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1. The Company and its Incorporation

Chapter: **(p. 1)** 1. The Company and its Incorporation
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Introduction

A company is very easily defined.[1] It is the kind of legal entity or corporate body which is brought into being by the registration procedures laid down by the Companies Act 2006 (CA 2006) and its predecessors.[2] Its creation is evidenced by the issue of a certificate of incorporation by the Registrar of Companies. Except in a few rare cases the last word of its name will be 'Ltd' (Limited) or, in the case of a public company, the unpronounceable abbreviation 'plc' (public limited company).[3] In the United States, the word corresponding to company is 'corporation', and the corporation's name normally terminates in that word (Corpn) or 'Incorporated' (Inc), although 'Limited' is sometimes used there, too.

Companies are encountered everywhere. They provide most of the goods and services we use every day. They own large and small stores; run transport, telephone and communication systems; supply water and power; and run schools and hospitals. When thinking of companies, we usually think of large organisations, although 'one man companies' are perfectly possible.

What makes companies remarkable is that they are 'legal persons' in their own right, not simply groups of individuals working together in a common enterprise. In the study of company law, therefore, it is not only necessary to address the types of rules that enable groups of people to work together in an organisation, but also to address the rules that enable a non-human 'person' to perform a wide variety of acts for itself.

Companies in action: special attributes and key parties

Company law is about the interactions between a *company* (as a legal person in its own right), the company's *members* (and since most companies are limited by shares, these are generally its *shareholders*[4]), its *directors* and its *creditors* (both *secured* and *unsecured*).

(p. 2) The relevant law must provide rules to deal with the creation of companies; the ways companies deal with outsiders (eg how companies contract with their suppliers and customers, how they commit torts and crimes and how they sue and are sued, etc); how people come to be directors and shareholders; the powers and duties of directors and shareholders in their various relationships with the company, the creditors and each other; the regulation of disputes *within* these groups (eg how directors make decisions, how battles between majority and minority shareholders are resolved, how priorities between secured and unsecured creditors are determined); and, finally, how companies 'die', or cease to exist.

The key players in all of this are the directors and the members. The task of the directors is to manage the company (although what this means in practice is determined by the constitution of the company, which in turn is governed by the members). The directors generally act collectively, via a *board of directors*. The boards of directors in medium-sized and larger companies will typically comprise both *executive directors*, who are employed by the company and intimately involved in the day-to-day management of the company, and *non-executive directors* (NEDs), who are not so employed or intimately involved in day-to-day issues.

The members are not often closely involved in the day-to-day management of the company (unless they are also its directors), but they do exercise ultimate control over the company. They too act collectively, via the *general meeting*, usually (but not always) by majority vote. The members have the power to dismiss the directors and, often, the power to appoint them. The rights of members are essentially a matter of contract between the

members and the company (agreed in the company's constitutional documents, supplemented by any subsequent agreements).

If the company has shares, the members of the company are its shareholders. These shareholders provide '*equity funding*' to the company by way of paying for their shares (and can be contrasted with the *debt funding* provided by bank loans, etc). The rights that the shareholders receive in return are set out in the terms of the share issue. Generally there are rights to *vote*, to receive *dividends* out of the company's profits while the company is a going concern (*if* the directors recommend dividends), and to share in any surplus assets of the company (ie assets remaining after all of the company's creditors have been paid in full) when the company is *wound up*. There may be more than one *class* of shareholder, with different classes having different rights to vote or to receive particular financial benefits. All these matters are settled by agreement between the company and its shareholders.

Companies are used as vehicles for all sorts of activities. Typically, they are used for conducting business, from the small corner grocery store to the large multinational corporation. Companies are also used for running many non-profit ventures. Despite the varied size and function of companies, there are certain core features that are common to most companies. Two are of central significance: the *separate legal personality* of companies (ie a company is a separate legal person, distinct from its directors and its members), and the *limited liability* of its members.[5] Both of these features are dealt with in detail in the next chapter, but deserve a word of explanation here.

The fact that a company is a legal person in its own right is fundamental to the whole structure of company law. And yet there is no fanfare about this in the Act itself: all that CA 2006 s 7 says is that 'A company is formed under this Act by … [and then describes how a company is formed].' But the separate legal personality of the company ensures that *it* owns property, **(p. 3)** *it* contracts with third parties, *it* is owed duties by its directors, *it* makes constitutional commitments to its members, and so on. Crucially, this independence enables the company's business assets and liabilities (and attendant risks) to be segregated from the personal assets and liabilities of the company's members and directors. This partitioning of assets is crucial to the attractiveness of companies as commercial vehicles.

The limited liability of a company's members is related to the company's separate personality, but does not follow automatically from it (after all, it is possible to have companies whose members have *unlimited* liability (CA 2006 s 3(4))[6]). Where liability of members is limited, it is either limited 'by shares' to the price of the shares or 'by guarantee' to the commitment embodied in the guarantee.[7] What this means is that the company's liabilities to third parties can *only* be met out of the *company's* assets (including, of course, the company's receipts of the full share price and the benefit of the guarantees provided by members). The company's creditors cannot seek satisfaction from the company members personally, even if the company has insufficient funds to pay its own liabilities in full. Notice that although we typically use the shorthand expression that a company is a 'limited liability company', the *company's* liability is not in fact limited at all; only its members' liability is.[8]

Sources of company law

Registered companies can only be created because legislation permits it. That same legislation is also the primary source of the rules that govern the operation of companies. Most of the relevant provisions are now to be found within the 1,300 provisions and 16 Schedules of CA 2006. This Act received Royal Assent on 8 November 2006, and was then slowly introduced over almost three years, from January 2007 to October 2009.[9] In the transition phase, the relevant provisions from the predecessor Companies Acts 1985 and 1989 (CA 1985 and CA 1989) continued to govern. Now virtually every provision in CA 2006 is in force, and the Act is fully operational. It replaces CA 1985 and CA 1989, other than Parts 14 and 15 of CA 1985 (company investigations).

In addition to UK legislation in the form of the Companies Acts, companies are regulated by other statutes,[10] common law rules, European law (especially harmonisation Directives), and certain other special rules (eg the Listing Rules of the London Stock Exchange).

UK Companies Acts

CA 2006 (especially Parts 1 to 39) either restates or amends almost all of the provisions of CA 1985 and CA 1989, as well as the Companies (Audit, Investigations and Community Enterprise) Act 2004 (C(AICE)A 2004). The Act also codifies certain aspects of the case law, **(p. 4)** especially that relating to directors' duties. Note that CA 2006 s 2 defines 'the Companies Acts' (note the plural) to mean CA 2006 itself (but only the Parts specified in s 2(2)), and parts of other specified Acts that remain in force (s 2(1)(b) and (c)).

CA 2006 is the product of the most extensive revision of company law since 1856. It arises from a consultation carried out over seven years, from 1998 to 2005, by the Company Law Review (CLR), which was set up by the Department of Trade and Industry (DTI). That consultation was itself preceded by substantial work and two reports delivered by the Law Commissions on directors' duties and shareholder remedies.[11] (Note that the DTI no longer exists. Early in 2007 it became the Department for Business, Enterprise and Regulatory Reform (BERR), which in 2009 became the Department for Business, Innovation and Skills (BIS). Each change of name reflects a change in the functions undertaken by the department.)

The CLR produced eight substantial consultation documents, followed by a two-volume final report in 2001.[12] In response to this, in July 2002, the government published a two-volume White Paper, *Modernising Company Law* (Cm 5553), and then in March 2005, after another three years' work, a second and substantially revised White Paper, *Company Law Reform* (Cm 6456). The Company Law Reform Bill, which resulted from all this work, was introduced into the House of Lords in November 2005 and, as indicated earlier, received Royal Assent a year later in November 2006. It is reputedly the longest Bill ever considered by Parliament.

According to a BIS Consultation Report published in August 2010, the key policy objectives of CA 2006 include:[13]

- to enhance stakeholder engagement and a long-term investment culture (promoting wider participation, and ensuring decisions are based on a long-term view rather than immediate return);
- to ensure better regulation and a 'think small first' approach;
- to make it easier to set up and run a company.

Regulatory amendments to CA 2006

The process of major company law reform is considered later. But many provisions in CA 2006 give the Secretary of State the power to make any necessary regulations by statutory instrument. This is done, as specified, by either the '*affirmative resolution procedure*' (s 1290) or the '*negative resolution procedure*' (s 1289).

The affirmative procedure requires the proposed statutory instrument to be laid before Parliament and approved by both Houses; the negative procedure does not require this, but the regulations may be annulled by resolution of either House. The latter procedure is reserved for regulations that do not increase the burdens on the affected parties (eg regulations introducing exemptions from audit requirements), the former for cases where Parliament needs to retain greater control over the delegated amendment process.

(p. 5) History of legislative reform

The first Companies Act was passed in 1844. It was not concerned with the creation of companies per se: 'joint stock companies' already existed in considerable numbers, and had done so for over a century. This Act provided for the registration of the 'deed of settlement' of such companies (ie registration of their principal constitutional document). In return for registration, they were accorded corporate status (ie recognised by the law as entities in their own right). 'Joint stock' companies formed on the basis of a deed of settlement were different from the chartered corporations like the Hudson's Bay Company and the Bank of England, and different again from the statutory companies which sprang up in great numbers early in the nineteenth century to build the nation's railways and canals and docks.[14] They were outsized, unincorporated partnerships, running sometimes into hundreds of members, carefully set up by the skills of clever equity draftsmen so that large-scale ventures could be organised on the basis of a common fund or 'joint stock' pooled by the participants, and run by directors and managers for the benefit of all concerned. By 1844, they were too important to be ignored or outlawed and too unwieldy to fit at all easily into normal legal procedures such as litigation. The 1844 Act was the first step in giving these companies legal recognition.

A decade later, in 1855, a further Act was passed which allowed the shareholders who invested in a company to limit their liability; and a year after that a revised statute, the Joint Stock Companies Act 1856, established the framework for the modern-style company, incorporated by the process of registration and enjoying limited liability. The old 'deed of settlement' gave way to the 'memorandum and articles of association', which in the 2006 Act gave way to a simple one-document constitution, the 'articles'.

There have not been any paradigm shifts in either the institution of 'the company' or in the legislation dealing with it from 1856 to the present day. That also includes the 2006 Act: for all its welcome changes, it does not fundamentally alter the structure of the subject. Of course, Parliament has been busy in company affairs from time to time, passing, amending and consolidating Acts, each bigger than the last one. Until the recent review (noted earlier), the last fundamental reassessment of the subject took place at the time of the Crimean War.

CA 1985 and CA 1989 are the immediate predecessors of CA 2006. Parts of these Acts remained in force during the transition to full operation of CA 2006; indeed, some minor parts which were not re-enacted in CA 2006 are still operational.[15] The 1985 statute was the result of parliamentary efforts to make a fresh start by consolidating all the company-related statutory provisions that were then operative into one major Act, the Companies Act 1985, and three minor ones, the Company Securities (Insider Dealing) Act 1985,[16] the Company Directors Disqualification Act 1986 (CDDA 1986) and the Companies Consolidation (Consequential Provisions) Act 1985.

But this tidying up exercise achieved very little. CA 1985 (747 sections and 25 Schedules) did not survive intact for long. In the same year it was enacted, the Insolvency Act 1985 (now almost entirely repealed and replaced by the Insolvency Act 1986) superseded nearly a third of it with sweeping new provisions. Further changes were made by the Financial Services Act 1986 (itself now superseded by the Financial Services and Markets Act 2000), and by CA 1989 (again, a substantial piece of legislation containing 216 sections and 24 Schedules).

It is an unhappy fact that the volume of companies legislation almost quadrupled in the course of the 1980s. And the process continues. Even in the lead up to the reforms embodied in CA 2006, there was a steady flow of new measures. These included some reforms of considerable importance, such as the provisions which authorise the formation of single **(p. 6)** member companies ('Classifications based on size', p 22) and those which have introduced a new regime to regulate the issue of prospectuses inviting the public to invest in a company's shares ('Prospectuses', p 725).

This complexity creates its own risks. When the law is embodied in a number of different statutes, and especially when those statutes are long and complicated, there is a risk that parties will not be aware of the relevant rules. For example, in *British Racing Drivers' Club Ltd v Hextall Erskine and Co* [1996] 3 All ER 667 (Ch), over £2.8 million was awarded in damages against an experienced commercial lawyer who wrongly advised that it was not necessary for a company to obtain the approval of its members for a substantial property transaction (now see CA 2006 s 190 at 'Transactions with directors requiring the approval of members', p 414). And in *Brady v Brady* **[10.08]**, the lawyers did not appreciate which statutory provision was relevant to the case until it reached the House of Lords.

The Company Law Review (CLR)

In March 1998, the DTI commissioned a fundamental review of company law. An independent Steering Group led the CLR. Its terms of reference required it to consider how core company law could be modernised in order to provide a simple, efficient and cost-effective framework for British business in the twenty-first century.

The CLR presented its Final Report to the Secretary of State for Trade and Industry on 26 July 2001. This report contained a range of recommendations for substantive changes to many areas of company law, and a set of principles to guide the development of the law more generally. Most notably it proposed that the law should be as simple and as accessible as possible for smaller firms and their advisers and should avoid imposing unnecessary burdens on the ways companies operate (ie 'think small first'). See 'The process of company law reform', p 17. Many, but not all, of the provisions of CA 2006 implement CLR recommendations.

The most important documents produced as a result of the CLR law reform process are:

(i) White Paper, *Company Law Reform* (Cm 6456, March 2005);
(ii) White Paper, *Modernising Company Law* (Cm 5553-I and Cm 5553-II, July 2002);
(iii) DTI, *Modern Company Law for a Competitive Economy: Final Report* (URN 01/942 and 01/943, 2001).

These, and all the other consultation papers, are available on the BIS website.[17]

Case law

In all these years of reform, no Companies Act has ever been a complete code. Much of company law goes back to the days of the deed of settlement companies and the chartered and statutory corporations which flourished in earlier centuries. A great deal of the essence and spirit of the present company law is derived from this old case law rather than from anything in the Companies Acts themselves. Indeed, these Acts always assumed the existence of companies, and took for granted matters of everyday practice in company affairs, and the body of judicial precedent that has grown up over the years. The influence of these background **(p. 7)** factors has been remarkably persistent, even, sometimes, on matters where business circumstances today are quite different.

In addition to the principles of common law and equity that have evolved independently of statute (eg on directors' duties, although that has now been codified in CA 2006), there are of course many other rulings of the courts based on the Companies Acts themselves. These are sometimes on the literal wording of particular sections and sometimes on the broader interpretations of the general institutional framework that is established by the Acts (eg the 'maintenance of capital' rules ('Dividend distributions', pp 541ff)). In addition, there are decisions concerned with the interpretation of documents such as the company's constitutional documents or shareholders' resolutions of individual companies. Many of these are of a common or standard type (eg provisions in articles defining the functions of the board of directors, or the terms on which preference shares are issued) and so have significance for company law generally as well as for the parties in the case in question.

In some areas, practice is almost as important as the law itself. A student of English company law who did not know something of 'the City' and those bodies which have traditionally been self-regulating, such as the Stock Exchange, would gain only an imperfect impression of such matters as public issues of shares and takeover bids. It is true that the financial services legislation of 1986 and its successors have slowly put much of this regulation on a full statutory basis, but the older rules and practices of these various bodies remain instructive.

European law

There are many ways in which the UK's membership of the EU influences its company law. The objectives of the Treaty of Rome (now renamed as the Treaty on the Functioning of the European Union, under the Treaty of Lisbon) include the facilitating of trade and the removal of barriers to people's freedom to establish their businesses and invest their capital on a basis of equality throughout the EU. To this end, a programme for the 'harmonisation' of the domestic company laws of the member states was instituted. It seeks to remove the differences of detail between those local laws which might act as impediments to such equality. The Treaty expressly authorises and empowers its organs to issue '*Directives*' for this purpose.

These harmonisation Directives are referred to as the 'First Directive', 'Second Directive', and so on, in the order in which they were proposed by the Commission and then jointly approved by the Council and the European Parliament following Art 251 of the EC Treaty. Of the 13 proposals so far, the fifth and tenth have not yet been adopted, and the ninth has been withdrawn. In addition to these 13 company-specific Directives, there are of course other EU Directives which impact on company law issues.[18]

Directives

In principle, a Directive is binding only on the member state, which must implement it by its own legislation;[19] it does not immediately or directly affect individual companies or citizens as a 'source' of law. However, a number of rulings given by both the European Court and English courts have made inroads into this principle. In the first place, if a Directive has been implemented by domestic legislation, recourse may be had to the text of the Directive as an aid to resolve questions of statutory interpretation in relation to that legislation. This will normally require the court to give a 'purposive' rather than a restrictive construction to the statute or regulations in question,

in keeping with the usual approach of the European Court (*Litster v Forth Dry Dock and Engineering Co Ltd* [1990] 1 AC 546, HL).

(p. 8) Even where the local legislation does not itself implement a Directive, but merely covers similar ground, the European Court has ruled that it must be interpreted in the light of the wording and purpose of the Directive (*Marleasing SA v La Comercial Internacional de Alimentación SA* **[1.01]**), although not where this would distort the natural meaning of the legislation (*Duke v GEC Reliance Ltd* [1988] AC 618, HL).

And if a member state has implemented a Directive, or has failed to do so within the time limit fixed for implementation, the terms of the Directive may be relied on as against the member state itself or a government agency or public body. Thus, in *Karella v Ministry of Industry, Energy and Technology* **[1.02]**, it was held that an individual could invoke the Second EU Company Law Directive for the purpose of having legislation of the Greek Parliament declared unlawful.

By and large, the object of a Directive is to set *minimum* standards: there is ordinarily nothing to stop a member state from enacting legislation which goes further than the Directive prescribes. Thus, most of the provisions of the Second Company Law Directive are made to apply only to public companies, but under the UK legislation many of them were made to apply to private companies as well. And in *Siemens AG v Nold* [1997] 1 BCLC 291, the Court of Justice of the European Union held that it was in order for German law to give shareholders greater protection than was required by the Directive when a company makes an issue of new shares. Even when a Directive or proposed Directive is only in a draft stage, it may be important to know about it, since it may indicate the lines along which tomorrow's law is likely to develop.

Regulations

EU law may also be made by Regulations. A Regulation, in contrast to a Directive, has direct effect as part of the domestic law of each member state, although local legislation may be necessary to supplement a Regulation by, for instance, providing administrative facilities.

A Directive does not have direct effect so as to impose obligations on an individual. Domestic legislation of a member state must be interpreted so far as possible in the light of the wording and purpose of any relevant Directive.

[1.01] Marleasing SA v La Comercial Internacional de Alimentación SA [1992] 1 CMLR 305 (Court of Justice of the European Union)

Marleasing sued a number of companies, including La Comercial. It alleged, inter alia, that the formation of La Comercial was void because it had been formed for the purpose of defrauding the creditors of one of its founding shareholders. The Court ruled that even though this might have been a ground for declaring that a company's incorporation was a nullity under Spanish domestic law, it was not consistent with Art 11 of the First EU Company Law Directive, so that the defence could not be relied on.

The Court delivered the following judgment:

> … It is apparent from the grounds set out in the order for reference that Marleasing's primary claim, based on, ss 1261 and 1275 of the Spanish Civil Code, according to which contracts without cause or whose cause is unlawful have no legal effect, is for a declaration that the founders' contract establishing La Comercial is void on the ground that the establishment of the company lacked cause, was a sham transaction and was carried out in order to defraud the creditors of Barviesa SA, a co-founder of the defendant company. La Comercial contended that the action should be dismissed in its entirety on the ground, in particular, that Article 11 of Directive 68/151, which lists exhaustively the cases in which the nullity of a company may be ordered, does not include lack of cause amongst them.
>
> **(p. 9)** The national court observed that in accordance with Article 395 of the Act concerning the Conditions of Accession of Spain and the Portuguese Republic to the European Communities, the Kingdom of Spain was under an obligation to bring the directive into effect as from the date of accession, but that had still not