection of minority shareholders and that shareholders should retain the power to bring an action against directors where they had exceeded their authority. Amongst those arguing against the proposition, it was suggested that as the requirements for new companies to include an objects clause in their constitution would disappear, and as it would be generally desirable for shareholders and other third parties to know that a consistent approach was adopted, existing companies should be required, over a reasonable timescale, to remove existing objects clauses - which provided no real protection for members and served no useful function - from their constitutions so that after a defined date there was a uniformity in order to avoid any suggestion that companies retaining objects clauses retained were different in form and substance from those who had them.

9.14 The vast majority of those who responded to **question 21** supported the view that the law should continue to be that 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 (including in any objects clause remaining in the Memorandum) or in a resolution, while not affecting the validity of a commitment entered into by the board or a person authorised by them. Only two commentators did not support the proposition, one arguing that it was of more theoretical interest than practical importance. Points made by those who supported the proposition included the suggestion that the fact that directors should be liable in misfeasance for such acts was more important than a power to restrain, because the act would often have been done before any shareholders had any knowledge of it: that it would be helpful to clarify the precise nature of the proceedings that could be brought against the directors and the liabilities that directors may suffer at the hands of the shareholders, perhaps as part of the codification of directors duties: and that the procedure involved in bringing a restraining action by shareholders should be simplified to allow for such a remedy to be, in practice, an effective remedy.

9.15 **Question 22** asked whether constructive notice of, and the duty as to enquire as to, limitations of authority in a company's constitution, should be abolished in full. A substantial majority of commentators who responded to this question supported the suggestion that the constructive notice doctrine be abolished. As one commentator put it, very few third parties doing business with a company knew or understood the constructive or deemed notice doctrine and, in such circumstances, it seemed illogical to retain it. Others however, thought that it could be retained in circumstances where it could be clearly shown that a third party was associated with the company and could therefore be reasonably expected to have a knowledge of the situation, and that a duty to enquire should remain in regard to charges registered against a company. A further point made was that it might be sensible to oblige a company to ensure that a record was made of any limitations on authority and that such record was publicly accessible, for example at Companies House. Although a third party would not be bound to make an enquiry it would then have the choice whether to do so or not. One point expressed by those arguing against the proposition was that the obligation on third parties to carry out due diligence inquiries acted as a vital protection for shareholders.

9.16 Again a large majority of those responding to **question 23** - which asked whether companies legislation should 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 - supported the proposition. A number of commentators expressed the view that the law of agency was sufficiently flexible and realistic, did not readily enable companies to unfairly repudiate the commitments of their individual directors and represented a better method of dealing with the issue than company law reform. One commentator thought that the involvement of companies legislation in this area would make the law of agency even more complex. Some commentators did, however, argue that consideration should be given as to whether the holders of certain offices in the company should be regarded as organs of the company and thus able to bind the company in the same way as the board and that it would be desirable to clarify who is, by default, an agent of the company in the absence of a specific agency agreement. The thought that it would be helpful to be able to establish who, below

board level, was able to commit the company, putting third parties in a better position to assess whether transactions entered into by other agents were validly entered into, was a common theme amongst a number of responses. On this topic, one commentator referred to the continental tradition of listing in a commercial register those who had full power to represent the company and to sign binding commitments, noting that this had an attractive transparency and clarity and suggesting a review of continental law to assess the advantages and disadvantages of such a solution. Finally, one dissenting commentator suggested that the position vis-à-vis the validity of transactions as between agents of the company and third parties should be clarified in companies legislation for the protection of all parties (the directors, shareholders, agents and third parties).

9.17 **Question 24** asked whether, if it proved impossible to remove the requirement that public companies must have an objects clause in their constitutions, having regard to the Second Directive, the residual objects clause should be deprived of effect to limit the authority of all 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. A majority of respondents supported this suggestion, although one noted that care should be taken to ensure, in so far as possible, that a dual system, with some companies operating with objects clauses and other companies operating without them, be avoided. One commentator, however, thought that the position should remain as it stood, with the position of third parties dealing with directors governed by sections 35, 35A and 35B while the existing rule of ostensible authority should apply to those dealing with other officials of the company. A third party, for example, should continue to be required to consider whether an official at below board level would have the power to enter into a major contract on behalf of the company. Other agents should be required to establish their authority. A further commentator noted that if it proved impossible to remove the requirement that public companies must have an objects clause in their constitution such clauses would be drafted in such a way as to cover all eventualities, as was now the case for many companies, and would thus be of little effect.

9.18 A substantial majority of commentators also supported the suggestion contained in **question 25**, that the existing special minority protection in relation to amendments of objects clauses be abolished. One commentator noted that this special protection was not used in practice and would be unnecessary against the background of the other proposals made in the Consultation Document. Some commentators did express the concern that the general protection of minority shareholders needed to be retained. One argued that if removal or amendment of the objects clause were to require a special resolution, a general requirement that constitutional changes should be made in good faith and for the benefit of the company as a whole should provide adequate minority protection. Another thought that the abolition of the special minority protection needed to be addressed as part of a broader assessment of the protection of shareholder rights while another argued that a shareholder who did not agree with the majority should not be able to block. Conversely if there were misconduct behind the change by the majority then the means to seek Court redress needed to be retained for minority shareholders. A possible way of achieving this would be to extend the current powers of the DTI rather than providing for the shareholders to take action.

9.19 Finally, in this part of the Consultation Document, commentators made a number of points that were not covered by the specific proposals:

- on formation of a company, directors should be required to give not only their names but also the title of any companies on whose board they have sat during the last 10 years which have been placed in receivership or administration or liquidation;
- consideration would need to be given as to whether it should remain possible to entrench class rights in the Memorandum so as to render them virtually unalterable;
- amendments to the law on formation required a careful balance. This should ensure that while the process not so burdensome or expensive as to deter companies from incorporating, it should be formal enough to be regarded with the seriousness and responsibility which it required. In particular, those forming a company and those who will be its directors should be aware of their obligations;
- section 18 of the Act should be amended to state that a change of name or increase in share capital did not necessitate the filing of a revised copy of the company's constitution;
- the subscriber page of a company's constitution should be amended so as to state clearly that the subscriber automatically became a member on incorporation. The current lack of clarity on this point had caused some confusion;
- as part of the rules on companies' constitutional requirements, consideration should be given to whether it should be possible for a company to contract out of its power to alter its constitution or to contract out of other statutory powers.

## **10      Comments on Chapter 5.4, *Capital Maintenance***

10.1 This Chapter of the Consultation Document focused on issues surrounding the preservation of certain financial reserves which are currently designated as not normally distributable to a company's shareholders. The law gives the shareholder the privilege of limiting his liability, so that once he has paid or has promised to pay an amount equal to the nominal value of the shares he has taken up he has no further responsibility for the debts of the company. In order to protect members and creditors, a body of rules - the capital maintenance regime - has been erected to prevent the capital so provided from being extracted or otherwise eroded, save as a result of trading or other business events.

10.2 **Question 26** asked about 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. The overwhelming view of those commenting on this question was that a company's share capital had little or no significance in influencing such decisions by creditors. As one commentator put it, the worth of a company was related to future earnings, and it was these earnings which

provide the creditors with security and not the assets acquired with the original capital. There were, however, a number of commentators who saw a company's share capital as having some significance in terms of creditor protection. Amongst the points made by this group of commentators were the following:

- all companies should be required to have a minimum level of capital which should be maintained. This minimum figure need not be linked to the nominal value of a company's shares and could be set at a specific level;
- the significance of issued capital of only £100 was that the proprietors may therefore have financed the company instead by way of loans. Even if they had not given themselves security, the members would compete for repayment with other ordinary creditors in the company's insolvency. For a small company, a small capital therefore probably meant indebtedness to its proprietors and a reduced creditworthiness. To this extent, capital was therefore significant as a preliminary indicator of the type of financing that a company had received;
- a company's share capital formed part of a large package of creditor protection and the lack of a significant share capital could be an indicator of lack of owner commitment;
- together with amounts of shareholders' and directors' loans, dividend and remuneration policy, a company's share capital was an essential part of the credit assessment.

10.3 The Consultation Document proposed a revised procedure for implementing capital reductions, without Court approval, but subject to shareholder approval and solvency certification. **Question 27(a)** sought views on this proposed procedure. The proposals attracted widespread support, with many respondents expressing their approval, in particular, of the suggestion that the Court no longer be involved as a matter of course in capital reductions. One commentator noted that it had become very expensive for a company that was solvent but had come to the end of its natural life to hand back surplus funds to the shareholders. Another thought that the time, cost and complexity of the legislation relating to seeking the approval of the Courts to reductions of capital far outweighed any protection it afforded to creditors. A range of commentators did, however, offer suggestions on detailed ways in which the proposals set out in the Consultation Document could be improved or amended in order both to facilitate capital reductions and to protect the interests of creditors. For instance, one thought that creditors should be notified of a proposed capital reduction and given sufficient information and time in which to respond. Others argued that solvency certification was essential and ought to be subject to independent professional review, and that - again with regard to directors' solvency statements - that a procedure was needed which directors would treat with the appropriate gravity but which did not act as a deterrent to companies which needed to reduce their capital.

10.4 Some commentators did express some concern at the nature of the proposals contained in the Consultation Document. One argued that the advantages of the present system of requiring confirmation by the Court outweighed the savings in costs and time which might be achieved by the abolition of the present system. It thought

that the principle of company law was that creditors were entitled to the benefit of the subscribed capital being maintained and that a declaration of solvency by directors did not represent sufficient protection for creditors. Another expressed the view that the Consultation Document did not demonstrate why Article 32 of the Second Directive, which provides for adequate safeguards for directors, should be characterised as putting unjustifiable power in the hands of creditors. It thought that any reform of the statutory provisions ought to be introduced within the framework of the existing Directives.

10.5 On the basis that a revised regime allowing capital reductions without Court approval, but subject to shareholder approval and solvency certification, would be implemented, **question 27(b)** asked what should be the appropriate sanction or sanctions for a defective certificate of solvency. Those that responded to this question suggested a range of possible sanctions, or combination of sanctions. By far the most well-supported option was making those responsible for the defective certificate of solvency personally liable for any losses to creditors. While this suggestion received wide support, there were a number of concerns expressed by commentators. One thought that too onerous a penalty might negate the purpose of the proposed reform as directors might be reluctant to make a declaration where their own resources were in jeopardy. This commentator thought also that there should be a defence for a director who had made proper enquiry and had a bona fide belief in the accuracy of the declaration, and for directors who were not party to the declaration. Another concern was that making directors personally liable provided creditors with little comfort in practice as the directors concerned could have few assets. Another issue raised in this context was the need to consider whether directors (or the company separately) should be able to insure against such liability. Other sanctions suggested by commentators included: a fine; imprisonment; director disqualification; the relevant sanctions prescribed under Schedule 24 of the Act for the defective provision of information; and finally, a 2-year clawback provision from the shareholders who received the proceeds of the capital reduction. A final point made by a number of commentators to this question was that the issue could be dealt with in the context of a wider-ranging revision of directors' fiduciary duties.

10.6 Again, on the presumption that the revised proposals for allowing a company to reduce its capital without reference to the Court were implemented, **question 27(c)** sought views on the case for and against requiring an auditor's certificate in relation to a certificate of solvency. There was a wide variety of responses to this question, with just over half of those replying accepting the case for requiring such auditor's certificate, largely on the grounds that it would introduce an independent and professional review of directors' opinions on their company's solvency, and would thus represent an important measure of protection for creditors. Other respondents, however, noted a range of concerns that needed to be addressed. The principal argument against requiring an auditor's certificate was that it would add an extra expense and burden on the company (and would in fact run counter to the de-regulatory thrust of the capital reduction proposals as a whole). Other arguments were:

- in many cases the auditors were also the company's external financial advisers and the directors would be expected to consult them in any event in the process of preparing a certificate;
- the subjective nature of many accounting estimates and the quality of the available evidence meant that auditors could not provide a certificate but only an opinion;
- an auditor's certificate merely transferred any liability away from where it belonged, with the directors;
- many small firms took advantage of the current exclusions on the requirement to have their financial records audited;
- auditors' liability was, in any event, limited to the interests of shareholders (i.e. rather than creditors more widely).

10.7 In responding to this particular question, a number of commentators did suggest other measures that could be adopted as an alternative to an auditor's certificate in support of a certificate of solvency in a capital reduction. These included allowing a parent company the option of underwriting any potential liabilities in relation to a subsidiary company; allowing a company's legal advisers to confirm that they had explained the relevant requirements to the directors and that the directors understood those requirements and for the company's auditors to confirm that as far as they were aware the directors had followed the requirements; requiring an opinion (rather than a certificate) from a reporting accountant, an approach intended to address the problem of an auditor being unable to issue a qualified certificate and the uncertainties connected with a statement of solvency that make the requirement for a certificate unreasonable; and the introduction of a materiality test, which limited the provision of a solvency certificate to cases in which significant values and risks were involved.

10.8 **Question 28(a)** asked, on the basis that the Second Directive precluded the adoption of the same scheme (i.e. for capital reductions without reference to the Courts) for public companies whether it was desirable to enable such reductions to proceed without prior Court approval, but subject to the right of creditors to apply to the Court to prevent the reduction on the grounds that they were not secured, nor had adequate safeguards and that the state of the company's assets were not sufficient to make such protection unnecessary. This suggestion received widespread support amongst those who responded to this question. In endorsing the proposal, some commentators did suggest that there would need to be some clarification of the process to determine which matters could be brought before the Court. Others raised substantial practical issues. It was pointed out that giving any single creditor the power to bring the matter to the Court could be conferring too much power to the individual. Equally, requiring some sort of collective action brought its own obstacles. It might in fact defeat the safeguard altogether if creditors had to work in a co-ordinated fashion. In addition, not being secured should not be sufficient grounds for appeal to the Court, because it would allow frivolous applications. One commentator expressed the view that in the event of an unsuccessful application by a creditor, this should not lead automatically to cost penalties being imposed. It would also be

important to develop equivalent procedures to allow parties to outstanding litigation to object to the capital reduction. Where share capital was to be repaid through the cancellation of shares other than on a pro-rata basis, affected shareholders should also be able to apply to the Court. Finally, another commentator argued that it would be important for any revised legislation on this issue to be cast in a flexible form so that it could be easily amended if satisfactory changes could be agreed to the relevant EU Directives.

10.9 Those arguing against the proposal noted that on cost grounds it would be impractical for many individual creditors or shareholders to make a Court application. Far better protection would be given to creditors if a reduction of share capital by public companies was only made by the order of the Courts. It could be reasonably assumed that if such a company sought a reduction of share capital it could either afford the necessary expense or had little alternative but to afford it. Other points made were that the right of creditors to apply to restrain a reduction was not sufficient protection, and was likely to cause more trouble than the present procedure.

10.10 One respondent, in a fuller answer to this question, argued that if there were evidence that prospective lenders were adopting a more cautious attitude to lending to public companies where there was no Court involvement in capital reductions, then it would favour retaining a requirement for prior Court approval. In that event it recommended that the present requirements of section 136 be modified so as to take advantage of the terms of the Second Directive to enable the Court not to require a bank guarantee or a cash retention for creditors if that was not necessary in view of the assets of the company. If, however, there were no evidence that lack of prior Court approval would lead to more caution on the part of the lending community, then it favoured the idea of not requiring Court approval but making the reduction subject to the right of creditors to apply to the Court if they objected to the reduction. In that case, it would be desirable for the criteria that the Court should apply to be set out in the legislation so that the Court did not feel constrained to adopt the present rigid approach for the protection of creditors in the form of bank guarantees or cash retention. It also thought the companies should be given the alternative for applying to the Court in any event, in case the timing of the reduction was critical and the company was not able to wait for four weeks after the passing of the special resolution and face the uncertainty as to whether or not any creditor would object and whether or not the objection would be successful.

10.11 The overwhelming majority of those who responded to **question 28(b)**, which asked whether there would be value for public companies in adopting the proposals outlined in question 27 in cases of capital reductions to write-off losses, as permitted by Article 33 of the Second Directive, supported the suggestion. One commented that there seemed little merit in preserving an illusion of financial strength as represented by a large share capital when that was offset by negative reserves deriving from poor trading results. Accordingly, it made sense to relax the requirement for public companies to require Court approval to write-off losses if that could be accommodated within the Second Directive. Very few commentators argued against this proposal; the only significant argument put forward was that losses should go through the profit and loss account so that all concerned can identify them - and be able to ask questions when the accounts were laid before the shareholders in general meeting. If losses were

written-off against a reduction in share capital there was a reduction in the figures in the balance sheet over the amount of the loss but the net worth remained the same and the loss itself was not transparent.

10.12 Similarly, the overwhelming majority of commentators endorsed the proposition set out in **question 29**, that if amendments to the Second Directive could be agreed to permit this, the proposals for simpler capital reduction procedures set out in question 27 should be extended to public companies. One commentator, while supporting the proposition, did however make the point that the simplified proposals, without the need for Court approval, might be available as an option for plcs whilst retaining the existing provisions as an alternative. Arguing against the proposition, one commentator noted that the reason for distinguishing between public and private companies was creditor protection. The creditors of a small company would be able to protect themselves in ways not available to those of a plc (e.g. guarantees from the directors and owners). The share capital and non-distributable reserves of a plc might, unlike most private companies, be of such a size that influenced the creditors in dealing with the company. Adopting the procedures addressed by question 27 would not enable the creditors to prevent the capital reduction. One means of addressing the problem would be to require Court approval if objections from creditors exceeded in aggregate a set monetary amount or percentage of the company's creditors. Another commentator thought that the response to this question depended on whether lenders would be concerned about the absence of Court involvement and thought that research might be carried out to establish the extent to which that might be the case, while another suggested that the scheme outlined in question 27 be extended to unlisted public companies but not to listed public companies, as the latter could afford the costs of an application to the Court which gave protection to creditors and members generally.

10.13 **Question 30(a)** which asked whether private companies should be permitted to provide financial assistance in connection with the acquisition of their shares, subject to approval by disinterested shareholders and solvency certification, also attracted an overwhelmingly favourable response. One commentator argued that in most cases financial assistance resulted in no overall loss to the company or reduction of its capital base. Given the lesser risk to creditors, it thought that many of the safeguards could be removed. It might even be acceptable to drop the financial assistance provisions altogether, at least for private or unlisted companies. At the very least, it thought there was no need for an auditor's certification of the director's solvency statement required as part of the "whitewash" procedure. Another commentator thought that private companies should be permitted to provide assistance to the fullest extent possible if approved in general meeting by the shareholders (other than any who had a special interest in the outcome). Another recognised that the provisions were intended to protect creditors and the introduction of equivalent proposals to those relating to capital reductions represented a compromise should it be unacceptable to abolish this area of legislation in its entirety.

10.14 A number of commentators did, however, sound more cautious notes. One argued that suggesting that proposals be subject to approval by disinterested shareholders would serve to prevent the provision of financial assistance in a position where all the shareholders in a small private company were selling their shares.

Another noted that while the proposals in the Consultation Document would certainly make the process of giving financial assistance easier, they did not address the underlying problem of determining whether illegal financial assistance was in fact occurring. Another thought that additional safeguards were required in the interests of shareholders and, to the extent that they were required, further examination needed to be undertaken as to whether they should be in the form of a special or ordinary resolution, while one commentator suggested that if a company was wound up within 3 years of the assistance being given, the Court should have the power (subject to appropriate exceptions) to order the person to whom the assistance was given, and any director who was party to the giving of the assistance, to make good to the company any loss it had suffered as a result.

10.15 Some commentators did express more serious reservations about the proposal. One suggested that the provision of financial assistance in connection with the acquisition of a company's shares could and did prejudice creditors. It had experience of seeing the assets of a private company halved by the buy-out by the company of one of two equal shareholders/directors. The company borrowed heavily to pay cash to the outgoing member and the payment was made out of capital. Creditors and possible future creditors who were unaware that the creditworthiness of the company had been diminished might suffer considerable potential prejudice with little protection. Another commentator argued that, since the restrictions were to protect the corporate assets for the benefit of creditors, approval even by a resolution of disinterested members was not a complete answer; in addition, solvency certification enabled a company to be taken to the margins of solvency and allowed only limited recovery against directors.

10.16 Amongst those commentators who focused on **question 30(b)**, which asked whether the Department's proposals for a de minimis provision and special resolution whitewash provisions offered a better way forward to that discussed in question 30(a), there was a slight majority in favour of adopting the Department's proposals. Points made in support of the Department's proposals were that: they avoided solvency certification which, if audited, was a costly option; they avoided the costs and upheaval involved in seeking an ordinary resolution, especially if the timing did not coincide with the AGM, which could be significant for large companies; and they legitimised many of those transactions which may, unwittingly, involve a marginal contravention of the rules. One commentator went on to argue that features of both proposals could be combined and this it might be helpful to provide that third parties dealing with the company should not be prejudiced by any contravention of the rule on the part of the company. Finally, one commentator argued that it would be a pity if a re-examination at this stage of the topic resulted in further delay to the badly-needed reform of the existing legislation. It strongly urged that the Department's April 1997 proposals, while not meeting all the points that it would wish to have seen addressed, should be proceeded with as soon as possible without awaiting the outcome of the Review.

10.17 Amongst those who argued against the adoption of the Department's proposals, one commentator made the point that the de minimis provisions appeared to be a purely arbitrary test while another thought they were too complicated and unnecessary for private companies. A percentage threshold in relation to share capitals of £1000 or less were, in practice, meaningless.

10.18 The suggestion outlined in **question 31(a)** - i.e. if appropriate amendments to the Second Directive could be agreed whether the regime for the provision by private companies of financial assistance in connection with the acquisition of a company's shares addressed in questions 30(a) and (b) should be applied to public companies - attracted overwhelming support. One commentator, however, while supporting the suggestion, argued that approval by the Court should remain a condition. A judge was more likely to take an impartial and overall view than a board of directors. Another, while acknowledging the objective of avoiding the imposition on companies of disproportionate legal compliance costs, thought that the appropriate protection of creditors remained an important principle and an important aspect, to which insufficient reference had been made in the Consultative Document, was the genuine concern that liberalisation in this area could increase the dangers of share price support or manipulation. If consideration was to be given to reform of the law, it will be important to decide extent to which shareholder authorisation and solvency certification would represent a sufficient safeguard.

10.19 **Question 31(b)** asked whether, in the event that appropriate amendments to the Second Directive could not be agreed, the Department's proposals, as set out in its consultative document, should be adopted. Amongst those who focused on this particular question there was a slight majority in favour of the adoption of the Department's proposals, although there was, in fact, little substantive comment on the issue. One commentator did, however, note that, in the event of the adoption of the Department's 1997 proposals, further guidance would be necessary on situations, for instance, group re-organisations, where there were no disinterested shareholders.

10.20 A substantial majority of those who responded to **question 32** were in favour of the suggestion that both new public and private companies should cease to be permitted to assign nominal values to their shares on formation, although there were, in addition, a significant number of commentators who expressed concerns about the proposal. One commentator, while supporting the proposal, argued that the system whereby the issue of shares was recorded at Companies House, with the amount paid, should be retained, so that the ability to search the fixed capital of a company other than through the accounts was maintained. Another noted that the accounting problem of the value attributable to shares issued, and any premium and how this was to be accounted for and what it could be used for, would remain under the proposal. Other commentators thought that the introduction of no par value shares would lead to confusion rather than easing the administrative burden. One noted that, although attaching a nominal value to equity shares was in most cases an anachronism, certain companies thought it desirable to do this. For example, a private company formed with a view to an early flotation might wish to have a par value if the Second Directive required one for public companies. Companies should thus be allowed to decide whether to adopt the no par value route and the assignment of nominal values should not be prohibited. Any such prohibition would, in any event, cause considerable transitional problems. For the prohibition to be effective, without a long a confusing transitional period, existing shares would have to be converted or deemed to be converted. This would have implications which would be difficult to foresee. The rights between different classes on a reduction of capital or on a liquidation might depend on nominal value. So might covenants by companies in debentures. A similar

point was made by another commentator, who argued that the changes involved in introducing the concept of no par value shares would be extremely far reaching for the Stock Exchange, professional advisers and for companies themselves. This commentator argued that the balance of benefit in introducing the concept did not outweigh the likely costs, confusion and uncertainty that might arise from it. Finally, one commentator pointed to the benefits of the nominal value regime. It noted that although the significance of nominal values may have declined over time, there was nevertheless some advantage in retaining nominal values, for example to determine respective voting rights where the share capital was divided into different classes, while in the circumstances of a share split the existence of nominal values could be of obvious convenience in identification of pre and post split holdings.

10.21 **Question 33** asked whether, if the Second Directive continued to require that shares of public companies be assigned either a nominal or an accountable par value, there was value in taking advantage of the limited flexibility provided by the accountable par provisions of the Directive. The views of those commentators who addressed this particular question were divided almost equally between supporting or declining to take advantage of the limited flexibility provided by the Directive. One commentator, while agreeing that the concept of an accountable par value should be examined further, expressed reservations about permitting a company to have a mixture of nominal value shares and accountable par value shares. Another expressed the view that there was little point in adopting the accountable par provisions of the Directive. These were likely to be more complicated and less flexible for companies, and more confusing for shareholders and creditors, than the existing system of par values. Another commentator, arguing against adopting the accountable par route, thought the concept to be of real significance only in that it acted as a constraint on the company's ability to issue shares below that level. This was not a matter of concern to creditors and hence it thought that companies should be at liberty, where they were authorised by a special resolution of shareholders, to issue shares at below accountable par or nominal value without any need to obtain the consent of the Court. The traditional British approach based on nominal values appeared on balance to be more appropriate than an approach which in effect apportioned pro rata the share premium account to all shares currently in existence. Finally, one commentator thought that no par value shares had in fact already been introduced in EU states such as Austria, Germany and France in order to avoid the need to re-nominalise shares after conversion to the euro. It thought it sensible to examine this legislation and see how those states had dealt with the constraints imposed by the Second Directive.

10.22 A large majority of those commentators who addressed **question 34(a)** expressed themselves against the suggestion that, if nominal shares were abolished for any class of new companies existing companies should be required to convert their existing share capital and register the conversion. While a small number of commentators thought that any abolition of nominal values should be applied equally across all companies of the same class (through converting existing shares or merely deeming existing shares to be of no par value) and that companies should not be allowed to choose between having nominal value shares and no par shares, on the grounds that the two parallel regimes would lead to confusion amongst companies and shareholders, a much larger group expressed the view that companies should not be required to convert. Some were, however, concerned that obligatory conversion might

give rise to unforeseen consequences upon third party rights, for example, if a return of capital or redemption right was framed in terms of the nominal value of a share or where covenants in lending documents referred to nominal values. Generally, commentators argued that the adoption of no par value shares by existing companies should be optional rather than compulsory. One explained that while it did not rule out the possibility of making the abolition of par values compulsory, it considered that such a proposal (and its potential consequences) required further research and consultation. It did, however, suggest that if a company did want to adopt no par value shares, it should convert wholly to this type of share. There would be scope for confusion if a company were to be permitted to create a new class of no par value shares but also to retain its existing par value shares.

10.23 The views of commentators were equally divided on the suggestion, posed in **question 34(b)** that, if nominal shares were abolished for any class of new companies, existing shares should be merely deemed to be of no par value with consequential effects on the balance sheet. Few substantive comments were made in relation to this question. One commentator did argue that allowing existing companies to retain par values would introduce the complication of having two concurrent systems unless all references to nominal/par values in legislation were removed or held to have no effect, while another thought that deeming existing shares to be of no par value represented the simplest and cheapest option and that least likely to cause confusion. Conversely, another commentator thought that such an enforced change would lead to a long drawn out transitional period. Many smaller companies did not need to have their accounts audited and would not know that any change had been made. If Companies House were required to monitor such accounts there would be innumerable rejections causing much unnecessary expense and difficulty.

10.24 **Question 34(c)** posed the question, again if nominal shares were abolished for any class of new company, whether existing companies should be permitted to choose between having nominal value shares and no par shares. The weight of opinion from commentators focusing on this question was firmly behind allowing companies the freedom to choose between nominal shares and non par value shares. One commentator noted that a move to no par value shares would involve a considerable number of consequential issues, e.g. provisions in Articles on payments of dividend or return of capital on a winding up or otherwise by reference to the amount paid up on shares, reference to issued share capital in other agreements and instruments etc. Companies with particular share or financing structures might well thus choose to retain par value shares. One point made by a number of those supporting the proposition of allowing companies to choose between nominal and no par value shares was that any particular company should not be allowed to have a mixture of par and no par value shares. Those that argued against companies being allowed the choice between nominal and with particular share or financing structures shares thought that with particular share or financing structures shares should be made compulsory for all existing companies as well as for new share issues. The view of this group was that it would be preferable for this to be achieved by a “deeming” provision in legislation (addressed in question 34(b) - see paragraph 10.23 above) rather than by requiring companies to take steps to convert their shares. There would have to be consequential amendment, e.g. to re-define the thresholds for certain minority protection provisions which, as currently drafted, were determined by reference to the size of holdings per nominal share capital.

Others argued in favour of compulsion as creating a single standard and easily understood share value system that would cover all companies.

10.25 The proposition suggested in **question 35**, that in cases where no par value shares were adopted the rules on the distributability on reserves should be as proposed in paragraph 5.4.32 of the Consultation Document (i.e. that there should be a single reserve for share capital equal to the net proceeds of its issue, with no right to write off the expenses of an issue of debentures against this reserve) attracted almost universal support from those respondents who commented on it.

10.26 The final question in this part of the Consultation Document, **question 36**, asked whether, if nominal share values continued to be permitted, the equivalent regime (i.e. that addressed in question 35) should be applied to share capital and share premium accounts. The responses to this question were overwhelmingly in favour of the proposition. One commentator noted that although it was obviously commercially attractive for companies to be able to do so, there was no logic in permitting the issue expenses etc of debentures to be offset against the share premium account. Indeed current accounting standards required such costs to be charged to the profit and loss account for the year (although permitting a subsequent reserve transfer to share premium account). While such a provision may have had some merit at the time when it was first introduced into British law, it did not really have any place in these days of complex capital instruments, where what was in reality interest may be expressed in the form of a redemption premium. A further commentator, while agreeing with the suggestion made in the question thought that making such a relatively minor change in isolation did not appear compelling.

10.27 Finally, a number of commentators made wider points in respect to the capital maintenance regime, or raised detailed issues not addressed in the Consultation Document. One, in particular, in arguing for the retention of the current regime, contended that if the company was to be allowed to liquidate its capital then the creditors (and this included suppliers) must have the right to object. The principles of capital maintenance could only be abrogated where the directors assumed full responsibility for their acts, and were bonded so that recovery against them for breach of their fiduciary duties was certain. Conversely, a number of other commentators advocated that the Review should take a more radical and wide ranging approach to the capital maintenance regime. One thought that the legislation was extremely detailed, having lost sight of the underlying principle. It thought that the capital maintenance requirements could be replaced by an all encompassing solvency test and directors' certificate of solvency, reinforced by appropriate penalties on the directors if the certificate proved to be negligent or fraudulently made. Another thought that the Review needed to address the question of whether the doctrine of capital maintenance in its current form had any real value, i.e. whether it afforded any protection to creditors. To do this effectively the origins of the doctrine had to be traced to attempt to ascertain the abuses which it was developed to redress. Central to these was likely to be the risk that where a company was in financial difficulties the shareholders could improve on their position in an insolvent liquidation by selling their shares to the company and becoming unsecured creditors as a consequence. Insolvency law was now, however, quite sophisticated and there were a range of provisions under which a Court could set aside such transactions. In this event it was quite conceivable that the

overwhelming majority of the provisions dealing with capital maintenance could be repealed

10.28 A further commentator noted that, while recognising the limitations imposed by the Second Directive in the case of public companies, other jurisdictions whose law is based on common law did not appear to find it necessary to have all or some of the capital maintenance rules. For example, in some states of the USA not only were no par value shares permitted but distributions (including returns of proceeds of share issues) could be made if key solvency tests were met. This commentator recommended that research be carried out into the way in which capital maintenance was addressed in other jurisdictions and, in particular, the extent to which, where rules equivalent to those of British company law did not exist, the abuses which the British rules were designed to prevent accrued, what other rules were used to prevent or discourage them and what other factors, for example greater use of credit ratings, might make prospective creditors comfortable with a regime which did not have the technical rules currently part of the British regime. If it was found that other jurisdictions avoided such abuses without these technical rules then a further consultation should be carried out as to whether they might be abolished or relaxed, at least for private companies and where prospective creditors would be likely to stiffen credit terms. For public companies, such abolition or relaxation would be precluded by the Second Directive, but if a good case could be made for such change, the Government could seek to have the Directive amended.

10.29 Other commentators thought that the scope of the Review's proposals on the capital maintenance regime should be widened to encompass the distribution rules. The current rules based distributions on accumulated realised profits minus losses. While they operated in a satisfactory way in the majority of cases, if capital reductions were to be based on the shareholders' special resolutions and the directors' declaration solvency, it would seem odd for distribution rules to operate differently. Another commentator argued that the current distribution rules were not working well due to uncertainty over realised profits. Accounting standards had recently been moving away from their previous focus on realised profits towards a more modern valuation based approach. Realised profits were therefore no longer well-defined in accounting standards and the reference in section 262(3) to generally accepted (accounting) principles was becoming less and less relevant. This commentator also suggested that the rules contained in section 275 be reviewed and at least up-dated and made more meaningful.

10.30 Finally, two commentators raised more detailed points on the capital maintenance regime:

- further consideration needed to be given to the unduly restrictive nature of section 171 of the Act which allowed a private company to purchase its own shares out of capital. Indeed, the whole area of law relating to purchase of own shares was unduly complicated; and
- it was important that the law should make clear in what circumstances if any a reduction or other re-organisation of capital, such as the re-sale of Treasury shares, would give rise to a realised profit.

## **11 Comments on Chapter 5.5, Regulation And Boundaries Of The Law**

11.1 This Chapter of the Consultation Document addressed issues arising from the various types of regulation - the Companies Acts and secondary legislation, accounting standards, the London Stock Exchange rules, the Takeover Code and the Combined Code - as they apply to companies. It considered the balance of the current regulatory system, and the need for change, in the context of the benefits of providing continuity and certainty for companies.

11.2 **Question 37** asked whether the broad analysis and approach in Chapter 5.6, 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 sanctions) was correct. This question attracted a wide range of comment, with the balance of opinion in support of the proposition it contained. In particular, commentators emphasised the benefits in terms of flexibility of non-statutory regulation, especially its ability to react to market changes and technological advances, and its ability to bring specialist experience and expertise to bear upon regulatory problems. More than one commentator suggested that a new Companies Act should clearly set the environment and objectives that established a correct balance between statute and self-regulation and between public interest and private enterprise. The main principles of company regulation should be contained in and enforced under statute rather than voluntary or self-regulatory auspices, though their detailed interpretation should be subject to a more dynamic non-statutory regime with a strong obligation put on the main market participants to fulfil their responsibilities.

11.3 A number of commentators, while supporting the general proposition of greater non-statutory regulation and less enforcement by criminal sanctions, expressed a number of concerns that would need to be met by any revised regime for company law:

- great care would need to be taken in ensuring consistency in respect of monitoring and sanctions between any statutory and non-statutory regimes to ensure that any hybrid approach did not result in an unequal application of similar regulations to different types of company;
- a large number of respondents pointed to the need for certainty and clarity in any revised regulatory regime applying to companies. The accessibility of such a regime was also an important concern. Any move towards a larger role for non-statutory regulation should be accompanied by a suitable level of accountability for the regulatory bodies to whom the powers were devolved, including an independent mechanism for review of their decisions;
- a regime that relied more on non-statutory regulation would also need to incorporate greater consultation procedures and sufficient safeguards for the regulated sector;

- similarly, a devolved system of regulation would need to ensure that there were adequate sanctions and enforcement powers available to the regulators. One commentator suggested that where criminal offences were currently in existence, each should be examined and their retention should be justified, or, where appropriate, suitably recategorised as civil offences.

11.4 Those commentators that expressed dissent from the proposition outlined in the question argued that self-regulatory bodies had proved to be ineffective (citing, in particular, the Press Complaints Commission and the Law Society). One noted that the self-regulatory bodies charged with enforcing, for example the Cadbury and Greenbury Codes, had not been swift to act and that market pressure from active shareholders, peer groups and the media had been the main mechanism to ensure the effectiveness of those Codes. Another commentator, in arguing against the widespread removal of criminal sanctions, argued that their presence represented very significant deterrents; it went on, however, to suggest that were criminal offences to remain it was important that the Department adopted a rigorous enforcement policy. There were many offences in the existing legislation the breach of which carried criminal sanctions but which in practice were rarely prosecuted. Another commentator thought that a move towards non-statutory regulation would lead to a plethora of non-Governmental institutions, each responsible for regulating some part of the operation of companies. Even while this would achieve a simplification of the primary legislation, it would be likely to lead to confusion particularly for the small private company. A further commentator argued that part of the problem with company law was the increased fragmentation of its presentation and the encouragement of Codes of Practice could only continue this trend. Finally, one commentator thought that a movement towards non-statutory regulation was only appropriate in the context of larger public companies, where there was a significant body of experts or practitioners with a sufficient common interest to be able to monitor the relevant requirements on an effective basis. While this approach could work satisfactorily in the context of the Stock Exchange listing rules, the Takeover Code and the requirements of the financial services regulatory bodies, it doubted if the approach could be extended much more widely than those areas that had already been identified in the Consultation Document. In particular, in regard to corporate governance, the regulation of directors required a core legal framework - a non-statutory regulator would be inappropriate in this case.

11.5 Other commentators pointed to the benefits of a combination of statutory and non-statutory approaches, while others suggested the creation of a body, responsible subject to a defined consultation procedure for recommending or proposing changes to permitted aspects of company law to keep it abreast of modern developments and best practice. In a similar vein, one commentator suggested that in view of the range of different bodies which had a role in companies regulation at present, a single companies regulator should be set up under statute in order to simplify the system and make it more accessible.

11.6 A number of other issues addressed by commentators in responding to this question were also touched upon by respondents commenting on question 53(a) (see paragraph 16.2-4 below).

11.7 **Question 38**, which asked how the present arrangements for allocating jurisdiction between regulatory bodies as set out in Annex F to the Consultation Document could be simplified, while improving, or at least preserving, their efficacy, attracted a large number of disparate responses. These included a number of suggestions - not all of which were directly relevant - on ways in which the current regulatory map as it affected companies could be improved. Among the more positive suggestions were the following:

- legislation to give the Department the power to transfer the relevant functions to another body. For instance, the provisions regarding disclosure of interests in shares could, if confined to shares in companies which are publicly traded, be delegated to the London Stock Exchange rules, with the Department retaining the power to impose criminal sanctions;
- there could be a statutory regime of company law focused on the needs of small-owner managed companies, with non-statutory regulation applying to more specialised areas and to larger companies and plcs. Thus, rules that were relevant to public companies that were not listed could be included in a new Companies Act as additions to the basic model;
- the number of statutory regulators should be reduced to the minimum number. The fewer sets of rules to be considered, the more attractive Britain would be to investors. Thus, each body which issued non-statutory rules should be reassessed as to whether that body was the most appropriate for setting such rules and whether it had the ability to monitor compliance with those rules and impose appropriate sanctions. The system could be improved by better sign-posting of responsibilities and providing the various regulators with the necessary enforcement powers. For example, the Stock Exchange should be given powers to fine directors where listed companies breach a continuing obligation. In the same vein, the development of published and approved guides to the use of the law with advice and information in plain English which could be disseminated using the Internet, together with accompanying software packages, could be explored as an option;
- some existing legislation that was really a matter of company law such as insolvency, the disqualification of directors, and aspects of the Criminal Justice Act dealing with insider dealing, should be brought into a new Companies Act;
- there should be greater co-ordination between the different regulatory authorities to ensure that rules introduced by one were not duplicated (often with subtle differences) by others;
- a single lead regulator should be made responsible for each company law related matter;
- legislation should be framed in such a way as to clearly describe the purpose behind the provisions and the mischief they were intended to remedy as well as the detailed rules. It would also assist if the particular area of law was dealt with clearly in one part of the Act rather than piecemeal throughout the legislation. In

this respect, better use of indexing and cross-referencing would make legislation more accessible to the layman. This could include incorporation of case law which had previously expanded or clarified existing statutes so that all related law was brought under one umbrella.

11.8 It is worth noting that amongst the responses to this particular question were a handful who expressed the view that there was no substantiated case for making changes to the present regulatory system. One commentator expressed the view that it had no real difficulty with the present arrangements for allocating jurisdiction, while another argued that it would be loathe to see any change based on pure policy grounds. A further commentator argued that regulatory changes which would undermine the wealth of work already undertaken by the professions in improving boardroom practises should be avoided.

11.9 The responses to **question 39**, which asked whether there were specific areas where there was a case for changing the present allocation of roles and functions and/or the extent to which statutory recognition or support was conferred on non-Governmental institutions, tended to focus on the areas of accounting and accounting standards and the roles of the Financial Reporting Council (FRC) and the Accounting Standards Board (ASB) (issues which were also addressed in the responses to question 52 - see paragraph 14.7-9 below). One commentator, for instance, suggested bringing all detailed requirements for the form and content of company accounts within the remit of the bodies established under the FRC. Another thought that there should be as little overlap as possible between the provisions of the Act and the requirements of bodies such as the ASB and suggested that the Act deal with core provisions only with the ASB designated as a relevant body for all other relevant issues. A third thought that regulation on accounting matters should be delegated to the ASB with all accounting requirements in the Act removed, other than the requirement to produce true and fair accounts (section 226) and the need to comply with accounting standards. Taking a slightly different view, one commentator believed that it was important that the form and content of financial statements continued to be laid down by legislation, noting that on a number of occasions, a line taken by the ASB had been in conflict with statutory provisions or relevant European Directives.

11.10 The FRC itself commented that it had considered whether there was a need for better regulation of financial reporting outside the remit of the Financial Reporting Review Panel (FRRP). Its conclusion was that there was no cogent evidence of abuse of the present system that would support a demand for change within the regulation of financial reporting outwith the annual accounts. There were, however, areas within the present system which could be improved. It suggested that further research be conducted to determine the extent and nature of any abuse of the present system and to review the various roles and responsibilities of those involved in regulatory process with a view to improving the consistency with which present regulatory mechanisms were applied. The FRC hoped that this could be undertaken within the context of the Review.

11.11 Other areas identified by commentators where there was a case for changing the present allocation of regulatory roles and functions were as follows:

- one commentator thought that the FRC would be a better alternative to the law in maintaining compliance with corporate governance codes;
- there was an argument in favour of giving statutory effect to the Takeover Code in order to provide a basis for direct sanctions against offending companies and their directors. Such a move should, however, avoid the possibility of applications to the Court and other litigation arising during the course of a hostile takeover, which could be used merely as a device to frustrate or delay a takeover offer;
- in order to make the treatment of takeovers consistent with the enlightened shareholder view of company law, a number of changes needed to be made to the Takeover Code. These were as follows: in a hostile bid, the onus should be on the bidder to say how there will be a long-term increase in value as a result of the bid; the bidder should also be required to produce an independently-verified analysis describing the likely consequences of the plans on the company's employees, customer suppliers and other stakeholders; the law should make it explicitly clear that the board of an offeree company was perfectly entitled to recommend rejection of the bid if it was not convinced that it was in the long-term interests of the company; and the board should also be entitled to comment on the likely consequences of the bidders' plans on the company's employees, customers, suppliers and other stakeholders, so that shareholders could take account of these impacts in reaching their decision;
- there would be value in establishing a single body responsible for overseeing and improving applications for the use of certain sensitive company names.

## **12 Comments on Chapter 5.6, *International Issues***

12.1 This part of the Consultation Document examined the relative attractiveness of the British regime for businesses, the basis on which jurisdiction was asserted and company law imposed on companies with an overseas character, particularly those rules for regulating companies incorporated abroad and operating here, and the relative impact of those rules as compared with rules applied to companies which are incorporated here.

12.2 **Question 40(a)** asked whether commentators agreed with the proposition that British company law was generally attractive to inward investors and that the list contained in paragraph 5.6.4 of the Consultation Document set out the main irritants. The overwhelming majority of those who responded to this question supported the contention that British company law was generally attractive to inward investors, with many pointing out that it was easier and cheaper to incorporate in Britain than in many other regimes (though one commentator did report a concern, often voiced by its overseas clients, that the British formation fee was very low compared to many other countries leading to the presumption that we had a poor registry and supporting legislation). Others echoed the points made in the Consultation Document to the effect that overseas businesses decide to operate in Britain for a variety of reasons, especially the tax regime, marketing reasons, employment law and the availability of

grants and that company law did not generally have a great impact on inward investment decisions. More than one commentator noted, however, that were the British company law regime to be flawed it could have a significant deterrent effect. In this context, one pointed out that attempts to impose elements of the pluralist approach to company law, or otherwise diminish the overriding interests of shareholders, could have serious adverse effects on the likelihood of Britain continuing to attract high levels of foreign investment. It thought that such changes would also probably adversely effect the attractiveness of British equity markets to foreign and perhaps even British investors. Finally under this question, more than one commentator took issue with the use of the term “irritants”, noting that the provisions to which the term referred were often necessary to protect shareholders, creditors and even companies themselves.

12.3 The next question in this part of the Consultation Document - **question 40(b)** - asked, if the list in paragraph 5.6.4 did not set out the main irritants in British company law for inward investors, what else should be included. Although a number of respondents to this question indicated they had no such suggestion to make, others did quote a wide range of provisions - some detailed, some at a more general level - which they thought could act as a deterrent to overseas companies incorporating in Britain. These included:

- the requirement for relatively small companies to have their accounts audited;
- the fact that British company law was complex, outmoded and highly technical in parts. The lack of a facility to rapidly issues and make changes, as existed in other jurisdictions;
- the rules on: capital maintenance, directors’ transactions, the disclosure of interest in shares and the registration of overseas companies;
- the objects clause, the ultra vires doctrine, and the need to have new issues of shares authorised by the general meeting;
- the absence of a Highway Code or other set of guidelines on (as distinct from a statutory code of) the duties of directors of British companies;
- the requirement to disclose directors home addresses on the public register;
- the complex rules relating to loans and quasi loans to directors;
- the uncertainties in British company law affecting the ability of a company to indemnify its directors and other directors against personal liability arising in the course of their duties;
- the uncertainties surrounding matters which may be fundamental to the ability of an inward investor to obtain finance for his venture, such as the application of the “Slavenburg” principles or the Aveling Barford decision;

- the continuing incidence of stamp duty on the transfer of shares and on contracts, or particulars of contracts under which shares are allocated for a non cash consideration;
- the continuance on the statute book of legislation which has not been, and probably never will be, implemented (such as Part IV of the Companies Act 1989 and section 13 of that Act);
- the lack of an orderly, accessible and fully codified civil law system;
- the rules on the distribution of profits by private companies;
- the extent to which British company law is increasingly subject to the EU Directives;
- the vulnerability of private shareholders to abuses. The clearest example was pre-emption rights; private shareholders were almost invariably excluded from placings and suffered dilution in the value of their holdings as a direct result;
- the need to prepare accounts in accordance with the strict requirements of the Act;
- redenomination of share capital;
- the level of detail required on Forms 288 (which cover the appointment, resignation and changes in particulars of directors and company secretaries);
- the Annual General Meeting and its purpose;
- the general complexity of the law for those not familiar with its scope and nuances;
- the requirement for British companies to disclose details of directors' emoluments;
- the requirement to treat Northern Ireland companies as foreign companies in Great Britain and vice versa;
- the requirement under the present system for an oversea company which has a presence both in Scotland and in England and Wales to register in both places;
- the divergence of the language used between section 409 of the 1985 Act which talks about an "established place of business" and the parallel Scottish provision (section 424)(which talks about oversea companies which have a "place of business in Scotland").

12.4 Similarly, those who responded to **question 41**, which asked what proposals for change beyond those contemplated in the Consultation Document were desirable in this context, were split into two fairly distinct groups: those who had no suggestions to make, and those who put forward areas for possible change, ranging from the fundamental to the detailed. Amongst the proposals for change were the following:

- allowing a company to have members with limited liability and members with unlimited liability;
- allowing shareholders to approve the nominal amount of a share expressed in one currency to be expressed in a different currency;
- allowing continuation of a company from one jurisdiction to another;
- requiring that in certain circumstances shares must be offered to existing shareholders in proportion to existing holdings. Currently AGMs are presented with complicated resolutions designed to give directors adequate powers to make issues otherwise than in proportion to shareholdings;
- a simpler way to dissolve solvent companies - without the need to appoint a liquidator - and to allow the return of residual capital and assets to the shareholders. It should be possible for example for an unwanted subsidiary company to be able to be simply wound up by the parent as long as it undertakes to meet any residual liabilities;
- the redrafting of Part XI of the Act into a clear logical code;
- the introduction of a business judgement rule. The case for such an express statement of non interference by the Courts in commercial decisions would be more pressing if a statutory statement of a directors' duty of care was introduced;
- the adoption of a unified approach to company law matters by incorporating the relevant aspects of the Insolvency Act 1986 and the Company Directors Disqualification Act 1985. In addition the Criminal Justice Act 1993 replicates much of Part X of the Companies Act 1985 as regards insider dealing;
- a means of providing limited liability for small traderships without incorporation under the Act;
- the amendment of section 409 in order to provide that a charge on property in England and Wales created by a company incorporated outside Britain was registrable under that section only in cases where a search conducted on the date the charge was created would show that the charging company was registered under Part XXIII.

12.5 **Question 42** asked whether there were any oversea models, or particular kinds of reforms, which should be avoided in the context of possible reform to the British regime. A range of interesting and relevant points were made by those who responded to this particular question. One commentator argued that overseas legal models could not properly be considered in isolation from the national political, economic, social and cultural factors that had influenced their development and operation. Others argued that it would be preferable to focus on the strengths and merits of the British regime, in particular its transparency which allowed those dealing with companies to access on

public registers a reasonable amount of information about the company and its financial position. One commentator, in particular, made the point that we should have confidence in the British regime, which had evolved in a very testing environment over the course of 150 years; reform should continue that evolutionary process and the Review should be wary of solutions imported from different or less demanding environments. A number of other commentators took the opportunity provided by this question to re-emphasise their opposition to the introduction of a pluralist approach to company law, including the introduction of two tier boards, compulsory employee participation and the dilution of the traditional primacy of the shareholder. Other specific reforms which commentators did not wish to see introduced in the British regime included: the statutory codification of directors duties, the proliferation of different types of corporate vehicle, reforms that weakened shareholders' pre-emptive rights or permitted companies to dilute equity without the prior approval of the members and, at a more general level, reforms which prompted the litigious approach of the USA.

12.6 The overwhelming majority of those who responded to **question 43(a)** took the view that the present British approach on the law applicable to companies, based on the law of the place of formation, was preferable to either the "real seat" doctrine or the Californian approach and thought that it should therefore be retained. Respondents to this question made the point that such alternative approaches suffered from the drawback of greater subjectivity in application, thus leading to uncertainty and legal disputes. Adoption of neither the real seat or the California approaches would compensate for the disruptive effects of change in present practice with any appreciable benefits. These alternative approaches seemed to be more bureaucratic than the present system which worked well, gave reasonable certainty to entrepreneurs on the laws to which they would be subject and promoted enterprise. An additional point was that there was a risk that, if such rules were applied aggressively by Britain, other countries might reciprocate, creating major problems of dual regulatory requirements for companies that were incorporated in Britain but had their major activities centred abroad. Other commentators identified specific difficulties with the adoption of the Californian approach (the burden of establishing the location of the underlying beneficial owners of shares) and the real seat approach (which was capable of leading to anomalous results by virtue of the non recognition of an entity which had been duly incorporated abroad, without any fraudulent or other wrongful purpose, and which had operated on the basis that it had been duly incorporated). Only a relatively few commentators supported adopting either of the alternative approaches. One thought that adopting either the Californian or the real seat approach might be easier to understand, explain and implement, and could be seen as fairer, in circumstances in which a company had a large percentage of its business and shareholders operating and living in the state or country and thus had at least a moral obligation to comply with the local law. Finally, one commentator argued that the real seat doctrine was preferable as it required a real connection between a company and its claimed place of incorporation.

12.7 Relatively few commentators addressed **question 43(b)** which asked whether there was 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 UK, analogous to clause 13 of the draft Limited Partnerships Bill (which would confer on

him the power to apply domestic law to foreign limited liability partnerships with “such connection” with Great Britain as he determines). The majority of those who did argued against the taking of such a power. The general view was that the adoption of such a vague and ambiguous approach on the law applicable to companies would create unhelpful uncertainty. One commentator expressed the view that such a broad general power might be dangerous, while another noted that it was not aware of any abuse which would justify the introduction of such a power. A distinction was to be drawn between the rules applying to limited liability partnerships and companies: under British law a partnership was not required to publish its accounts and there was therefore clear opportunity for abuse, whereas a company incorporated overseas and which had a place or business or a branch in Britain had within limitations to publish financial information.

12.8 In addressing this question, one commentator did, however, suggest action to enhance the remedies available to British investors in, and creditors of, overseas companies (regardless of whether they were or were not within the place of business regime or the branch regime) whose directors acted in such a way which would, if the overseas company were a British company amount, to a breach of duty but which did not amount to a breach of duty under the law under which the overseas company was incorporated and which did not lead to compulsory insolvency of the overseas company. This commentator thought that there might be scope for extending the “just and equitable” ground for winding up to overseas companies in cases where the overseas company had assets in Britain and the petitioning shareholder or creditor had a reasonable expectation of participating in a distribution of the assets over the overseas company at the conclusion of the winding up.

12.9 Virtually all the commentators that responded to **question 44(a)** supported the suggestion that Part XXIII of the Act should be simplified. Commentators noted that it was an unnecessarily complex, confusing and difficult to follow and entailed an additional compliance cost for those overseas companies doing business in Britain. The need to simplify the dual “branch” and “place of business” regimes was particularly noted. One commentator, in particular, explained that any simplification of the rules should be carried out together with a modernisation, to take account, for instance, of the growing number of companies who trade in Britain without a physical presence, via electronic commerce (a point addressed by question 47 -see paragraphs 12.16-17 below).

12.10 **Question 44(b)** asked, on the basis that Part XXIII should be simplified and given that the branch registration regime was an EC requirement, whether the rules should be aligned on branch registration, or by applying the current regime for branches to all places of business. The balance of opinion in the responses made to this question favoured the second of these two options, although some confusion in the views of commentators was discernible. Generally, commentators felt that the existence of both the branch and place of business registration regimes caused confusion for companies and greater clarity would flow from replacing the current dual regime with a single regime based on branch registration. A further argument that was expressed by a commentator was that the regulatory requirements of the place of business regime did not provide as much protection for domestic creditors and investors as that of the branch registration system. Other commentators expressed the

view that care should be taken to decide the level of activity in Britain that would require registration and regulation and to define that level clearly.

12.11 **Question 44(c)**, which asked whether there should be simplification in some other way, attracted only a very few responses. Only two relevant suggestions emerged from these responses, the first that one means of simplifying the current regime would be to have a stand alone schedule applicable to overseas companies and the second that overseas companies incorporated overseas but registered in Britain should be obliged to comply with the disclosure regime along the lines of that required by a British company.

12.12 The majority of those commentators who responded to **question 44(d)** took the view that nothing of value would be lost by the abandonment of the place of business registration requirement. One concern to emerge from the responses, however, was that there be no loss of investor and creditor protection through lack of access to public information in Britain about overseas companies. In a somewhat fuller response, one commentator noted that if the two regimes were homogenised by bringing the requirements under the place of business regime into line with those of the branches regime, there was a risk that inward investors might be deterred by some of the requirements of the branches regime, such as that to file audited accounts (if the overseas companies parent law required it to prepare audited accounts) rather than section 700 accounts and the need to register each branch separately. However some inward investors might regard the additional disclosure through their audited accounts to be an acceptable price to pay for not having to prepare section 700 accounts and to be able to rely on the “common management structure” principle in order to avoid multiple registrations. If the place of business regime were abandoned, there would be some loss of investor and creditor protection through the lack of access to public information about the overseas company concerned. This, arguably, would be contrary to the principle that the price of limited liability was public disclosure of information. Abandonment would not solve the problem of determining what constituted a “branch” for the purposes of the branches regime.

12.13 While the majority of those commentators who responded to **question 45**, which asked, if a regime based on branch registration were adopted whether it would be desirable to ensure that a place from which control was exercised was treated as a branch, with EC law amendment if necessary, supported this contention, few substantive points were made in support. One commentator did, however, note that it would be practicably impossible to know where control was exercised from and even more difficult to prove it.

12.14 Few commentators were aware of any significant harm in practice arising from either compliance or non-compliance with the Part XXIII rules - **question 46(a)** - although some did point to the difficulties businesses encountered in complying because of the complexity and obscurity of the legislation and others expressed concern that non compliance might have a negative effect on creditor protection. As one commentator pointed out, the vast majority of overseas companies which carry on business in Britain do so by way of a subsidiary vehicle incorporated under and subject to all the rules of Act. Two commentators did, however point to the need to consider the position regarding the Slavenburg decision on charges created by an overseas

company registered as such which had established a place of business in Britain at the time of the creation of the charge. The lack of certainty in this area has led to multiple “shadow” registrations at a cost both to the taxpayer and the inward investor. Companies with a place of business in Britain should be required to register charges whether or not they were registered with an overseas company and a solution could be achieved by implementing part (but only part) of Part IV of the Companies Act 1989.

12.15 Other legislative responses, suggested by respondents in addressing **question 46(b)**, were: that any company trading in Britain should be wholly subject to British company law, or to a unified European law; that the place of business registration regime be replaced with a regime that treated anyone operating in this manner as a sole trader or partnership, and with a wider branch regime encompassing a much wider range of business and subject to a regime very similar to that which applied to all companies; and, finally, giving overseas companies the option to register as a branch, a company or a partnership.

12.16 Most of those commentators that responded to **question 47(a)**, which asked whether the growth of electronic commerce had made Part XXIII outmoded or suggested that it should be extended to ensure adequate disclosure by companies accessible via the Internet, recognised the problems created by the growing trend of doing business via the Internet. However, many tended to take the line either that these issues were of wider scope than merely company law and should be addressed as such, or that the difficulties of applying and enforcing a regime on those offering goods and services over the Internet were such as to make a review of Part XXIII not feasible in this context. While two respondents did suggest that this Part be extended to ensure adequate disclosure by companies accessible via the Internet, most took the line that this did not seem a sensible option. An alternative suggestion was that a way be found to enable users of the Internet to be able to identify the country of origin or registration of the companies they accessed and whether or not that company had a place of business in Britain. The legal regime for the country of origin or registration would then apply, and in the case of a company with a British place of business the overseas companies provisions could be enforced. Other commentators took the view that the imposition of a requirement to make all companies which did business and were accessible in Britain over the Internet comply with registration requirements would be contrary to other Government initiatives designed to encourage the use of electronic technology. Another view to be expressed was that the growth of electronic commerce did not necessarily make Parts XXIII outmoded - an overseas company which had a physical place of business in Britain was more visibly conducting business here than a company overseas which did business via the Internet. Finally under this question, a number of commentators suggested that this area required further consideration and research before legislative proposals could be considered.

12.17 The final question in this part of the Consultation Document - **question 47(b)** - asked, if it were agreed that Part XXIII should be extended to ensure adequate disclosure by companies accessible via the Internet, what proposals should be considered for providing sanctions for non compliance, given the absence of a physical presence within the jurisdiction. Although one commentator questioned whether users of the Internet for commercial transactions would expect from the British authorities the same level of protection and disclosure as when dealing with a physical presence in

the home jurisdiction, a number of others suggested possible means of enforcement for non compliance:

- reciprocal legal rights, along the lines of reciprocal tax arrangements;
- disqualification from trading and interdict/injunction. Although the absence of a physical presence makes enforcement difficult, it should be possible to seek a remedy within the country concerned via commercial pressures;
- tracking “e commerce” companies via the home tax authorities;
- obliging Internet service providers to close any site that did not clearly identify its country of origin and therefore the laws governing its activities;
- transferring liability to UK financiers which allowed transactions by means of a credit or debit card.

### **13 Comments on Chapter 5.7, Information And Communications Technology**

13.1 This part of the Consultation Document was concerned with issues surrounding modern electronic means of communication and storage of information, their application for the competitive operation of companies and their implications for company law.

13.2 A large majority of those respondents who commented on **question 48** agreed that paragraphs 5.7.1 to 5.7.10 of the Consultation Document correctly described and assessed the material characteristics of the technologies and their relevance. One emphasised that it was a characteristic of these technologies that they may be used by both companies and shareholders to communicate with each other and changes to the law needed to allow such communication, subject to the issues of security and integrity of information of being resolved. Another emphasised that a company should be free to chose the format or formats in which it provided information to shareholders. These might include the Internet, with appropriate password protected sights, CD-ROM or a closed network such as an “extranet”. Whilst the Internet was likely to be the most important way of communicating with shareholders on a regular basis, consideration also needed to be given to the possibilities that companies would wish to supply by other means - the availability and flexibility of delivery channels was the key issue.

13.3 While generally in agreement with the approach taken in the Consultation Document, a number of commentators did sound warning notes. One thought that more could be done to highlight to companies and shareholders the additional risks of electronic communications, particularly where interaction was proposed, e.g. voting procedures. Because electronic material was capable of being corrupted or forged or identity “spoofed” companies must understand the additional risks they ran unless they

adopted appropriate safeguards such as digital signatures or inscription technology. Others noted that changes in technology were happening so rapidly that any statements of characteristics and objectives could quickly become out of date and it was essential that some attempt was made to assess likely future developments. Another warning note was sounded about document retention and archiving in an electronic regime. Changes in software package functionality, in the manner in which information was encoded on media such as computer, tapes and disks, and in the physical characteristics of those media themselves, often meant that it was impossible to examine data or documents dating back only a few years, or in cases, months. A related thought was whatever information technology proposals were adopted, it should be a legal requirement to have hard copy and that it should be preserved securely.

13.4 Those commentators that expressed a more negative view argued that the treatment in the Consultation Document of these issues was somewhat superficial and underestimated the need for standards that could be policed effectively. One expressed concern at the speed with which the Review might be considering adopting too completely the use of the Internet, suggesting that there might be consequences which were as yet unseen. The fear was that the Review might be attempting to jump too far ahead without testing the water and identifying all the relevant issues. Another commentator noted that no mention was made of digital television which was expected to provide access to the Internet without the need for a personal computer. A number of commentators focused on the need to ensure that appropriate security, and particularly creditor protection, measures were in place before electronic communications could be used reliably and securely in the company law area. Concerns about authenticity and proof of delivery were particularly mentioned. One commentator, however, considered that authentication procedures already existed which made it more difficult for electronic communications to be corrupted, lost, forged or destroyed rather than easier. These could also provide an equivalent to a personal signature, such as on a share transfer form. Generally, however, the level of security required need to be related to the value of the transactions; some information could be passed on without the need for expensive security measures.

13.5 Similarly, the overwhelming majority of those who responded to **question 49** agreed that the objectives and principles proposed in this context (and set out in paragraphs 5.7.11 and 5.7.12) were correct and complete. Comments along the lines that it was essential that the benefits of information and communications technology were harnessed for the benefit of all involved in the company law process were made by a range of commentators, although at least one noted that the use of technology must recognise the limitations on its availability to all and in respect of its efficiency. The final principle in paragraph 5.7.12 - that 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 - attracted the support of a range of commentators who emphasised the need to ensure that care was taken to treat all shareholders equally. Other general points made by those responding to this question concerned the benefits of a single regime covering both large and small companies, and doubts about the premise that companies would be able to significantly reduce their costs and ease of compliance by supplying information electronically - this was due partly to the costs of setting up and

maintaining electronic delivery channels and partly due to the likelihood that companies would have to continue to offer paper-based communications at least for the foreseeable future. One commentator, focusing on the principle, outlined in 5.7.12 that while security was an important consideration, a proportionate approach needed to be adopted, noted that the current structures for IT security were primarily based on confidentiality and tended to ignore accuracy and completeness. Thus, the principle failed to address all the security needs for electronic disclosure. This commentator suggested that the key principles in such security were: confidentiality, with a proportionate approach adopted to preserve the confidentiality of company information that was not authorised for disclosure and to limit access to information which had a limited disclosure; availability, with a proportionate approach adopted to ensure that the company's electronic information and processing capacity was available at least during offices hours; and integrity, with information for disclosure, including all items specified in the Act, generally disclosed only after specific authorisation by a company officer.

13.6 A number of respondents offered additions to the objectives and principles outlined in the Consultation Document. Amongst the additional principles and objectives suggested by commentators were:

- companies should not be given any greater liabilities than they already had in respect of communications when a new format was approved or selected by shareholders;
- an objective should be to accelerate the speed at which information is available to shareholders, the market and others;
- a further objective should be to promote the security and reliability of company information;
- there should be sufficient “safe harbour” provisions built in to protect companies which had made appropriate attempts to deliver documents by electronic means;
- any enabling legislation or regulation must be technology neutral;
- electronic communications methods generally enable end-users to select the specific information they wished to view from a more extensive range of data on a particular subject. It should be a principle that this ability to choose was embodied in the law, thereby allowing shareholder choice in the information they receive;
- the principles set out in 5.7.12 should recognise the question of liability, although the question of jurisdiction could be difficult to resolve. The issue of liability was especially relevant in relation to the increasing use of real time and rapidly-changing information. Assurance at any one time rapidly became out of date and liability issues might arise where the expectations of users of this information were not subsequently met;
- consideration should be given to establishing minimum criteria for the processing of a company's information, covering areas such as: access to the records by a

company's staff and, where records are processed outside the direct control of the organisation's management, external auditors and legitimate authorities, disclosure of the location of the records or processing not in Britain, with an option to stakeholders to insist the processing is in Britain.

13.7 One commentator, taking a wider approach, argued that company communications with company law implications crossed the boundaries of the different forms of media, arguing that there was a need for an overriding set of principles for the communication of information regardless of the means by which it was transmitted. This should cover the legal principles, authorities, responsibilities and liabilities, crossing the boundaries of printed matter, postal communication of information, access to printed material, faxed information, telephoned information, and access to electronic information and the electronic communication of information. Some elements of this would clearly need to be picked up in company legislation. Focusing on electronic communication, and the Internet in particular, it noted that it was in many ways much more like spoken communication than like printed matter in that it was hard to discipline and to record. In order to counter the proposition that this was uncontrollable substantial effort was needed to create appropriate control mechanisms.

13.8 Finally under this question, one commentator argued that this part of the Consultation Document was viewed from the perspective of the company and the favourable aspects of electronic communications. It argued that the key issue was not that the computer, the e-mail, and the Internet were beneficial technological developments and that companies would prefer to conduct their administration by electronic means, but what the members of companies wanted and if they were not ready for electronic communications it should not be forced on them. More consideration should thus be given to the wishes of members.

13.9 **Question 50** asked whether the substantive proposals set out in paragraphs 5.7.17 and 5.7.18 of the Consultation Document, covering information sent to the registrar, meetings via electronic means, company/member communication and the rules on information on business communications, were the right ones. This question attracted a wide range of comments, the vast majority of which were supportive of the thrust of the proposals. Three concerns did, however, emerge from the responses to this question. These were: that issues surrounding the verification and authentication of electronic records needed to be resolved before electronic communication could replace traditional paper-based methods; that a company's shareholders needed to be given the opportunity to approve changes in the way a company operated and communicated to embrace electronic and information communication technologies; and provision should be made for those, especially shareholders, who did not have access to electronic communication technologies. On authentication and security, one commentator suggested that there might need to be two sorts of authentication, one type to authenticate the individuals signing the document and the other which verified the material signed. If reliance were placed on digital signatures, there would need to be a mechanism to address the possibility that the cryptographic quality degraded over time. Company law might thus need to be facilitative whilst the detailed authentication procedures might be better addressed in separate electronic commerce legislation.

13.10 A number of other general points were made in respect of the Consultation Document proposals:

- while strongly favouring the use of technology to communicate and make a decision effectively, one commentator believed that the presumption should be in favour of using electronic communication with the option to revert back to the postal service;
- the changes proposed would be effected by alterations to Table A. The Review thus needed to remember that companies incorporated under former Acts were still governed by the Table A to the Act under which they were incorporated unless they had since adopted new Articles. There were still many companies on the register governed in whole or in part by the 1948 Table A, and a few by the Table A applicable to the 1929 or earlier Acts;
- a further commentator expressed the concern that it was too easy to create fraudulent websites (i.e. false and misleading material could easily be placed on official looking websites, and until a truly secure environment had been established, action needed to be taken to safeguard the public from hoax information);
- finally, at the general level, more than one commentator suggested that the application of electronic and information technology to the regime for the registration of charges should be considered at the earliest opportunity;

13.11 Focusing on the proposal that any information required to be sent to the registrar or maintained in documentary form should be permitted to do so in electronic form and by electronic means, with appropriate powers to prescribe for authentication, the following were the main points to emerge from the comments received:

- one commentator, who acted as a company formation agent, expressed the concern that as it was responsible for filing numerous documents, it could, become the ultimate responsibility for proving an authority. At present, a director had to sign that he was prepared to act and this signature was lodged at Companies House. When a director denied that he had agreed to be appointed, the original signature could be found and used in evidence. If the appointment was filed electronically, the agent would have to hold similar evidence which shifted the burden of proof from the registrar to the agent;
- a similar concern was that, if Companies House was no longer to hold original signatures (of consents to act, for example) the onus rested on the company or the individual who filed the document. What would happen if the documents were lost or disposed of following a liquidation;
- it would take time for the registrar of companies and the various software providers to develop systems to allow all documents currently filed at Companies House to be delivered in electronic form and by electronic means. Changes to the Act should thus be put in place to allow this to develop over time;

- appropriate constraints for encryption and digital signatures must be prescribed so that data delivered electronically to Companies House could not be amended, forged or spoofed;
- it should be made clear that the option to file paper copies remained open.

13.12 Addressing this particular proposal, two commentators made further suggestions with regard to Companies House. One recommended that the companies registry be converted to an electronic database which could be accessed via a website on the Internet. This would make the information currently held on the register available readily to anyone with access to the appropriate technology. Furthermore, it would mean that smaller companies which at present did not have their own websites, would at least have some easily accessible information on their business available publicly. Another advantage resulting from the register being available through the Internet would be that users would have the ability to check the “official” records against information held on company’s own websites.

13.13 Focusing on company meetings, the Consultation Document suggested that meetings via electronic means should be expressly declared to be valid so long as all participants had a reasonable opportunity to participate (subject to further consideration of virtual meetings). This proposal attracted wide support, with the following the key points to be made by those commentators who are focused on it:

- there would need to be a well-designed regime for the production and circulation of minutes;
- care would have to be taken concerning notice and it might be advisable for a director - in relation to a board meeting - to be able to demand a real meeting;
- while agreeing that meetings via electronic means should be expressly declared to be valid, one commentator thought that regulation would have to deal with the situation where communications were interrupted during the meeting;
- it was possible that the use of virtual AGM’s or electronic links into AGM’s would significantly increase the involvement of shareholders and improve the dissemination of information to all shareholders;
- meetings via electronic means seemed to offer much potential, given that the research of one commentator showed that amongst private investors 82% had never attended an AGM with three quarters citing the reason that they were “not relevant”, and “inconvenient time/place” being specifically mentioned by 59%;
- allowing electronic voting at meetings would remove a substantial administrative burden, particularly on public companies and especially those with a large number of oversea shareholders. The paper based proxy voting system was costly and cumbersome;

- one commentator noted that the Courts were already developing the concept of what may constitute a “meeting” when all persons are not physically present in person or by proxy. It would prefer to allow this concept to be developed by the Courts rather than introduce a blanket validation of the kind proposed. Not every form of electronic communication that might be used would be suitable for “reasonable participation” except in a very formal sense. In the context of corporate governance it was important that the stewards of significant funds actually met and discussed matters in person. In the case of small private companies, however, there would be more scope for a permissive region of electronic meetings if that was what the shareholders or directors wished.

13.14 The third of the substantive proposals put forward in the Consultation Document was that companies should be free to communicate electronically with members for all purposes with their consent, including by notifying them of the availability of information on the Internet. Again, this recommendation attracted wide support. The following were the main points to be made in relation to it:

- shareholders should have the right to be able to choose in which medium or media they wished to receive information. Thus while companies should be empowered to use electronic communications by a simple majority that majority should not, be able to impose one particular method of delivery on those who did not have access to the newer forms of communication. At least for the foreseeable future, the availability of paper records should be open to any shareholder who requested it;
- it was important that the notification to members of the availability of accounts, notice of a meeting, or a proxy form at a website should be deemed under the legislation to have fulfilled any requirements regarding the number of days’ notice to be given;
- in considering such proposals, it was necessary to bear in mind that while people might have fax and e-mail facilities and access to the Internet available they did not necessarily use them on a day-to-day basis (in contrast to the post which did arrive on a regular basis);
- focusing on the concept of obtaining shareholders’ consent to using electronic media, one commentator argued that this should not be so cumbersome that it becomes impracticable. In most cases, there would be a need to change the Articles of Association, requiring the usual majority for a special resolution at a company meeting. Beyond this, companies should not be obliged to seek the prior consent of individual members to exempt them from sending a paper copy of the accounts. The suggestion that companies might inform members that accounts were available at a website, accompanied with an offer to send a paper copy on request, would be a sensible approach. Private companies, in particular, were unable to make use of the provision in the Act which enabled public companies to send abbreviated accounts to members. The lack of such a provision made it difficult for the company to present its accounts to members in a form that was both economical and understandable. Any provision permitting electronic participation in meetings and communications such as notices and proxy forms should be available to private companies as well as those limited by guarantee;

- it needed to be clear to users what level of assurance each section of corporate information carried. Some information might be audited, some might have been reviewed by the auditors to ensure consistency with financial statements, some might be subject to assurance on the security of the process by which it was included on the website but not independently verified in itself. The variety of assurance could be confusing to users and information needed to be clearly labelled;
- in “dematerialising” company communications with shareholders and allowing electronic proxy voting for investors, account needed to be taken of the need to ensure that unpublished price sensitive information was properly announced;
- there should be provisions to ensure that an Internet version of the annual report and accounts could not be changed from the audited version either by the company itself or by a visitor to its website.

13.15 In making the proposal relating to electronic communications between a company and its shareholders, the Consultation Document also sought comments on the potential duplication of information currently held at company offices in electronic form and information held at Companies House. The following were the main points to be made by commentators who addressed this particular issue:

- there was no reason why documents that had been filed at Companies House should also be available for inspection at the offices of the company. Such documents could be filed on the Companies House website and public libraries could have the facility for visitors to search this specific area. Alternatively libraries could be able to enter Companies House direct for this specific information. It had to be easier for anyone interested to go to a local library or even Business Link than to a company’s registered office;
- if information was held electronically by companies at their registered office and by Companies House this did seem to be a duplication, particularly filed electronically. At present, duplication could not be avoided as the categories of documents which must be held by companies for inspection at their registered office and those documents which must be filed at Companies House overlapped but were not identical. Consideration should be given to whether those documents which must be held at Companies House need not also be held by the company;
- the registrar should remain in a position to police the completeness and the timeliness of the information that companies were required to file for public inspection;
- companies should not be obliged (although they should have the option) to provide information, such as copies of registers, in electronic form which could be easily manipulated and misused;
- copies of information should continue to be available from a central public registry (though in electronic form) so as to provide a freely available anonymous means by

which a definitive copy of the accounts (or any other company document which has to be made public) might be obtained.

13.16 Finally, in relation to question 50, the Consultation Document proposed that the existing rules on the disclosure of various information on company documents and correspondence should be extended to include their electronic substitutes. This proposal elicited the following comments:

- there was no reason why electronic documents - including faxes - should not be treated exactly like mailed documents;
- the rules on company information on business communications were already treated by many, but not all, companies as extending to equivalent electronic communications. However, the provision of such information should be examined as an aspect of the law itself rather than simply being duplicated into electronic formats. Clarity of the law would be much appreciated by companies even if this resulted in the present business stationery requirements being applied to electronic communications;
- it would seem counter-productive to require all the information that has to be included currently on hard copy communications. While it might be necessary where the e-mail is to be legally binding, it should be possible to reduce this for other types of communication;
- equal emphasis should be given to the unique, and constant, company number as to the company name (which could easily be changed). The objective of publishing company details on letterheads was to enable readers to be able to identify exactly who they were dealing with;
- if Internet material required legal status, it was important that the usual information normally found on a companies business stationery continued to be available.

13.17 The final question in this part of the Consultation Document - **question 51** - asked whether 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. The vast majority of those who responded to this particular question supported the concept of conferring such a power on the Secretary of State, many arguing that technologies were rapidly developing and the pace of change would continue in the future and that legislation resulting from the Review must not only provide a flexible method to implement the immediate changes but a continuing mechanism to permit changes to the law which would enable companies and shareholders to take advantage quickly of future, but as yet unseen, developments in electronic and interactive communications. Equally, however, a number of commentators made the point that such a power would need to be subject to appropriate safeguards and protection against abuse. One suggested that any Statutory Instruments made using this power should be subject to the affirmative resolution procedure, while another thought that sufficient genuine consultation with the preparers and users of information would need to take place before any changes were made, and a third suggested that it was not always clear that sufficient time and

thought was given to the introduction of secondary legislation, especially in respect to enforcement procedures. In this last context, it was important that business was given sufficient opportunity to be involved in consultation exercises in respect of proposed secondary legislation - criticism had been made in the past in respect of Statutory Instruments which amended existing legislation but which were not then consolidated, making the law difficult to understand and therefore less accessible. In the same vein, more than one commentator suggested that the basic safeguards for shareholders and Companies House should be prescribed by statute, with the power conferred on the Secretary of State only applying to the forms of electronic communication that might be used within that statutory framework.

13.18 Only a relatively small proportion of commentators argued against conferring such a power on the Secretary of State. One argued that such issues were too important for an approach that did not involve primary legislation, while others echoed the points made about the possibility of abuse of such powers and the disadvantages of Statutory Instruments in terms of making the law less accessible mentioned in the previous paragraph.

#### **14 Comments on Chapter 6, High-Level Reporting and Accounting Issues**

14.1 This Chapter of the Consultation Document explained that while some specific accounting and reporting issues had been considered, for example, in the context of the Review's work on small and private companies and stakeholders, the subject had not so far been addressed in its own right. This Chapter represented an initial attempt to map out the territory. It invited initial responses on what it considered the key issues. It was intended that these should help focus the work of the Working Group to be set up on this topic in the next phase of the Review.

14.2 **Question 52(a)** sought views generally on the issues raised in this Chapter to assist the prioritisation of work in the next phase. In particular, it asked whether the main issues mentioned in the Chapter were the important ones which further work on accounting and reporting should address, or whether there were issues included which did not deserve attention, or excluded, which did. Most of those commentators who responded to this particular question agreed that the issues mentioned in the Chapter were important and merited further work. Only a handful of respondents had additional issues to suggest for consideration. These were:

- the accuracy of interim reports;
- the issue of privileged briefings given by officers of listed companies. The current regulatory framework allowed companies to brief privileged participants - generally business analysts, journalists and large shareholders - while excluding the broader membership. These privileged briefings inevitably affected the participants' perceptions of the company's state of health and were sometimes followed by significant price movements. It was now becoming increasingly practical for companies to make such briefings available to a far wider audience, via the Internet. In due course, it might even become possible to require that contents of these

briefings be made available to members, on demand and free of charge, or at very low cost;

- environmental and social reporting was an area that continued to become more important world-wide. There was an increasing body of evidence demonstrating the value of social and environmental reporting to businesses as well as the overall benefits to society;
- if a pluralist approach were adopted consideration would need to be given to the users of the annual report and the information that it should be required to contain. In a pluralist framework, there may no longer be any justification for report for the exclusive use of shareholders;
- the Review needed to consider the impact of company law on the capital markets. For there to be efficient capital markets, the needs of investors needed to be considered. In particular, information that affected the valuation of securities needed to be available to investors in a timely and responsible way.

14.3 A number of the commentators that addressed this question, while agreeing that the Chapter had identified the main issues for consideration, highlighted particular matters, or approaches that they wished to see adopted, or points they particularly wished to be emphasised. These included:

- making the accounts of small companies more meaningful. One commentator felt that many of the issues raised within this Chapter were not relevant to small and private companies and thought that much work needed to be undertaken to develop the form and content of the accounts which small and private companies were required to produce and submit (a topic addressed by the Consultation Document in Chapter 5.2 - see paragraphs 8.14-8.25 above) ;
- while the use of the report and accounts to provide information on issues such as the environment and community involvement was to be welcomed, statutory requirements had a tendency to prompt the use of boilerplate language. Voluntary disclosure and best practice was a better route to follow;
- the key issue for any new approach was to get the right balance between those who used a company's accounts, principally shareholders, creditors, investors and the Inland Revenue;
- another commentator thought that the way the Chapter was framed gave rise to the concern that these issues were being addressed in a piecemeal manner, rather than focusing on the creation of an integrated solution that might evolve over time;
- priority should be given to the conceptual basis of disclosure and auditing requirements with particular reference to the need for greater social reporting. This commentator indicated concern over the polarisation of viewpoints over the stakeholder debate and thought that social reporting could play an important role in developing as a "third way" alternative to the existing positions. Accordingly, the

question of social reporting should not be viewed in isolation as an accounting matter, but rather as one of fundamental nature to the purpose of the company in society.

14.4 **Question 52(b)** asked, in considering the issues raised in the Chapter, what were the key high-level considerations which should be borne in mind. This question attracted a wide range of response from a number of commentators. In attempting to describe the overall thrust and tenor of these responses, it has proved useful to order the responses in accordance with the headings used in the Chapter in the Consultation Document. It is also worth recording that a significant number of commentators cross-referred to their responses to question 6, which addressed the issue of change to the regime of accounting and reporting in the context of the scope of company law issue (see paragraphs 7.31-36 above), and question 11, which addressed the accounting requirements for small and medium-sized companies (see paragraphs 8.14-25 above).

### **The existing regime and key issues**

14.5 The comments that were grouped under this heading covered a wide range of views and approaches to accounting and reporting issues. Some commentators took the opportunity to emphasise the importance of the information that companies published in their annual accounts and related statements, constituting the prime source of data for stakeholders and the general public as to how effectively and responsibly the company was operating. The publication by all companies of information that was sufficient to meet the demands of stakeholders should, therefore, form an essential feature of company law. Another thought that the traditional report and accounts should remain the prime regulatory vehicle for company disclosure and other communications should therefore be reconciled to it. Others took the opportunity to point to particular areas of concern, such as the historic perspective in accounting for a company's costs, income assets and liabilities. The historical cost/tangible asset model was being increasingly challenged and the Review would need to address this. Accessibility was also an important issue for some - few people understood company accounts and their value to ordinary people who were consumers, employees and shareholders was unclear. Another problem area to emerge from the comments was the current statutory filing deadlines, which were regarded as outdated. Advancements in information technology and communications meant that accounts could easily be finalised before the existing 7 and 10-month deadlines. More than one commentator suggested that the dates be brought forward, perhaps on a phased basis, so as to provide more prompt and therefore more useful information for users of company accounts.

14.6 The remainder of the comments that fell under this heading proposed either key issues which needed to be taken into account as part of the Review's consideration of the reporting and accounting regime, or suggested approaches that the Review might like to take. Among these were:

- in the future, company reporting was likely to develop into something radically different from what most companies did today. Market dynamics, rather than

regulation, should drive the future shape of reporting. At the heart of this process was the globalisation of capital markets which brought with it more sophisticated business, more advanced technology and faster communications;

- shareholders should remain the primary focus of accounts. Third parties might use the information but had to realise that it was not prepared for their specific purposes, would not necessarily address their particular interests and that the information had its limitations. It would be dangerous for regulators to imagine that the current accounting model and form of accounts could simultaneously accommodate both a stewardship account by directors of the assets under their custody and provide useful information on the underlying value of the company and its future prospects. One possible solution might be for legislation to require directors of all companies to prepare accounts, similar to current statutory accounts, on a historical cost “hard” figure basis, as stewardship statements that would also be used in determining profits available for distribution. An incremental requirement for listed companies might require their directors, with adequate protection, such as the “safe harbour provisions” contained in the US legislation, to provide additional forward looking statements outside of their stewardship accounts;
- the reintroduction of intangible items in to accounts would be a retrograde step. The values attaching to such items were too volatile for meaningful measurement. Putting tangibles such as marketing skills into a balance sheet only provided an opportunity for accountants and directors to massage a balance sheet. Another commentator thought that unwise change to the accounting and reporting regime ran the risk of exchanging limited but real competence for wider scope which was likely to prove to be unsustainable;
- conversely, another commentator pointed to a growing demand for both financial and non-financial information which the existing statutory requirements failed to reflect. A growing number of companies were now responding to the demands for greater transparency and accountability, including the wider social and environmental impacts of a company. In addition, the commercial environment operated much more on the basis of the intellectual property of workforces and proprietors of companies than was reflected in accounting requirements;
- several commentators suggested that a review of the purpose of financial reporting needed to form part of the Review’s further work on these issues. This would need to assess what was required as well as what was appropriate to include in the set of financial statements, who was going to use the information reported on, especially where it could affect corporate share value, and how to persuade companies to report more than the good news;
- another commentator noted that research amongst private investors showed that in the main their focus remained on the basic reporting requirements. Of those who received and read annual reports, the great majority were interested in the harder edged financial information relating to the profit and loss, balance and dividend information and, overall, seemed to be less engaged with issues relating to say, employment, ethical or community involvement. The implications of this would be

that there was no case for extending the scope of the statutory reporting. On the contrary, ways should be found of encouraging companies to clarify and, where appropriate, simplify the presentation of historical data and related company information;

- another thought to emerge from the comments received under this heading was that Britain should avoid creating superfluous corporate governance burdens on business, in line with the need to maintain an attractive environment for foreign companies who would wish to register in Britain. In this context, Britain was already at the leading edge in the field of governance and the regulation of company accounts, and company reporting was still in a state of flux following the introduction of the Combined Code;
- one commentator suggested adopting a three-layered approach to a new reporting and accounting structure, based on, at the core, statutory requirements providing a very basic framework, an expanded role for the FRC taking over what has, until now, been in company law, and an important role for company-led experimentation and market-driven evolution. Against this background, the historical statutory reporting model remained an important tool for company communications. The amount of information being supplied through this model had increased due to new accounting standards and because of additional management-led initiatives to meet the specific needs of analysts and institutional investors. There remained, however, an increasing information gap, in which the information needs of institutional investors, and the extent to which key measures and performance were reporting adequately by companies were lacking. To reduce that gap, companies should be encouraged to provide information seen as valuable so that users did not have to seek it from less reliable sources;
- another commentator identified two high-level considerations that needed to be borne in mind: first, that the focus of company law should move from the form and content of financial statements to recognising that for most companies the obligation to maintain proper accounting record meant having adequate systems to ensure that business facts and transactions were captured on a complete, reliable and timely basis; and, second, that because reporting was an area in which there would be substantial changes because of the influence of new technology, the elements within the law should be the absolute minimum and the authority to develop appropriate reporting rules should be designated to another authority;
- a further commentator noted that the question of enforcement had not yet been dealt with by the Review. In the context of the accounting and reporting regime, it was important that gaps in legislation and enforcement that currently existed between company law, insolvency law and financial services legislation were bridged.

**Form and content of company accounts: Companies Act and accounting standards**

14.7 The Consultative Document addressed the present hybrid arrangements for determining accounting and reporting rules, whereby the law sets a framework of disclosure and the accounting profession supplements it through the issue of guidance, largely on measurement issues. The majority of those who addressed this particular issue took the view that there was a strong case for greater delegation to the standard-setting bodies (i.e. the FRC and the ASB), with the Act doing no more than requiring that directors produce annual financial statements that give a true and fair view and have to be filed within a specific time-limit. Detailed issues on the content of the accounts and the accounting standards to be adopted could then be left to the relevant delegated authority. In taking this view, however, many commentators noted that the adoption of such a regime might require changes to the relevant EC Directive. It was generally felt that such a devolved regime would provide adequate scope for the flexible evolution of financial reporting so that it continued to meet user expectations. It would be simpler and more accessible, as it would avoid much secondary legislation, the present confusion as to the relative status of individual requirements, and the overlaps and gaps in the various requirements. Other commentators, while supporting the development of such a regime, suggested that there might need to be greater oversight of the ASB, particularly in respect of listed companies where the information needs of investors were paramount, and that it may be advantageous to introduce a system so that every mandatory disclosure requirement be accompanied by guidance notes from the ASB or the Auditing Practices Board in order to reduce the danger of boilerplate compliance.

14.8 A handful of commentators did argue against any greater delegation of powers to the FRC and ASB, arguing that, in the light of the existence of the Fourth and Seventh Directives (from which most of the statutory provisions derived) the ASB would be just as constrained in implementing standards as was Government. Therefore there would be no difference and little need for any change. One commentator argued that the existing system had proved effective, particularly since the restructuring of the standard setting process following the Dearing Report and should be retained. Another argued that the FRRP's remit should not be extended to cover areas where there were no detailed rules on financial reporting laid down by the ASB. Finally, one commentator argued that statutory provisions regarding accounting and reporting requirements were necessary in order to ensure accountability to the public.

14.9 In addition, there were a number of more detailed comments on the form and content of company accounts. The chief of these were:

- given the importance of cashflow in business, it would be appropriate for the law to reflect this by requiring all companies, including small companies but exempting wholly-owned subsidiaries, to produce a cashflow statement as part of their statutory accounts, on the same level of detail as a balance sheet and profit and loss account;
- the ability for the true and fair override to be exercised should be retained;
- the current format of full company accounts was unsatisfactory. The directors as a whole were responsible for the running of the company so all matters in the report

should be published in their name, rather than as a statement by the chairman etc. In addition, there should be an obligation on an institutional shareholder with the largest shareholding over 3% in a company to make a statement in the annual accounts, without legal liability but on the information available to it, that it was satisfied with the progress of the company. The inability of the largest institutional shareholder to make such a statement would, of course, have an adverse effect on the share price, but it would help to focus the minds of management;

- while the change of emphasis from historical cost to some form of present value accounting was inevitable, value statements were not accounting information and were not based on the accounting records. They were rather expressions of opinion and were not verifiable by audit procedures as currently understood. Another commentator suggested that accounts include both the historic cost and current market valuation data;
- the way in which the profit and loss account was constructed needed to be reformed. Useful proposals had already been made by the ASB to try and create one performance statement with three types of gains and losses so as to differentiate between: operating or trading activities, financing and “treasury” activities and other gains and losses not actively managed by the business, for example, pension liabilities and assets. They were an attempt to move away from the practice whereby a business’ performance is judged by a single “line” which was neither a transparent measure of performance or a practice that encouraged forward thinking.

### **International Accounting Standards**

14.10 The Consultation Document noted that since 1973 the International Accounting Standards Committee (IASC) had worked to develop accounting standards which could gain world-wide recognition and observance and that a number of European countries were changing their law to allow companies whose securities were quoted on a stock exchange to compare consolidated accounts in accordance with International Accounting Standards (IAS) or US Accounting Standards as an alternative to national requirements, though still subject to the Fourth and Seventh Directives. It went on to note that there was an argument that Britain should also allow the use of IAS on the grounds that this was a competitive issue for international companies registered in Britain. However, before reaching that conclusion, it accepted that there were several important considerations that needed to be taken into account.

14.11 The issue of whether to allow greater use of IAS attracted a wide range of comment, the majority of which supported allowing British public companies the option of using international standards, although as one commentator pointed out, the strong capital market focus of present British accounting standards meant that there was a significantly weaker demand for a move to IAS than in other EU countries that had not previously had a capital market orientation. Arguments voiced in support of greater use of IAS included: the fact that, although there remained significant areas of difference, recent changes to both British and international standards had narrowed these areas of difference significantly and this trend could be expected to continue; it would promote harmonisation and comparability and consistency across the accounts of different EU countries; it would help ensure that companies were better able to

exploit the opportunities which a global economy brought; it would become increasingly difficult to defend Britain being different from other parts of the EU; it would be illogical to exclude the use of IAS from some companies while allowing their use for listed companies; and by the time the changes in the law arising from the Review had been implemented, British accounting standards and IAS might be very similar, if not the same.

14.12 A number of commentators, while supporting the introduction of greater freedom in the use of IAS, emphasised that a revised regime should allow, but not require, the use of IAS, though one added that in the interests of comparability, there might be a case for requiring companies which opted for IAS to add a reconciliation statement, as was currently provided by British companies with US listings. Other notes of caution sounded by those supporting the use of IAS included: the suggestion that additional provisions be adopted in cases where current IAS were weaker than their British counterparts or provided no safeguards to abuses such as off-balance sheet finance; that some British multinationals, which already produced accounts with a reconciliation statement to US FASB standards, might not wish to produce a second reconciliation to IAS; that there was a need for IAS to become accepted as global standards and for appropriate regulation to ensure consistent enforcement; and the suggestion that British companies should be free to produce dual accounts, if they so wished, but should be obliged to continue to publish accounts according to British standards.

14.13 A number of commentators did, however, argue against the use of IAS in Britain. One pointed out that British accounting standards were in a number of instances superior to those developed in the international arena, had been effective in preventing a number of abuses while IAS were not yet sufficiently well developed to allow British companies to move to them as the basis for their only set of accounts. Other commentators also pointed up possible difficulties from a shift to IAS. From a practical perspective, if British and IAS standards remained different, there would be problems of comparability. In addition, accounting convergence might mean in practice that all standards converged around, or at least close to, US standards rather than IAS. Another commentator argued that while there was a good case for allowing companies of an international nature for whom a listing on the London Stock Exchange was a matter of choice and convenience, the option of reporting in accordance with IAS standards, the interests of users of accounts and also the influence of Britain in promoting developments in best practice generally would probably be best served by the continued existence of British financial reporting standards and adherence to them by British companies. One commentator thought that giving greater recognition to IAS in British company law could not be undertaken without establishing more effective accountability on the part of the ASB. Finally, one commentator expanded on the point that British standards were currently more rigorous than many of their international counterparts, focusing particularly on two significant underlying factors that contributed to business failures that had occurred in the UK during the 1980s. These factors - off-balance sheet financing and acquisition provisions had allowed directors to over-extend their businesses by disguising the true position. This commentator was thus concerned that any precipitous rush to permit or oblige companies to use current IAS would risk courting disasters that could not occur under current British accounting standards.

14.14 Finally, it is worth recording that the IASC responded to the Consultation Document in its own right, explaining its role and its policies, especially vis-à-vis the ASB, addressing the issue that allowing the use of IAS would involve some loss of comparability, and suggesting that this could be dealt with by allowing private as well as public companies in Britain to use IAS. This response also argued that IAS were of high quality and fully stood comparison with British standards, contending that, in some cases, they were in fact more rigorous.

### **Exemptions for small and medium-sized enterprises**

14.15 The Consultation Document referred briefly to the current provisions that allow small and medium-sized companies to be exempt from some statutory accounting, reporting and auditing requirements. It also pointed to potential problem areas with these arrangements - that abbreviated accounts provided little information of value to the user and the exemption thus weakens transparency, that no deregulatory function is served, in that accounts have to be prepared for shareholders in any event, and that the perceived benefit to those companies taking advantage of the concession does not provide a strong enough countervailing reason - noting that issues therefore arose as to the value and scope of the accounting and audit exemptions and as to their legislative form and accessibility.

14.16 In fact, relatively few respondents addressed this particular set of issues, most of those with an interest in the subject having commented on question 11 (see paragraphs 8.14-25 above). Those that did address these issues did, however, provide the following suggestions:

- as the provision of abbreviated accounts fulfilled no useful purpose, was a costly and purposeless exercise, involving small companies in disproportionate expenditure for no good reason, companies with a turnover of less than £2.8 million should not be required to present anything to the registrar of companies other than an annual return and a declaration of solvency;
- a single accounting standard summarising the requirements for small and medium-sized companies should be adopted;
- an extension to the present limits beyond which an audit was compulsory would be desirable, perhaps up to the maximum under the terms of the relevant EU Directive. Holders of 10% or more of the shares could, however, be entitled to require an audit. Conversely, another commentator noted that the current audit exemption meant that proprietors of smaller companies were deprived of the benefits of an independent assessment of the fidelity of the staff they employed;
- the present structure of the small company reporting regime was too complex, a position that had arisen through piecemeal reform. There were so many key differences between large listed companies and small-owner managed private companies that it seemed sensible to separate the two accounting and reporting environments;

- the criteria for determining a small or medium-sized company were now somewhat out of date and new measurement criteria (perhaps linked to the RPI) needed to be considered.

### **Directors' report**

14.17 The Consultation Document pointed out that the statutory directors' report had proved over the years a convenient peg on which to hang a range of statutory disclosure requirements including on research and development, political and charitable contributions, the employment of the disabled, employee involvement and, from 1996 for public companies and their large subsidiaries, a statement of the company's policy on the payment of creditors. This had given rise to the criticism that such requirements did not seem to reflect any coherent philosophy and invited standard and valueless statements. The Consultation Document expressed the view that there was a case for reviewing the rules about the content of the directors' report and re-considering its role, taking into account in particular the growth of non statutory reporting.

14.18 Relatively few commentators focused on the issue of the directors' report. Those that did were largely in agreement with the view taken by the Consultation Document that its use as a vehicle for statutory disclosure requirements had tended to weaken its value. As one who drafted directors' reports for listed companies put it, they included everything that had to be included but said little of value about the company. For many listed companies, which present an operating and financial review, a chairman's statement, a remuneration report, the statutory directors' report had become almost an irrelevance. It sometimes did not even exist as a report in its own right, but was compiled by cross reference to relevant sections of the other reports. So far as private companies were concerned, particularly wholly-owned subsidiaries, the norm was to do the bare minimum necessary to satisfy the legal requirements. Commentators generally supported the principle of a fundamental review of the directors' report, one suggesting that such a review identify whether the contents of the directors' report were still necessary, whether they should be statutory or non-statutory disclosures and, if the directors' report as a concept was dropped, where the necessary disclosures might most usefully be made. One commentator noted that the answers to these questions would be different for listed and unlisted companies, given the additional information which listed companies already published. For listed companies, many of the disclosure requirements of the directors' report had been overtaken by the listing rules and market-led voluntary disclosure. Others disclosure requirements could arguably fit better within the many other reports which listed companies were required to produce, such as the corporate governance statement, the operating and financial review (OFR), the remuneration committees' report and the detailed disclosure of the individual directors' remuneration. One commentator went so far as to suggest that the FRC be asked to set up a working party to review the purpose and content of the directors' report. There were very few commentators arguing in support of retaining the current form and content of the directors' report, although one noted that the regular addition of disclosure requirements was a useful "release valve" for pressure from groups which might otherwise seek to promote more burdensome legislation, while another felt that locating statutory disclosure requirements in one place made it easier to check that they had all been made.

14.19 Those that did comment on this particular issue offered a number of more concrete suggestions for improvement to the statutory directors' report:

- a core content for all a mandatory directors' report to apply to all companies could be modelled on the content of the OFR statement. Directors of listed companies might in addition be required to update annually the business risk information that the Stock Exchanges listing rules require on flotation - it was incongruous that listed companies should spell out the risks associated with their business solely at this point in time. Because such a requirement would encourage forward looking statements the law should provide "safe harbour" protection for directors making such statements in good faith. An annual statement of business risks was necessary for shareholders to understand how directors maintained and monitored a sound system of internal control;
- there should be a requirement for directors to provide an analysis of all the major environmental impacts of a company, the related risks and how these might affect a company's competitive position. To this could be added the disclosure of the company's environmental compliance record, whether or not the company had a director at board level responsible for environmental matters, and environmental management system and an environmental policy, and a discussion of environmental initiatives taken and planned.

### **Auditors' report**

14.20 The Consultation Document briefly outlined the role and responsibilities of auditors, and pointed up some particular problems to which this gave rise. It went on to note that the role and liabilities of the statutory auditor and auditor independence were both major issues which the Steering Group believed required full consideration in the next phase of the Review.

14.21 This part of the Chapter on high level reporting and accounting issues attracted a significant level of comment, focusing on a number of important issues relating to the audit and auditors, from a range of commentators. Amongst these, several emphasised the value of the independent audit, the core legal purpose of which was to make sure that a company was complying with its statutory responsibilities to maintain accurate financial records and to prepare annual accounts that gave a true and fair view. This alone was an essential public interest function and it was right that the law provided for it. In addition, the audit process indirectly exerted legitimate pressure on a company's management to make sure that its internal financial management was effective and correct and that it accounted for its activities properly and made full disclosures of all relevant matters. Without the involvement of the auditor and the audit process the pressure on company management to operate legally, efficiently and correctly was significantly reduced. One commentator made the point that auditor's assurance to the capital markets was a vital support to a system of corporate regulation based on transparency and accountability rather than legal prescription. Another emphasised the importance attached by banks and financial institutions and their advisors to audited accounts as the starting point for assessing the financial health of businesses, while the discipline of having accounts audited to a consistent standard using accepted conventions was an aid to good financial practices and disciplines in all sizes of

companies. Equally, however, more than one commentator noted the limitations on an auditor's abilities. One noted that under no likely cost structure of audit resource allocation could auditors stand a reasonable chance of detecting deliberate fraud perpetrated with care.

14.22 There was a consensus that it would be right for the Review to reconsider the role and responsibilities of auditors. One commentator noted that the expectation gap between the breadth and depth of assurance the public commonly considered the auditor's report to give and what it in fact provided was a matter which needed to be addressed. The responsibilities of auditors needed to be re-visited with a view to increasing public understanding of what auditors did, and at the same time maintaining public confidence in the statutory audit. There was an inevitable tension between the wishes of the company to reduce audit costs and the consequent requirement on auditors to justify the same level of assurance at a lower cost.

14.23 There was, perhaps unsurprisingly, no consensus on proper scope of the auditor's role. One commentator supported moves to extend the responsibility of auditors so as to enhance the practical usefulness of the audit to companies and their shareholders. This commentator encouraged the Review to consider ways in which the scope of the audit might be so extended (while noting that proposals in this direction could not be considered in isolation from the concerns of the audit profession had over the issue of professional liability). Others, however, pointed to the difficulties inherent in attempting to extend the auditor's role. One thought that the creation of significant new statutory responsibilities for auditors would create practical problems in application and increase audit costs. It would, in particular, be impracticable for auditors to provide a level of assurance on "softer" forward-looking financial information and non financial information that would meet the current expectations of users of annual reports. Another commentator noted that the introduction of new statutory responsibilities for auditors would incur substantial extra costs and it was not clear whether companies or their stakeholders would be willing to pay for the costs of this additional assurance. There was scope for the requirements to prove unduly expensive and, indeed, deter companies from incorporating in Britain. Another commentator noted that if auditors' responsibilities were to be widened, especially to include soft and forward-looking data, then the discussion must include the aspects of costs, liability limitation and the expectation gap, as well as the Combined Code requirements on internal controls. The audit scope should only include areas where the audit could add value. For example, it was questionable whether an audit opinion on value at risk was of benefit to the user, although in the light of the proliferation of IT dependency, audit criteria could usefully be expanded to encompass a company's IT systems. Those expressing a cautious approach to the extension of the audit function focused particularly on the problems inherent in extending the role in relation to various stakeholder groups beyond shareholders. This would require a very clear statement of the relative roles of directors, auditors and the company as well as a greater measure of protection for auditors.

14.24 Still on the issue of the scope of the audit function, a number of commentators argued that the current scope of audit should not be changed by statute but driven by the demands of the market. One argued that, for reasons of flexibility, the present requirements, i.e. for an annual audited report to shareholders, remained appropriate.

Another noted that the auditing process was fundamentally based in stewardship accounting and the less the annual report dealt with accounting information and the more judgmental it became, the weaker would be the assurance to be obtained from the auditor. Another referred to the new framework for independent regulation of the accountancy profession which had been announced by DTI Ministers in April 1999, noting that it contained detailed arrangements described as introducing a robust and effective framework of regulation which would ensure public accountability, and in particular the creation of a new Review Board and Ethics Standards Board, which were likely to take a close interest in the issue of auditor independence. Against this background, it was premature (and could create potential conflict) for legislative change on the role of auditors to be considered. Finally on this issue, one commentator argued that statutory audit requirements should be confined to financial matters. The extension of the audit to other areas should be additional and for the company to initiate if the board considered it appropriate or if sufficient shareholders required it.

14.25 Amongst the responses that focused on the audit, the single issue to attract most comment was that of auditors' liability. A range of commentators noted that the accountancy profession had consistently urged that the position under which an auditor may have to pay the full amounts of any damages awarded, notwithstanding he was only marginally to blame, be changed. One noted that it had become increasingly difficult in recent years for large audit firms to obtain adequate and affordable insurance cover. This was largely due to the increasing tendency of plaintiffs to join the auditor in their actions when suing companies for financial loss, on the basis that auditors through their indemnity insurance, had the necessary resources to meet any claims. The time was thus right for the introduction of a system of proportional liability under which auditors could be held financially liable up to the level of their actual responsibility for the loss that the plaintiff had been caused. It was also important that the law be reformed to ensure that auditors had the contractual ability to avoid onerous or unreasonable liability. The current exposure to overwhelming professional negligence claims which resulted from the present regime of joint and several liability was damaging to business efficiency and acted against the public interest. One commentator thought that, in view of the difficulties in auditing forward looking figures and statements a distinction could be made in terms of potential legal liability between an auditor's certificate (covering all aspects of the company's operations as they are at the time of the audit) and an auditor's opinion (relating to future orientated information). Another argued that it should be possible to toughen the present legislation in respect of directors misleading auditors, and to widen its scope to encompass any others on whose evidence auditors might rely, while another suggested that the Review address the issue of the statutory protection from action for defamation for auditors in furtherance of their work, provided they acted in good faith. This should cover all communications, and in particular those with potential successor auditors, and also statutory declarations and declarations to approved foreign regulators and enforcement agencies.

14.26 A further issue that attracted a good deal of comment was that of auditors' independence. One commentator argued that auditors' independence should not be specified by statute as the requirements of companies were continually evolving. For example, auditors had roles in respect of circulars required by the Stock Exchange and

reports required by other regulators. Mandating independence could lead to several auditors being required for companies active in a regulated sector. Rather, independence should be left to non-statutory bodies such as the regulatory authorities for the profession. In addition, the users of audit would find that costs escalated if the auditors were prevented from supplying other services. This was particularly the case for smaller companies where business advice was often the by-product of an audit. Another commentator argued that the assurance of auditor independence should be based on a framework of principles adapted to changing circumstances, and should be overseen by the new system of audit regulation rather than the law. Another thought that changes to the nature of the audit's function as a result of the Review would support the case for the establishment of a framework for principles and safeguards relating to auditor independence, rather than a statutory approach. Another commentator noted that objectivity of the auditor was his main competence and that, in reality, auditors could remain objective despite the fact that they also provided other services to management, because the basic culture in which auditors were trained attached such great importance to such objectivity. One commentator did, however, argue that if an auditor was also receiving significant other, unrelated, income from a company it was debatable whether, in undertaking the statutory audit function, it could remain detached and independent of the pressures that might be put upon it.

14.27 Finally, a number of other points were made in relation to auditors:

- the issue of the proper role of the auditor should be for the new Auditing Practices Board (APB), under the proposed new arrangements for audit regulation, rather than for statute. In particular, the APB should review and rationalise the current statutory responsibilities;
- in view of developments taking place in the European Commission, it would not be useful for the Review to consider the role and liabilities of the statutory auditor and auditor independence in isolation for Britain, other than to provide input in to these other arenas. It would seem sensible for the focus to be on ensuring that the statutory and non-statutory framework were sufficiently flexible to cater for such evolving European and international rules;
- the Review needed to recognise a clear distinction between internal and external audit. For example, the Turnbull Report placed great emphasises on the role that an internal audit function could play in providing assurance on internal controls. The internal audit role should be given due weight in any consideration of the role of the statutory auditor;
- the requirement for an audit of wholly-owned subsidiaries should continue. Many such subsidiaries were unnecessary, and if there were good reasons for maintaining them then that would suggest an audit be required;
- in looking at the scope of the statutory audit the approach adopted by the SEC in the US should be examined. In particular, consideration should be given to adopting the SEC's practice of allowing companies to publish forward-looking, and unaudited information as long as the document clearly stated that it was such.

## **Statutory and non-statutory reporting**

14.28 The Consultation Document referred to information other than the statutory accounts and reports that companies regularly publish or make available to groups, such as shareholders, analysts etc, noting that the extent of this non-statutory reporting suggested that there was a market need or a wider demand for financial and non financial information on companies which the existing statutory requirements failed to reflect. It went on to note that a fundamental consideration, in assessing the extent to which statutory requirements should be extended into new areas, was to whom, in a modern economy, the directors should be accountable and in what respects (an issue that had been discussed in Chapter 5.1 of the Document).

14.29 A small number of those who responded to the issues raised by this part of the Consultative Document argued that environmental and social reporting should be included as a statutory requirement. The experience of one commentator was that the practice of the company community fell a long way short of the required level of disclosure. While a statutory framework might make reports more bland the purpose of disclosure was not to entertain but to inform. This commentator did not think that establishing a standard that set minimum levels of disclosure would put current examples of positive reporting at a competitive disadvantage. Best practice would continue to develop and the existence of recognised mechanisms would continue to act as a driver for improved reporting. Furthermore, a standard would allow for comparability of information and would circumvent the problems suffered from the disclosure of information which only showed companies in a positive light. Another commentator argued that wider reporting on social and environmental issues was becoming increasingly common for listed companies and that the market had come to expect such statements. Increasingly, investors were checking such “soft” issues before investing in listed companies. All listed companies should thus include an environmental statement (covering the whole group and not just the parent company or British part of the group) in their annual reports. Another commentator noted that the justification for reporting on social and environmental performance had the same basis as that for financial performance - the company was the steward of capital belonging to others.

14.30 A wider group of commentators argued the opposite case, that there was no case for increased statutory requirements. One pointed out that the growth of non-statutory reporting demonstrated that companies were responding flexibly to the demands from interested groups. Forcing all companies to provide the information that was currently provided on a voluntary basis would unnecessarily add to the regulatory burden. Directors should not be accountable to groups other than shareholders and creditors - foreign companies were not so as a general rule and to make British companies accountable in this would lower their competitiveness. One commentator argued that any additional disclosure requirements should be subject to a rigorous cost-benefit analysis and scrutiny as to the part they might play in the overall burden on business while another argued against the extension of statutory disclosure on the basis that the information that it was appropriate to be disclosed would vary from company to company. It was also pointed out that some non-statutory reporting fell under the auspices of other regulatory bodies such as the London Stock Exchange, and a review to ensure that they were robust enough to

ensure consistency was preferable to the extension of legislation to include them. The growth of non-statutory reporting demonstrated that companies were responding to demands from interested groups and this should be allowed to develop as individual companies saw fit.

14.31 A number of other points were made by commentators focusing on this particular part of the Consultation Document:

- the auditing of documents such as preliminary announcements and interim statements would represent a useful safeguard; to this end, ASB statements on these should be mandatory;
- it would be helpful if annual reports provided a clear indication as to which information they contained had been audited and which represented best practice;
- the information needs of shareholders should be those which were primarily recognised in company law. It was thus necessary to determine what information shareholders should be able to expect. To impose statutory requirements to provide a wider range of information would be too onerous for companies.

#### **Impact of electronic communication/IT and frequency and timeliness of reporting**

14.32 Finally in this Chapter, the Consultation Document referred to the pressure, particularly on large companies, to provide financial information more frequently than the annual statutory report filed within the seven to ten months allowed for publishing accounts after the financial year end, against the background of the use of information technology to manage company finances and electronic communications to disseminate such information.

14.33 This part of the Consultation Document attracted few comments; those commentators with an interest in information technology issues naturally directed their comments at Chapter 5.7 (see section 13 of this document). Those that did comment had the following points to make:

- the Act should be brought up-to-date so as to reflect developments in technology, with the aim of, inter alia, making published company information more useful;
- if the majority of accounting and disclosure requirements were delegated to a body responsible under the law, this could provide for a more flexible approach to be taken as technological developments occurred. A more dynamic approach to supervision was needed to include the establishment of good practice guidelines and the setting of a framework of monitoring and sanctions;
- were companies to put their financial statements on the Internet they would need to disclose clearly whether they were statutory or non-statutory. While there was clear scope to make financial statements more timely a particular concern was the reliability of information provided on the Internet;

- one commentator argued that, in the future, companies would be establishing knowledge bases, held electronically which could be accessed either on a restricted or unrestricted basis by those seeking information on the company and the information which they sought would be capable of being packaged through electronic templates to meet their requirements. Such information would not be exclusively financial reports but would cover other areas of business performance. Accordingly, it would be unfortunate if the Review resulted in successive legislation in respect of reporting matters. It would be preferable to provide merely the framework to allow practice to develop in a regulated way in the 21st Century;
- while electronic media could be expected to make company accounts and the annual report more accessible to consumers, possibly through the Internet, the level of information published needed to be standardised, and should be made simple enough to understand, yet relevant enough to add to the understanding of a company;
- the Review would need to consider carefully issues of information security and authenticity in the context of the dissemination of company information via the Internet. It needed to be reasonably assured that the information received by the end user was neither corrupted or incorrect.

### **15 Comments on Chapter 7, *The Law Commissions' Project: Company Directors: Regulating Conflicts Of Interest And Formulating A Statement Of Duties***

15.1 Chapter 7 of the Consultation Document contained a brief description of the consultation paper, *Company Directors: Regulating Conflicts Of Interest And Formulating A Statement Of Duties*, issued by the Law Commission and the Scottish Law Commission in September 1998. In particular, it explained that the Law Commissions' work covered ground which formed part of the area on which the Review would be making proposals in the light of the Law Commission's final report (subsequently published in September 1999).

15.2 The Consultation Document did not specifically seek comments on this Chapter, nor did it ask any questions in relation to it. Nevertheless, a handful of respondents took the opportunity to offer their views both on the general question of the reformulation of a statement of directors' duties and on some more detailed issues. Those that addressed the general question supported the move towards a simplified, clear and explicit description of a director's duties, although at least one commentator recognised the importance of drawing the duties sufficiently broadly so as to allow flexibility and initiative. The more detailed points made by this group of respondents were:

- the rules on the legality of directors' transactions with companies were now extremely complex and it would simplify the law if the legality and disclosure of directors' loans, quasi-loans and credit transactions could be combined;

- the introduction of simplified requirements to notify directors' share interests and dealings should be progressed without delay ahead of the main Review. The impact of the current provisions imposes an onerous burden on listed companies and it would be desirable to reduce this burden as soon as possible;
- a director should be trained and officially informed of the responsibilities and duties that the position implied. Training could involve a formal introduction to the legal requirements of directors, who should be encouraged to become qualified, e.g. by becoming Chartered Directors in the same way as Engineers, Accountants and Company Secretaries obtain a formal qualification; and
- directors should be legally required to disclose the previous directorships they have held, so that potential investors know whom they are dealing with.

## **16    Comments on Chapter 8, *Legislative Options And Future Machinery For Reform***

16.1 This part of the Consultation Document addressed two related problems concerning legislation and on-going reform in the area of company law: first, the legislative shape of the measures taken to implement the Review; and, second, what, if any, new steps should be taken for subsequent reform, in order to secure the best possible system for keeping the law in line with future needs as they arise.

16.2 Those who responded to **question 53(a)**, which asked which form should the legislation to implement the Review's proposals take, and what was the best distribution between primary and secondary legislation, offered a wide range of views. Nevertheless, one common theme to emerge across the responses was the need to ensure that any new legislation was simple to read, easy to understand and clear in its intention and effect. The concept of accessibility was regularly emphasised by respondents, with one suggesting that a new Act be located (and updated) on the Department's website.

16.3 Those respondents that focused on the structure and form that new legislation might take tended to adopt two fairly standard positions. The first of these was that there should be a single Companies Act identifying core requirements for the simpler form of company, with additional requirements to cater for larger, listed and public interest companies, often referred to as the building block approach. The other commonly held view was that a new Act should contain the broad rules, principles and framework, with the detailed regulation (particularly that likely to be subject to regular change) assigned to secondary legislation, or even delegated to independent regulators. The thought was that relevant bodies (such as the FRC, the ASB and the London Stock Exchange) could be used to reduce the need for extensive secondary legislation.

16.4 The majority of the comments that fell under this question were, however, focused on the most appropriate balance between primary and secondary legislation in implementing the eventual Review proposals. While many respondents expressed misgivings on the more extensive use of secondary legislation - on the basis that company law included controversial areas, such as the stakeholder question, that

should properly be subject to Parliamentary scrutiny, that the Review would address property rights, that large numbers of Statutory Instruments made the law uncertain and difficult to identify, that many Statutory Instruments were obscure and difficult to follow, that there was a tendency for the executive to amend legislation using secondary legislation on political rather than merely administrative grounds, and the fact that greater use of secondary legislation eroded Parliament's authority - there was also a large body of opinion to the effect that much of the technical detail required by company law was best dealt with by secondary rather than primary legislation. In technical areas such as capital maintenance, the use of secondary legislation could, for instance, allow for flexibility and updating as required. Procedural matters, in particular, were likely to require change and refinement (as opposed to matters of principle which should be relatively stable). Many respondents shared the view that secondary legislation was more responsive to changing circumstances and its use would help to ensure that company law remained both relevant and up-to-date, not only embracing emerging corporate issues but also harnessing developments in information and other technologies. One commentator argued that the ability to amend regulation relatively quickly as the company environment developed was essential for good company law in the 21st Century. Another offered a slightly different solution, proposing that a mixture of primary and secondary legislation should be used, supported by a Company Law Review Board, to advise the Department of Trade and Industry on necessary changes to legislation and, more importantly, to comment on proposed changes put before Parliament.

16.5 **Question 53(b)** asked, if more extensive use of secondary legislation was desirable, what, if any, additional safeguards should be adopted. The comments made by respondents to this particular question tended to focus on a narrow range of suggestions. The first of these was pre-legislative consultation on proposed secondary legislation and its scrutiny by key professional bodies and representatives of industry and commercial bodies, to ensure its appropriateness and accessibility. Variations on this pre-legislative consultation process included the suggestion of a minimum three month notice period before a Statutory Instrument came into effect and the publication of proposed amendments to the law published via the Internet. Another group of comments centred round means of incorporating an independent review body into the secondary legislation process. One commentator suggested a committee of opposition member of Parliament, which would have the duty of checking every Statutory Instrument to ensure that the Government had not acted ultra vires in any way; another suggested the establishment of an independent monitoring body; while a third went rather further in suggesting that an independent Company Law Review Board be given the specific function of continually monitoring and reviewing company law, making proposals to the Department on changes to provisions contained in both primary and secondary legislation, and to review all proposals for secondary legislation in the field of company law. In addition, more than one commentator suggested that the use of the affirmative resolution procedure be adopted with regard to relevant Statutory Instruments, in order to provide more stringent Parliamentary control. Finally, a number of commentators pointed to the fact that oversight and monitoring of secondary legislation was not uniquely a company law issue and any solution would need to be applied to all legislation generally.

16.6 The final question in this group, **question 53(c)** asked, if continued heavy reliance on primary legislation was favoured, were the problems of inflexibility and piecemeal reform and likelihood of insufficient Parliamentary time recognised, and if so, what were the remedies for these. The respondents to this particular question certainly recognised the problems referred to in the Consultation Document. In terms of potential remedies, commentators suggested that there should be an obligation on the Government to make sufficient Parliamentary time available to allow the implementation (and revision) of this important area of the law. Others thought that the lack of sufficient Parliamentary time meant that it was important to ensure that all proposals for change brought forward as part of the Review should be internally coherent, conceptually sound, well articulated and based on sound empirical evidence of the need for change. A further solution, suggested by some, was the greater delegation to appropriate bodies, such as the ASB and the London Stock Exchange to provide the detail behind the basic requirements. Finally in this question, commentators suggested the use of a Standing Commission which could propose company law reforms, and the establishment of a Company Law Review Board (referred to in paragraph 16.5 above) which would have the function of producing additional standards and guidance on the application of certain principles of company law contained in legislation or established under common law and to produce standards in areas where a formal legal approach was not appropriate. Such codes or standards could be taken into account by the Court in determining liability (along the lines that the Highway Code is used for determining negligence in relation to road traffic offences).

16.7 A clear majority of those responding to **question 54(a)**, expressed support for the concept of new institutional arrangements to ensure effective continuing reform in company law. Commentators pointed out that rapid technological developments and increasing global competitiveness made new arrangements essential in order to ensure effective continuous reform, and that the present ad hoc basis for change was ineffective and resulted in anomalies in the overall body of company law. There was, however, a range of commentators that argued that continuing reform brought with it uncertainty and confusion and that there should, for instance, be a set of changes at a particular time and then a moratorium on further change for a set period of, say, five or ten years.

16.8 The proposals mentioned in paragraph 8.12 of the Consultation Document - the establishment of a standing committee, with statutory backing, and the requirement that the Secretary of State should be obliged to consult this body regularly and to bring forward a report to Parliament every five years, reporting on the operation of the Act, and considering the case for further reform - attracted widespread support from those commentators responding to **question 54(b)**. In expressing support for these proposals, respondents made a number of relevant points: that any such standing committee should consult regularly with interested groups and should be open to suggestions for revision to the law; that it should also have a responsibility to monitor the effect of successive statutory instruments to ensure that over time the sub-structure of secondary legislation did not become over complex; that its members be appointed via a politically independent process; that it should contain those with a range of practical experience as well as those with legal expertise; and that it would be desirable

that changes to its terms of reference could only be made with the consent of Parliament.

16.9 Whilst expressing support for the proposals, some commentators sounded a more cautious note, suggesting that a standing committee should not be allowed to propose change for the sake of change. Consistency and continuity of the legal regime were beneficial to companies. The law should be updated to reflect changes in practice and correct identified weaknesses rather than allow radical reform on a regular basis. In addition, one commentator suggested that the framework should provide that the Secretary of State should only enact and amend law, within defiant perimeters, having obtained an affirmative recommendation from the standing committee; this measure was thought necessary to prevent abuse by Government. Those commentators that expressed opposition to the proposals pointed to the fact that such a standing committee might not be truly independent and that the Secretary of State's reports to Parliament would necessarily present an unduly positive picture of the company law background. One commentator thought that such a committee would become captured by professional and academic interests and would become isolated from business.

16.10 In responding to this question, other commentators suggested a number of alternative ways of ensuring that company law was kept up-to-date. One suggested the establishment of a Law Nomination and Scrutiny Committee, to whom anyone could write and offer suggestions for a change in the law. Another suggested the inclusion of a "sunset clause" leading to the automatic repeal of the legislation after one year. In addition, commentators suggested the establishment of a Company Law Best Practice and Review Board and that the Company Law Review Board (referred to in the responses to previous questions) should have a role in monitoring the effect and progress of existing legislation and proposing changes to it.

## **17    Comments on Chapter 9, *The Way Forward***

17.1 This part of the Consultation Document described the work that remained to be done on the Review, set out how it was intended to take it forward and the timescale for its completion.

17.2 In commenting on **question 55(a)** a large majority of respondents supported the proposals set out in the Consultation Document to establish a new series of Working Groups to take forward key aspects of the Review. As well as this widespread support there were, however, a number of dissenting voices. One commentator thought that the Review work programme needed to be re-ordered so that urgent action could be taken in respect of small companies, while a number of others expressed concerns at the transparency of the Working Group process, with one suggesting that the detailed programme of work for each Working Group should be made available (perhaps via the Internet) as soon as possible. Much of this concern focused around the selection of Working Group participants (including some comments directed at the first phase of Working Groups, whose work is now complete). Some emphasised the importance of increasing the representation of day-to-day users and practitioners of company law on Working Groups while others suggested that a more “inclusive” approach to the recruitment of Working Group members be adopted. Another proposed that the Working Group concerned with the argument as to the respective merits for a competitive economy of shareholder value as opposed to a pluralist approach required members, not necessarily politicians themselves, but who were able to present and debate the political implications of the various options in order to ensure that the modernisation of company law was implemented. On the proposed programme of activity for the new Working Groups one commentator voiced the concern that there might be too many groups and the process could become unduly cumbersome, while another thought that some of the Groups appeared to have a very wide remit which would make it difficult for them to perform their task.

17.3 On the topics to be addressed by the Working Groups, a number of commentators suggested additional issues that needed to be addressed:

- greater emphasis needed to be attached to charitable companies, especially disparities between the rules that applied to charities that were incorporated and those that were unincorporated. In addition, the Review’s work in this area needed to examine whether it was possible to provide adequate protection for charity trustees, equivalent to that provided by a limited company but without the need to incorporate as limited companies;
- there was a need to review the regulations concerning dormant companies, with a view to removing from the Companies House register non-trading dormant companies whose sole reason for existence was the protection of a valuable company name. This could be achieved by having a very substantially higher fee for the annual return for a dormant company;

- greater emphasis should be devoted to creditor protection measures, including in particular the incidence of “phoenixism” and greater use of director disqualification as a deterrent;
- the next phase of the Review should consider how the environment could be recognised as a stakeholder. The environment was an abstract entity (much like companies themselves) and it therefore did not have the capacity to seek remedy for any misconduct committed against it even in principle. The protection of its interest thus required additional provisions.

17.4 A majority of the commentators who responded to **question 55(b)**, agreed that the list of issues which it was proposed that these Working Groups should address was appropriate and complete. More than one commentator, however, pointed out that there would need to be close co-ordination between the activity of the various Working Groups, especially those dealing with corporate governance issues, while others echoed the point made in the Consultation Document that the detailed topics assigned to each Working Group would need to develop as the work of the Review progressed.

17.5 In addition, a number of commentators had their own detailed suggestions as to issues which could be added to those to be addressed by the Working Groups or which they thought merited greater prominence than currently seemed to be afforded them. These topics included:

- a review of the law on distributions, which presented practical difficulties concerning, for example, the treatment of asset write downs and the meaning of “realised”;
- the issue of groups which have different year ends for holding company (and the consolidated accounts) and for key subsidiaries. This provided the opportunity for manipulation of the figures for both group and the subsidiaries as at their respective year ends. In addition, the Review needed to address misrepresentation in accounts where a group had what appeared to be reasonable trade debtors in terms of sales, but where an important subsidiary had discounted trade receivables. This represented a type of finance charge, but was not identified as such in the accounts;
- a mechanism already existed for shareholders to opt out of receiving the full report and accounts and receive a summary financial statement instead. The question of whether shareholders should have the right to elect not to receive any notices at all needed to be considered;
- more than one commentator suggested that the Review needed to consider the consequences of the Caparo judgement, with a view to ensuring future company law removed any unreasonable impediments to prevent shareholders suing auditors;
- Working Group D should also have within its remit issues around the abuse of corporate status, groups of companies, definitions of affiliates and duties across the group;

- Working Group E should have a specific remit to consider stakeholder issues as they impact beyond UK territorial boundaries, in particular in the developing world;
- Working Group F should consider whether the thresholds on share ownership required to bring resolutions to AGMs were too onerous, against the background of the potential cost to reformers of this provision for giving shareholders an effective voice or a route to change a company's policies;
- Working Group G, in examining wider reporting issues, should consider any lessons and recommendations to be drawn from the recent changes in company law in other countries, as set out in Chapter 4 of the Consultation Document;
- Working Group G should also consider existing requirements on shareholders to disclose their interests in a company shares once a holding of 3% has been acquired. It could be argued that this was too low a threshold and placed an unnecessary reporting burden on institutional investors;
- the Review would need to address the needs of the capital markets. One commentator found it extraordinary that the list of topics in Annex I to the Consultation Document did not include any reference to the needs of investors or any consideration of the efficiency of the capital markets;
- consideration should be given to greater use of the sanction of disqualification to replace the criminal or quasi-criminal sanctions currently contained in Part X of the Act;
- the special position of companies limited by guarantee should be addressed. In particular, it should not automatically be assumed that what held for companies limited by shares was also held for companies limited by guarantee;
- the Review should consider the case for obliging any company to have sufficient insurance to protect a company's customers and creditors;
- the Review should also consider the movement of registered offices. When a company used a formation agent or a solicitor as its registered office and contact with that company was lost there was no way of removing the registered office from the formation agent or solicitor's address;
- the Review should look again at the law relating to dissolution, with special regulations to restore companies within a year of dissolution, as was the position in Ireland.

17.6 A majority of those respondents who commented on **question 56(a)** agreed that the proposed future research programme outlined in paragraph 9.9 of the Consultation Document was appropriate. A number of commentators did, however, wonder whether the proposed programme was somewhat ambitious, given the wide scope of some of the topics, and doubted whether the Review had significant resources

to tackle all of these topics in sufficient depth. One commentator suggested that it would be better to prioritise and concentrate on certain key or more manageable topics. Others, while supporting the concept behind the proposed research programme, wondered whether it was achievable within the timescale of the Review while others noted that it would need to be developed as the work of the Review progressed. Some commentators pointed to the fact that much work had already been undertaken on some of the proposed research topics and suggested that the Review should focus on exploiting this material rather than commissioning new work to cover the same ground. It was also thought that further research might not be needed in certain areas (for example the usefulness of the objects clause) where a clear consensus for change was likely. In addition, a number of commentators offered their own thoughts on how the detail of the programme could be improved:

- the proposed survey of the users of company law could usefully focus on recently formed companies, in order to provide a picture of the current use of new companies, and their size, which would be of use of determining the appropriate level of regulation for such companies, whether some incorporations were inappropriate and whether the needs of the businesses concerned might be better served by a registered unlimited corporate form;
- it would be valuable to assess whether proposed new sections of the law in plain English were likely to be clear to company directors and other users of company law;
- the proposed investigation into the shareholder population could usefully draw out the distinction between those who hold the shares (mostly fund managers) and the ultimate owners (mostly pension funds, insurance companies and individuals) and the implications of this split for the exercise of voting rights and other corporate governance matters;
- the proposed study of the economic impact of different company strategies in relation to the management of wider relationships should be put into the context of the competitiveness of national economies, i.e. careful consideration should be given to the link between consistently superior economic performance and corporate culture and the implications of this for the international competitiveness of the British economy;
- research topics (d) - high level reporting issues - and (e) - the usefulness of published accounts - could be expanded slight to investigate how interested parties obtain company information, the degree to which such information affects opinion on the company (including investment decisions) and how users assess the reliability and objectivity of such information.

17.7 Only a relatively few respondents thought that the proposed research programme would serve little useful purpose. One expressed the view that it was now time to act and that the research programme would create delay, which would in turn create inefficiency and cost as outside events and technologies moved on. Another expressed the view that there seemed little merit in devoting significant time or

resources to some of these issues as the likelihood of significant new knowledge emerging was slight.

17.8 Those respondents that addressed **question 56(b)**, which asked whether other issues should be under consideration in the proposed future research programme, suggested a range of other issues that they considered needed addressing. These included the following:

- research into the impact of environmental performance on economic performance and into ways in which companies are approaching the issues of sustainability;
- a review of the experiences of companies which had engaged in social accounting and reporting;
- work to determine the constraints imposed by EC legislation on proposals to change British company law, so that a programme of action could be developed to influence necessary changes;
- the proposed study into the economic impact of different company strategies in relation to the management of wider relations should include a study of the wider social impact of alternative strategies. This would be in the interests of the wider community as well as the company;
- an exploration of the factors which determined a business's choice of location;
- the extent to which non-executive directors were currently appointed on the strength of their environmental, social or other stakeholder background and expertise and their ability meaningfully to influence company strategy and behaviour in these areas;
- the impact of competent management on business performance. In other words, could improvements in performance be achieved by raising the skill and expertise of management;
- an international comparison of the differences in statutory audits;
- an analysis of the extent to which directors were aware of their duties and liabilities;
- further research into the potential uses of information technology and, in particular, its use in presenting legislation in a more user friendly style;
- a review of the role played by auditors and, in particular, the views of directors on the role auditors should play;

17.9 The overwhelming majority of those respondents who replied to **question 57**, which asked whether the other key tasks for the Review, identified in paragraph 9.11 of the Consultation Document were appropriate, answered positively. None took the view that they were not appropriate. The only substantive point made by

commentators to this question were to emphasise the importance of the Review covering all relevant aspects of company law and the need to introduce timescales for the various actions envisaged.

17.10 The final question posed by the Consultation Document, **question 58**, asked whether the outlined timetable proposed in paragraph 9.12 was acceptable. Most commentators thought that the proposed timetable would be acceptable, although a number did express the concern that the objective of a final report from the Review, with final conclusions, in Spring 2001 represented an ambitious, if not over-optimistic, target. Another point to be made by a number of commentators generally supportive of the progress of the Review was the need to ensure the rapid and full implementation by Parliament of its output. Some commentators, however, offered a dissenting view. They took the view that essential changes to the law, dealing with small firms issues for instance, should be made earlier than the timetable envisaged in the Review. Another group argued, conversely, that such an important and comprehensive reform required more time and should not be subject to the pressures of tight time constraints. One commentator, in particular, thought that, in order for the Working Groups to perform their tasks effectively, bearing in mind the great demands that would be made upon the busy people who would serve on them, and also to ensure that the research programme was effectively linked into the process, more time would be necessary than currently provided for under the timetable envisaged in paragraph 9.12. It therefore urged that consideration be given to extending the timetable for at least a further six months beyond the projected final date of March 2001.

## **18 Comments on issues not covered elsewhere**

18.1 There were, in addition, a range of comments on company law matters that did not specifically address issues raised in the Consultation Document. Some, for instance a comment to the effect that companies should be allowed to buy in shares and retain them on their balance sheet without having to cancel them, addressed issues that are already being dealt with outside the limits of the Company Law Review, while others raised matters which could arguably have been included as an additional item for consideration in response to question 55(b) - see paragraphs 17.4-5 above. Others provided detailed suggestions to improvements to specific parts of company law. These are not included here, for reasons of space, though all will be followed up and considered as part of the Review process.

18.2 The issue to attract most attention in those comments that fall to be addressed in this part of the summary concern the role and nature of the annual general meeting (AGM). The points made by those who commented on the AGM were as follows:

- the AGM remained an essential part of corporate governance and had a key role to play in focusing boards on the interests of all shareholders. The AGM did influence corporate behaviour. If companies were not deriving value from their AGMs that was a comment on the attitude and approach they took to them. While institutional shareholders might not attend a AGM they did monitor their conduct and were reassured by the way a company ran its AGM, believing that it was important properly to take care of private shareholders;

- another commentator pointed to widespread dissatisfaction with the role of the AGM, which was bypassed as the primary medium of communication between the company and its institutional investors. Encouragement should be given to a number of experiments which would help to form the good practice which could then, in time, be reflected in regulation. These included: the simplification of the process whereby shareholders were empowered to challenge the actions of the board, with the costs for such challenges being borne by the company, thus giving the company an incentive to improve its shareholder communications; the division of the agenda at the AGM to include a formally recognised separate space for a stakeholder dialogue; agenda items at the AGM for progress reports on each of a company's key relationships, and an agenda item on companies overall values, risk and reputation; the development of electronic stakeholder dialogues; and the broadcasting through the Internet of all company investor presentations;
- finally, another commentator expressed the view that at present AGMs were ineffective when it came to forcing changes in excessive boardroom pay and in other matters. There was a case for changing the existing law relating to AGMs so that proxy voting by corporate bodies was abolished or was restricted to a nominal percentage vote of shares (e.g. not more than 0.1 or 0.2% of issued share capital) unless a personal representative of the corporate body attended the AGM in person and identified himself in the way individual shareholders did. This could prevent a board from being certain in advance of the majority of votes, would increase the intended power of the shareholders in general meeting and may curb excess, such as undesirable excessive remuneration and share bonus allocations.

18.3 The other issues raised by those who commented on the Consultation Document were as follows:

- the law should be reviewed and tailored to cater for groups of companies. The focus of company legislation was still predominately on individual companies, whereas much business activity was now conducted through groups. Company law was not ideally suited to groups, especially where subsidiaries were wholly owned and operated as a division of the group rather than separate companies in their own right. In particular, the directors of a company were meant to act at all times in the interests of the subsidiary itself rather than following the instructions of the parent. In many cases the law did not correspond to what happened in practice and should therefore be re-examined. This re-examination would need to consider issues such as whether the parent company should be able to walk away from an insolvent wholly owned subsidiary by relying on its limited liability and whether any of the rules for subsidiaries (for example on their preparation audit and filing of what might be fairly meaningless accounts) could be relaxed where the parent company committed itself to standing behind the subsidiary, and whether the rules on capital maintenance and distributable profits should be recast to cater for groups;
- the position of company directors was worthy of further attention. It was very easy to become a director in Britain but it was also very difficult to disqualify unfit directors. There was evidence that there was a high level of ignorance amongst directors of their responsibilities, especially in the small company sector. Across

companies of all sizes there were directors who flouted the requirements of company law both intentionally and unintentionally. These problems needed to be addressed in relation to companies by requiring a greater financial commitment from those wishing to carry on their business as a company, such as increasing the minimum paid up share capital for companies, requiring compulsory indemnity insurance to be held by directors, adopting a formal procedure for the appointment of directors, whereby new directors either make a formal solemn oath that they understand and accept the duties and responsibilities of a company director or take a test of their understanding of their duties and responsibilities, and proper enforcement of the current requirements on directors and making disqualification of directors easier;

- once the Combined Code had become firmly established and governance reporting had become a routine matter for directors, there should be no necessity for corporate governance provisions to be anything other than best practice as opposed to legal rules. It was an area which was best left to the London Stock Exchange to enforce. The UK should avoid creating superfluous corporate governance burdens on business, in line with a need to maintain an attractive environment for foreign companies who would wish to register in Britain, while British companies should not be disadvantaged on the international stage by burdens that were placed on them;
- two commentators addressed the issue of the application of company law to specific types of company. One raised the issue of the application of changes introduced for public companies to Open Ended Investment Companies. The rules governing the constitution and structure of such companies were currently set out in a separate corporate code in Treasury regulations made under section 2(2) of the European Communities Act. Although such companies had a separate code and operated within the regulatory framework set by the FSA, the corporate code applied a number of provisions of the 1985 and 1989 Companies Acts directly to them and certain other provisions were replicated in the ECA Regulations. There was thus a continuing interface between these regulations and possible changes to the Companies Acts. Similarly a second commentator raised issues surrounding Investment Trust Companies (ITCs). These were investment companies within the definition of section 266 of the Act and were afforded special treatment with regard to distributions and accounting. If the Review was intended to cover the entire Act there would be a stage when the provisions applying to investment companies would need to be looked at in some detail. The Review should therefore appreciate the unique position of ITCs (and other investment companies) within the company law context and ensure that proposals for change were flexible enough to cater for such classes of company without imposing requirements that were inappropriate to their circumstances;
- the process of disincorporation need to be reviewed. Incorporation of an unincorporated business was a very simple process whereas disincorporation was a cumbersome and expensive process full of tax pitfalls and legal complications. Disincorporation procedures should be made much easier and the tax burdens upon disincorporation should be eradicated;

- the company law framework should include special provisions to enable charities, community businesses and micro businesses to have access to and make effective use of loan and equity funding from socially responsible investors;
- the system for registration of charges was an integral part of core company law and merited attention. A major reform of the system had been attempted in the Companies Act 1989 but the relevant provisions had not been brought into force. There should be no change to the fundamental purpose of registration as an information system, backed by sanctions for failure to provide the required information, but both chargors and chargees looked for simplicity of operation. Chargees looked for conclusive, accurate and up to date information on charges and wished to minimise any scope for litigation or enforcement. Reform should make use of the benefits provided by the current system - the meaning of most language and concepts used had been clarified and the system functioned reasonably well - by concentrating on streamlining the system and dealing with areas where problems or anomalies had been identified; and
- finally, one commentator emphasised the need for a review of Part VI of the Act. The current regime on the disclosure of interests in shares imposed a particularly heavy reporting burden on pension funds while appearing to offer no obvious advantage to the wider public interest.

Company Law Review Team  
December 1999

0109c

**ANNEX A: LIST OF RESPONSES IN THE ORDER IN WHICH THEY WERE RECEIVED**

<b>No</b>	<b>Name</b>	<b>Date of reply</b>
1	Brian G Strand FCA	2/3/99
2	Jonathan Charkham Esq	2/3/99
3	G L B Pitt Esq	4/3/99
4	Top Pay Research Group	10/3/99
5	Robert Monks Esq	16/3/99
6	Consumer Credit Trade Association	25/3/99
7	John A Franks, Chethams, Solicitors	25/3/99
8	Andrew Morton Esq	26/3/99
9	Martin Simons Associates	7/4/99, 8/6/99 and 19/7/99
10	The Association of Corporate Trustees (TACT)	19/4/99
11	S W Blunt Esq	20/4/99 and 22/4/99
12	Fork Truck Association	21/4/99
13	MSP Secretaries Ltd	21/4/99
14	Rio Tinto plc	30/4/99 and 16/6/99
15	Hans-Christoph Hirt, Research Student, LSE	4/5/99
16	Moore Stephens, Chartered Accountants	6/5/99
17	John Francies FCA	6/5/99
18	David M Martin Buddenbrook Consultancy	6/5/99
19	Accounting Standards Board	7/5/99
20	John Brady ACIS	12/5/99

21	York Place Company Services Ltd	17/5/99
22	K F J Slade FCA	17/5/99
23	South Essex Society of Chartered Accountants	17/5/99
24	CAFOD	17/5/99
25	H W Higginson Esq	17/5/99
26	Slough Estates plc	19/5/99
27	Halifax plc	20/5/99 and 23/7/99
28	Andrew Hicks, Senior Lecturer, School of Law, University of Exeter	20/5/99
29	Philip Morgan, Bevan Ashford, Solicitors	21/5/99
30	The Faculty of Advocates	11/6/99
31	HM Land Registry	21/5/99
32	New Economics Foundation	24/5/99
33	Professor John Birds, University of Sheffield	24/5/99
34	K B Stone Esq	23/5/99
35	Dr Eilis Ferran, Director, Centre for Corporate and Commercial Law, University of Cambridge	24/5/99
36	Fund Managers' Association	24/5/99
37	The Law Society	25/5/99
38	Birmingham Law Society	25/5/99
39	The London Law Agency Ltd	26/5/99
40	Royal Institution of Chartered Surveyors	26/5/99
41	Association of Unit Trusts and Investment Funds	27/5/99
42	Association of Accounting Technicians	27/5/99

43	Association of Chartered Certified Accountants	27/5/99
44	Dr N and Mrs P Marriott, Cardiff University Business School and Glamorgan University	14/4/99 -rec'd 28/5/99
45	Amnesty International UK Business Group	28/5/99
46	E-vote Ltd	28/5/99
47	Institute of Social and Ethical Accountability	21/5/99 - rec'd 1/6/99
48	Institute of Chartered Accountants in England and Wales	27/5/99
49	F A G Kay	27/5/99 and 31/5/99
50	Standard Life Assurance Company	27/5/99
51	Confederation of British Industry	28/5/99
52	Construction Industry Council	28/5/99
53	The General Council of the Bar	28/5/99
54	Institute of Credit Management	28/5/99
55	London Society of Chartered Accountants	28/5/99
56	The Medical Defence Union Ltd	28/5/99
57	Pannell Kerr Forster, Chartered Accountants	28/5/99
58	Standard Life Investments Ltd	28/5/99
59	The Stationery Office	28/5/99
60	Traidcraft Exchange	28/5/99
61	Joint submission on behalf of range of NGOs	28/5/99
62	Dr David Wheeler and Janice Dean, Kingston University	28/5/99
63	Institute of Chartered Accountants of Scotland	31/5/99 and 31/8/99

64	Financial Services Authority	28/5/99 and 8/6/99
65	World Development Movement	28/5/99
66	Foreign and Colonial Management Ltd	1/6/99
67	John Kaler, University of Plymouth Business School	1/6/99
68	The Institute of Chartered Secretaries and Administrators	26/5/99
69	W M Arthurs ACA ACIS	31/5/99
70	Dr Elaine Sternberg	31/5/99
71	WWF-UK	31/5/99
72	The Centre for Tomorrow's Company	1/6/99
73	Eversheds, Solicitors (Nottingham)	1/6/99
74	Grant Thornton, Chartered Accountants	1/6/99
75	The Hundred Group of Finance Directors	1/6/99
76	Qui Credit Assessment Ltd	1/6/99
77	Railtrack Group plc	1/6/99
78	Trussler Davies Associates	1/6/99
79	Professor Chris Mallin, Nottingham Business School	28/5/99
80	Department for International Development	28/5/99
81	Deloitte & Touche, Chartered Accountants	1/6/99
82	PricewaterhouseCoopers	1/6/99 and 11/6/99
83	London Stock Exchange	1/6/99
84	Institute of Personnel and Development	31/5/99
85	The Chartered Institute of Management Accountants	2/6/99
86	UK Shareholders Association	2/6/99

87	Association of Investment Trust Companies	4/6/99
88	Arthur Andersen, Dundas & Wilson, Garretts	3/6/99
89	Tayside Environment Centre	28/5/99
90	International Underwriting Association of London	4/6/99
91	KPMG	4/6/99
92	Lovell White Durrant, Solicitors	4/6/99
93	The National Association of Pension Funds Ltd	4/6/99
94	UK Social Investment Forum	4/6/99
95	British Bankers' Association	7/6/99
96	Better Regulation Task Force	8/6/99
97	CISCO	8/6/99
98	City of London Law Society	8/6/99
99	Richard Brandt and Sheila Fearnley, University of Portsmouth	8/6/99
100	The Environmental Industries Commission	8/6/99
101	The Abbey National Group	9/6/99
102	ProShare (UK) Ltd	9/6/99
103	Forum for the Future	10/6/99
104	The Takeover Panel	11/6/99
105	Institute of Directors	11/6/99
106	Jordans	14/6/99
107	Association of British Insurers	15/6/99
108	Barclays plc	15/6/99 and 22/7/99
109	The British Chambers of Commerce	15/6/99

110	Birmingham Chamber of Commerce and Industry	1/6/99
111	National Council for Voluntary Organisations	14/6/99
112	Norwich Union Investment Management Ltd	15/6/99
113	Trades Union Congress	16/6/99
114	Hermes Investment Management Ltd	17/9/99
115	Pensions and Investment Research Consultants Ltd	17/9/99
116	Stephen Copp, European Centre for Corporate Governance, Bournemouth University	21/6/99
117	Ernst & Young	22/6/99
118	Sir Bryan Carsberg, Secretary General, International Accounting Standards Committee	23/6/99
119	Richard Allnutt Esq	24/6/99
120	Labour Finance and Industry Group	undated - rec'd 28/6/99
121	The Music Alliance	28/6/99
122	K S V Thorogood, CEng, MIEE	30/6/99
123	Consumers' Association	1/7/99
124	The Bailiff of Jersey	24/6/99
125	Railway Pension Investments Ltd	1/7/99
126	NatWest Group	5/7/99
127	The Institute of Investment Management and Research	6/7/99
128	The Association of International Accountants	14/7/99
129	The Law Society of Scotland	16/7/99
130	K G Speyer Esq	14/7/99 and 29/7/99
131	Richard Hyde Esq	undated -rec'd 23/7/99

132	Bank of England - Electronic Shareholding Working Group	26/7/99
133	Shann Turnbull, MAI Services Pty Ltd	30/7/99
134	Financial Reporting Council	30/7/99
135	3i plc	20/8/99
136	Allen Sykes Esq	24/8/99
137	Alastair J Telford Esq	11/10/99

## ANNEX B: ALPHABETICAL LIST OF RESPONSES

<b>Name</b>	<b>No</b>
3i plc	135
The Abbey National Group	101
Accounting Standards Board	19
Richard Allnutt	119
Amnesty International UK Business Group	45
Arthur Andersen	88
W M Arthurs	69
Association of Accounting Technicians (AAT)	42
Association of British Insurers	107
Association of Chartered Certified Accountants (ACCA)	43
The Association of Corporate Trustees (TACT)	10
The Association of International Accountants (AIA)	128
Association of Investment Trust Companies	87
Association of Unit Trusts and Investment Funds (AUTIF)	41
Bank of England Electronic Shareholding Working Group	132
Barclays plc	108
Better Regulation Task Force	96
Bevan Ashford	29
Professor John Birds	33
Birmingham Chamber of Commerce and Industry	110
Birmingham Law Society	38
S W Blunt	11
John Brady	20
Richard Brandt	99
British Bankers' Association	95
The British Chambers of Commerce	109
Buddenbrook Consultancy	18
CAFOD	24
Sir Bryan Carsberg	118
The Centre for Tomorrow's Company	72
Jonathan Charkham	2
The Chartered Institute of Management Accountants	85
Chethams	7
CISCO	97
City of London Law Society	98
Confederation of British Industry	51
Construction Industry Council	52
Consumers' Association	123
Consumer Credit Trade Association	6
Stephen Copp	116
Janice Dean	62
Deloitte & Touche	81
Department for International Development	80
Dundas & Wilson	88

The Environmental Industries Commission	100
Ernst & Young	117
Eversheds	73
E-vote Ltd	46
Faculty of Advocates	30
Dr Eilis Ferran	35
Sheila Fearnley	99
Financial Reporting Council	134
Financial Services Authority	64
Foreign and Colonial Management Ltd	66
Fork Truck Association	12
Forum for the Future	103
John Francies	17
J A Franks	7
Fund Managers' Association (FMA)	36
Garretts	88
The General Council of the Bar	53
Grant Thornton	74
Halifax plc	27
Hermes Investment Management Ltd	114
Andrew Hicks	28
H W Higginson	25
Hans-Christoph Hirt	15
The Hundred Group of Finance Directors	75
Richard Hyde	131
Institute of Chartered Accountants in England and Wales	48
Institute of Chartered Accountants of Scotland	63
Institute of Chartered Secretaries and Administrators	68
Institute of Credit Management	54
Institute of Directors	105
Institute of Investment Management and Research (IIMR)	127
Institute of Personnel and Development	84
Institute of Social and Ethical Accountability	47
International Accounting Standards Committee	118
International Underwriting Association of London	90
The Bailiff of Jersey	124
Jordans	106
F A G Kay	49
John Kaler	67
KPMG	91
Labour Finance and Industry Group	120
HM Land Registry	31
The Law Society	37
The Law Society of Scotland	129
The London Law Agency Ltd	39
London Society of Chartered Accountants	55
London Stock Exchange	83
Lovell White Durrant	92
MAI Services Pty Ltd	133

Professor Chris Mallin	79
Dr N and Mrs P Marriott	44
David M Martin	18
Martin Simons Associates	9
The Medical Defence Union Ltd	56
Robert Monks	5
Moore Stephens	16
Philip Morgan	29
Andrew Morton	8
MSP Secretaries Ltd	13
The Music Alliance	121
The National Association of Pension Funds Ltd	93
National Council for Voluntary Organisations	111
NatWest Group	126
New Economics Foundation	32
NGOs (joint submission)	61
Norwich Union Investment Management Ltd	112
Pannell Kerr Forster	57
Pensions and Investment Research Consultants Ltd (PIRC)	115
G L B Pitt	3
PricewaterhouseCoopers	82
ProShare (UK) Ltd	102
Qui Credit Assessment Ltd	76
Railtrack Group plc	77
Railway Pension Investments Ltd	125
Rio Tinto plc	14
Royal Institution of Chartered Surveyors	40
K F J Slade FCA	22
Slough Estates plc	26
South Essex Society of Chartered Accountants	23
K G Speyer	130
Standard Life Assurance Company	50
Standard Life Investments Ltd	58
The Stationery Office	59
Dr Elaine Sternberg	70
K B Stone	34
Brian G Strand FCA	1
Allen Sykes	136
The Takeover Panel	104
Tayside Environment Centre	89
Alastair J Telford	137
K S V Thorogood	122
Top Pay Research Group	4
Trades Union Congress	113
Traidcraft Exchange	60
Trussler Davies Associates	78
Shann Turnbull	133
UK Shareholders' Association	86
UK Social Investment Forum	94

Dr David Wheeler	62
World Development Movement	65
WWF-UK	71
York Place Company Services Ltd	21

## ANNEX C: BREAKDOWN OF COMMENTS BY SUBJECT

Subject	Pages of comment	%age of total
General comments on the Consultation Document	8	1
Chapter 1, <i>Introduction and Background</i>	3	<1
Chapter 2, <i>The Overall Approach</i>	22	3
Chapter 3, <i>The European Dimension</i>	1	<1
Comments on Chapter 4, <i>The Comparative Dimension</i>	2	<1
Comments on Chapter 5.1, <i>The Scope of Company Law</i> : Questions 1-8	222	27
Comments on Chapter 5.2, <i>The Needs of Small and Closely Held Companies</i> : Questions 9-14	100	12
Comments on Chapter 5.3, <i>Company Formation</i> : Questions 15-25	76	9
Comments on Chapter 5.4, <i>Capital Maintenance</i> : Questions 26-36	93	11
Comments on Chapter 5.5, <i>Regulation and Boundaries of the Law</i> : Questions 37-39	31	4
Comments on Chapter 5.6, <i>International Issues</i> : Questions 40-47	48	6
Comments on Chapter 5.7, <i>Information and Communications Technology</i> : Questions 48-51	49	6
Comments on Chapter 6, <i>High Level Reporting and Accounting Issues</i> : Question 52	78	9
Comments on Chapter 7, <i>The Law</i>	2	<1

*Commissions' Project: Company Directors:  
Regulating Conflicts of Interest and  
Formulating a Statement of Duties*

Comments on Chapter 8, <i>Legislative Options and Future Machinery for Reform: Questions 53-54</i>	34	4
Comments on Chapter 9, <i>The Way Forward: Questions 55-58</i>	31	4
Comments on issues not elsewhere specified	21	3

**ANNEX D: STATISTICAL BREAKDOWN OF RESPONSES TO SPECIFIC QUESTIONS**

<b>Question number/ proposition</b>	<b>without clarification</b>	<b>with clarification</b>	<b>No. commenting</b>
1 Should the present law requiring directors to have regard to the interests of members as a whole remain in force: without further clarification, or 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?	34	40	77
	<b>Statutory</b>	<b>Non-statutory</b>	<b>No. commenting</b>
2 If such clarification is desirable, should it take the form of statutory clarification of the position or clarification by some non-statutory means, and if so what?	27	26	58
	<b>For retention</b>	<b>For repeal or revision</b>	<b>No. commenting</b>
3 What (in the light, in particular, of the answers to the preceding questions) should be done about section 309?	13	51	68
	<b>No. in favour</b>	<b>No. against</b>	<b>No. commenting</b>
4(a) If the present law (with or without any such clarification) is not to be retained, should some variant of the pluralist approach be adopted -i.e. 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 members, where the directors believe the situation justifies it?	13	59	76
4(b) Is it agreed that it would not be desirable to make such a duty enforceable on behalf of those concerned?	26	6	35
	<b>No. in</b>	<b>No.</b>	<b>No.</b>

	<b>favour</b>	<b>against</b>	<b>commenting</b>	
4(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?	14*	20	37	
4(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 can be chosen by companies if they wish?	13	18	35	
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?	11	54	68	
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?	28	37	70	
6(b) For example are all or any of the following desirable for this purpose: a mandatory report on employee relations, supplier relations, customer relations, community relations, philanthropic activity and/or environmental performance, or more detailed changes to current reporting requirements, e.g. as to the disclosure of relationships and dependencies and of their value to the business?	10	19	31	
7 If a pluralist approach is adopted, should directors be permitted, or required, in takeover and merger cases, on behalf of the company to take action to meet the interests of employees, suppliers and others above those of shareholders where they believe it is justified, even if this damages the prospects of the bill or merger proposals?	13	41	57	
	<b>All</b>	<b>Some</b>	<b>None</b>	<b>Total</b>
8 What parts of any such proposals, mentioned in	16	16	20	58

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?				
	<b>No. in favour</b>	<b>No. against</b>	<b>No. commenting</b>	
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?	48	5	56	
10 (a) Is it agreed that it is not desirable to restrict access to limited liability?	38	5	46	
11(a) Should the current accounting exemptions for small and medium-sized companies be removed or amended?	42	4	52	
11(b) Do current exempt accounts provide proportionate, or any, protection to creditors, bearing in mind the costs of their preparation?	4	28	36	
11(c) Should such accounts be replaced by a different requirement, e.g. solvency certification?	8	29	40	
11(d) Would there be value in aligning tax and company law reporting requirements?	20	10	33	
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?	50	4	65	
14 If the integrated approach is favoured, what detailed provisions would be desirable for small and closely held companies:	20	6	30	
(a) an “opt-in” on formation?				
(b) a special “Table A”?	20	7	29	
(c) a broader elective regime and/or more flexible written resolution procedure?	24	5	31	
(d) special minority protections in such cases?	18	9	28	
	<b>No. in favour</b>	<b>No. against</b>	<b>No. commenting</b>	

15 (a) Should the distinction between a company's Memorandum and Articles be abolished?	52	9	63
15(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, together with the company's constitution in a single document?	40	7	48
15(c) Should the statutory declaration, which now accompanies documents for registration, be replaced by a formal statement of compliance, signed by the founder shareholders?	39	6	49
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?	31	19	53
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?	47	5	54
18 Should the requirement to have an objects clause in a company's constitution on formation be abolished (subject to question 24, below)?	48	11	60

	<b>No. in favour</b>	<b>No. against</b>	<b>No. commen ting</b>
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) (i.e. as in section 35A)?	40	6	48
20 Should existing companies be free to retain or remove their existing objects clauses 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	38	9	51
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 (including in any objects clause remaining in the Memorandum) or in a resolution, while not affecting the validity of a commitment entered into by the board or a person authorised by them?	49	2	53
22 Should constructive notice of, and the duty to enquire as to, limitations of authority in the company's constitution be abolished in full?	39	7	47
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?	39	5	47

	<b>No. in favour</b>	<b>No. against</b>	<b>No. commenting</b>
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 all 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?	32	7	44
25 Should the existing special minority protection in relation to amendments of objects clauses be abolished?	34	6	41
	<b>Insignificant</b>	<b>Significant</b>	<b>Total</b>
26 What is the significance of the amount of <u>share capital</u> (as opposed to net assets or other features of its financial performance) for decisions on whether to extend credit to a company ?	40	9	52
	<b>No. in favour</b>	<b>No. against</b>	<b>No. commenting</b>
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?	47	7	57
27(c) What is the case for and against requiring an auditor's certificate in relation to such a certificate of solvency?	21	13	41
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?	36	7	44
	<b>No. in favour</b>	<b>No. against</b>	<b>No. comment</b>

			<b>ting</b>
28(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?	34	4	38
29 If amendments to the Second Directive can be agreed to permit this, should the scheme in question 27 be extended to public companies?	32	8	43
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?	31	4	39
30(b) Are the Department's proposals for a de minimis provision and a special resolution "whitewash" provisions a better way forward?	15	13	29
31(a) If appropriate amendments to the Second Directive can be agreed, should the same regime be applied to public companies?	37	3	42
31(b) If not, should the Department's proposals, as set out in its consultative document be adopted?	14	10	25
32 Should both new public and private companies cease to be permitted to assign nominal values to their shares on formation?	36	17	53
33 If the Second Directive continues to require that shares of public companies are assigned either a nominal or an "accountable par" value (i.e. that the shares have attributed to them a fixed amount of the share capital reserve, with constraints on issues at a discount to this), is there value in taking advantage of the limited flexibility provided by the accountable par provisions of the Directive?	16	17	36

	<b>No. in favour</b>	<b>No. against</b>	<b>No. commenting</b>
34 (a) If nominal shares are abolished for any class of new companies should existing companies be required to convert their existing share capital and register the conversion?	3	20	25
34(b) Or should existing shares merely be deemed to be of no par value with consequential effects on the balance sheet?	11	11	22
34(c) Or should existing companies be permitted to choose between having nominal value shares and no par shares?	20	7	28
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 - i.e. that there should be a single reserve for share capital equal to the net proceeds of its issue - i.e. with no right to write of the expenses of an issue of debentures against this reserve?	36	1	37
36 If nominal value shares continue to be permitted, should the equivalent regime be applied to share capital and share premium accounts?	29	1	31
37 Is the broad analysis and approach in Chapter 5.6, 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 sanctions) correct?	37	11	63
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?	30	2	38

	<b>Nothing to suggest</b>	<b>Suggestion</b>	<b>No. commenting</b>
40(b) If not, what else should be included?	9	17	26
41 What proposals for change beyond those contemplated in this document are desirable in this context?	16	14	31
	<b>No. in favour</b>	<b>No. against</b>	<b>No. commenting</b>
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?	33	3	36
43 (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 the UK, analogous to clause 13 of the draft Limited Partnerships Bill?	5	14	21
44(a) Is it agreed that Part XXIII should be simplified?	29	-	30
	<b>align on branch registration</b>	<b>apply regime for branches</b>	<b>No commenting</b>
44 (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?	5	16	25

	<b>No. in favour</b>	<b>No. against</b>	<b>No. commenting</b>
44 (d) Would anything of value be lost by abandonment of the place of business registration requirement?	4	12	20
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?	14	7	23
46(a) Are consultees aware of significant harm in practice arising from compliance, or non-compliance, with Part XXIII rules?	2	17	22
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 via the Internet (World Wide Web)?	13	9	27
48 Are the material characteristics of the technologies and their relevance correctly described and assessed in paragraphs 5.7.1 to 10?	35	4	45
49 Are the objectives and principles proposed in this context correct and complete (paragraphs 5.7.11 and 12)?	39	2	50
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?	44	6	53
52(a) Are the main issues mention in Chapter 6 the important ones which further work on accounting and reporting should address, or are issues included which do not deserve attention, or excluded ,which do?	31	6	41

	<b>Mainly primary</b>	<b>Mainly secondary</b>	<b>Total commenting</b>
53(a) What form should the legislation to implement our proposals take, and what is the best distribution between primary and secondary legislation?	23	22	59
	<b>No. in favour</b>	<b>No. against</b>	<b>No. commenting</b>
54(a) Are new institutional arrangements desirable to ensure effective continuing reform?	18	7	26
54(b) Are the ideas mentioned in paragraph 8.12 (standing committee; obligation on the Secretary of State to report every five years to Parliament on the operation of the Act and the case for reform) of value?	39	5	47
55(a) Are the proposals to set up a new series of Working Groups to take forward key aspects of the Review set out in paragraph 9.4 acceptable?	43	7	50
55(b) Is the list of issues which it is proposed that these Groups should address, at Annex I, appropriate and complete?	28	10	42
56 (a) Is the proposed future research programme outlined in paragraph 9.9. appropriate?	22	7	32
56 (b) Should other issues be under consideration?	12	12	26
57 Are the other key tasks for the Review, identified in paragraph 9.11, appropriate?	25	0	29
58 Is the proposed outline timetable in paragraph 9.12 acceptable?	28	6	36

Notes:     excludes those questions that are not easily to statistical analysis  
\* - split equally between those advocating a mandatory and an optional approach

**ANNEX E: ATTACHMENTS TO RESPONSES NOT INCLUDED IN THE SUMMARY**

<b><u>Respondent</u></b>	<b><u>Attachment</u></b>
7	Outline History of Company Law, from Pennington's Company Law, 2nd edition, 1967, pp 5-11
9	Letter published in Journal of the Canadian Institute of Chartered Accountants, on disclosure requirements for private companies, May 1994
9	Letters published in the Financial Times on German disclosure requirements, September and October 1998
9	Paper on late creditor payment legislation
9	Article in Accountancy Age on AGMs, August 1996
9	Letter published in the Financial Times on ICI policies on selling businesses, 13 May 1999
11	Letter from correspondent to Disqualification Unit, Insolvency Service, 5 December 1998
11	Article published in the Economist, 20 March 1999, on Newscorp Investments British tax position
11	Extract from Report and Accounts for Wendover Underwriting Agency Ltd, 30 September 1993
37	Law Society's response to the Law Commissions on Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties
37	The Australian Company Director's Survival Kit
37	Law Society's response to the Financial Reporting Council on Financial Reporting and the Need for Better Regulation
43	Summary Report of MORI research study into small company audits
58	Comments on DTI Consultation Letter on possible changes to the Companies Act 1985 to facilitate electronic communication
63	Extracts from "Business Reporting: the Inevitable Change", ICAS, 1999

- 65 Making Multinationals Work for People: Briefing Paper by World Development Movement
- 83 Note: Role of the Stock Exchange as UK Listing Authority
- 90 Background note outlining the role of the International Underwriting Association
- 96 “Enforcement”, April 1999; BRTF publication
- 103 “Accounting for environmentally sustainable profits”, Rupert Howes, Management Accounting, Vol 77/1, January 1999
- 103 Forum for the Future, Annual Report 1999
- 119 Draft outline of Part I of a new Companies Act
- 133 “Corporate Governance Codes Misleading?”, Australian Company Secretary, 51:8, September 1999, Sydney
- 133 “Self-governance: a new agenda?”, Company Director, Australian Institute of Directors, 15:4, pp 26/29, May 1999, Sydney
- 133 “Should the law make Corporations Ethical?”, Australian Company Secretary, 51:7, pp 306-7, August 1999, Sydney
- 134 Interim Report of the Remit Working Party to the Financial Reporting Council