

Understanding Company Law

Second Edition



Alastair Hudson



Understanding Company Law

Understanding Company Law is a lively introduction to the key principles of the Companies Act 2006 and modern company law. It takes a unique approach to the subject, which also encompasses the important and growing fields of securities regulation, corporate governance and corporate social responsibility.

This book covers all of the key topics that a student reader will encounter in any company law course. The discussion presents the key principles simply, before guiding the reader through the more complex issues that are often the focus of examinations in this subject. It also offers pathways into further reading, while injecting enjoyment back into the topic.

In *Understanding Company Law*, Professor Hudson provides a straightforward guide to the law, while providing context, detailed analyses of the leading cases, and no little humour.

The second edition covers key recent changes and developments in company law, both case law and statutory, including: Two recent Supreme Court decisions on piercing the corporate veil, *VTB Capital plc v Nutritek International Corp* and *Prest v Petrodel Resources Limited*, and an analysis of the Conservative government's Green Paper on Corporate Governance.

Online support

Visit the author's website at www.alastairhudson.com to find podcasts of specially recorded lectures covering the basic principles and an audiobook version of this text.

Alastair Hudson, LLB LLM PhD FRSA FHEA, Barrister, Lincoln's Inn, is Head of School and Professor of Equity & Finance Law at the University of Strathclyde. He has been voted Law Teacher of the Year and is a National Teaching Fellow.



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Preface

A fresh approach to company law

A company is merely a device created by human minds to achieve identified goals: nothing can be understood unless that central fact is recognised. This is a book in which we will bring the technical rules to life. It is a book that is intended primarily to be used by university students seeking an overview of the subject before class, or seeking a guide through revision, or seeking some context within which to understand company law more generally (maybe to provide them with pathways into further reading). There is sufficient technical detail to satisfy professionals seeking a refresher or alternatively an introduction to the subject. Above all else this is a critical essay about the nature of company law in the modern world. It presents a theoretical analysis of the role of company law at the beginning of the 21st century.

This book is accompanied, as are all my books, by a series of podcasts that parallel an entire undergraduate course in company law on my website at: www.alastairhudson.com; just follow the links to the ‘company law’ area. There are also vidcasts hosted on that site, as well as advice on answering exam questions prepared originally for my students in the University of London, and podcasts and essays that probe into further issues.

New to this edition are discussions of the Supreme Court decisions in *Prest v Petrodel*, *VTB Capital v Nutritek* and *Jetivia v Bilt*; the 2016 UK Corporate Governance Code; the BHS collapse; the 2016 Green Paper on ‘Corporate Governance Reform’; and several other minor updates.

The scope of this book

Traditionally company law considers the legal nature of companies, the principal legislation governing the operation of companies, the regulations governing the ways in which companies raise capital, the rights of shareholders, and the duties of company directors. This book, however, extends beyond that traditional material to consider the role of corporate governance standards and the rapidly growing topic of corporate social responsibility.

We begin with a discussion of the history of the company and the development of the *Salomon* principle of separate legal personality. Aron Salomon was

a bootmaker in London's East End in the nineteenth century, and the litigation about the debts incurred by his business is the foundation stone for modern company law. In homage to that great case, there was a pair of boots on the cover of the first edition of this book. That case established the principle that a company is a distinct legal entity: something that has profound legal, commercial and moral ramifications that continue to be of huge significance in our global economy today. This principle is examined in Chapters 2 and 3.

Then the book explains how a company is structured, set up and run (Chapters 4 to 6). All the while, however, we shall be considering how companies are used in the modern world, and how company law theory tends to be locked into a narrow conception of the company. We will then spend a large proportion of our time considering the legal obligations of directors (Chapter 7) and the rights of shareholders (Chapter 8) – both of which are fascinating in terms of the differences between the decided cases, in terms of the recent development of the statutory principles and simply at the conceptual level.

In essence, I think that the interaction of directors and shareholders through the prism of 'the company as a distinct legal person' is the beating heart of company law. Consequently it forms a large part of this book. Related to those issues is the new vogue for studying corporate governance, which used to be considered to be outside company law but that has increased in importance in practice. Once we have considered the human dramas within companies between directors and shareholders, we turn to the organisation of the company's capital and its shares.

From there it is a short hop to the growing field of securities law, which governs the means by which large public companies raise capital so as to fund their activities. This is a very new, parallel dimension to mainstream company law and one that most of the company law books have yet to embrace fully. The securities field is part of a new zone in which companies are regulated by statutory and other bodies, which is considered in Chapter 11. More high finance is considered in Chapter 12 in relation to mergers and takeovers. When these issues of finance law are grafted onto traditional company law, we have to recognise that a new beast emerges. Having moved through the birth and life of companies, we come to the death of companies by means of corporate insolvency (Chapter 13) and the means by which outsiders recover (or do not recover) what they are owed.

To that extent, the book may seem to have moved from a contextual, historical discussion to a large amount of discussion of technical matters. However, these later chapters consider the company's place in the larger world, and its economic, political and ethical place in society more generally. The final chapters of the book consider corporate social responsibility head-on. This growing field (which is important now in the management and/or the public relations of large companies, depending on your view) relates particularly (but not exclusively) to the activities of larger companies and their effects on developing economies, their workforces and the environment. The final chapter then draws together much of the critique of company law that runs through this book like a seam of iron ore through rock. To

think properly about company law is to think about the whole of the modern world. It is a fascinating zone of engagement.

The writing of this book

I have written this book for anyone who is interested in company law. It covers all the key ideas that one might need to confront for a university course in company law. It does not pretend to be a full textbook, although most of the major cases, schools of thought and statutory provisions are considered here. I am a teacher and so what I will attempt to do is to teach you the key principles of company law in this book. All good teaching, however, must also seek to enthuse the learner, to open her mind, and to point out interesting paths through the thicket of ideas. So, what this book also tries to do is to encourage those with an interest in the subject to think about what company law is, how it relates to the rest of our law, and how it affects our world. If I can communicate a little of my enthusiasm for the subject to you, then I have achieved one of the key goals of this book. In my own mind, this book was intended to be a long, elegant essay on modern company law, and it has been a joy to write. In it, I have been able to meet lots of favourite ideas as though they were old friends. The first edition of this book was written at various times during 2009 and 2010, frequently late at night after the rigours of the day were over, before being finished in January 2011. The law is as I found it, and as it seemed to me, in the materials available to me in the autumn of 2016.

I would like to offer thanks to a number of people, in no particular order. To the good folk of Routledge Law who have produced the book that sits in your hands. To those who first lit a fire in me for this subject as a student: Harry Rajak and Eva Lomnicka; to Rebecca Long Bailey, John McDonnell and Danyal Arnold who relit that fire latterly. They bear no blame, however, for what has emerged between these covers. To colleagues and friends whose scholarship and camaraderie have contributed to this book enormously, possibly without them realising it: Pete Bailey, Helena Howe, Dawn Devenish, Andrea Lista, Geraint Thomas, and of course Huxley. Finally, to friends and family who have become used to (or possibly delighted in) my extended absences while I have tinkered away in my study. They help me to remember, as is the message in this book, that nothing is either good or bad, but rather thinking makes it so.

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Haywards Heath*



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Introduction

A company is a means to an end. It is an abstract legal device created by human minds. Companies are not found growing in fields, or hanging from trees, or swimming in rivers. They are not a part of nature. There is nothing ‘real’ about companies in that sense. Nothing can be understood about company law unless we recognise this.

Companies are the products of human minds and human ambitions

Everything that is said and written about companies and about company law is the product of human minds and human ingenuity. We choose to believe that companies exist because the law recognises them as existing and because they are convenient tools. They have become essential to the operation of modern capitalism. Companies are entirely artificial but they are nevertheless very useful in a number of contexts. The whole of company law has been brought into existence as part of our jurisprudence in the United Kingdom both to explain the operation of companies and also to regulate their activities. In this book I will suggest to you that the company device is an empty shell into which human beings pour their ambitions, their aspirations and their activities. There is nothing intrinsically good or bad about any particular company: instead it is a vessel into which capital and work is poured and a conduit through which human activities are carried on. Whether a company is used to achieve immoral ends or productive ends, to raise the common wealth in society or to plunder it, to provide a communal workplace for human beings or to shield assets from taxation, is entirely dependent on the motivations of the human beings who have called that company into existence. As Shakespeare said: nothing is either good or bad, but rather thinking makes it so.

While companies are artificial creations, they nevertheless seem to live

Companies are so much a part of our modern life that it is somewhat counterintuitive to think of them as being merely empty vessels. This is partly due to the fact that most of the companies that are household names are the owners of the

large brands that seem to people our high streets, our houses and our workplaces with their gaudy logos and exciting products every bit as much as the human beings who walk there. All companies whose names or logos we recognise will create an image in our minds. For example, when we think of the Nike Corporation, we probably think instinctively of their ‘swoosh’ logo and their sportswear products. Immediately, we will also have an association in our mind with that name and brand. Perhaps we will think of clean, minimalist stores full of training shoes, or healthy athletes competing on television, or concerns about the possible use of sweatshop labour in the manufacture of those products. What is important is that thinking of that company, the Nike Corporation, will automatically cause us to make an association with its brand. The success of the company’s advertising is precisely that we have come to associate that company with something immediate in our brain.

In consequence, companies can seem like living people because they create an association in our minds in the same way that the mention of a human being will also create an association in our minds: based on fondness or dislike or nostalgia or whatever. Companies have therefore come to occupy a particularly important emotional role in our societies. They are part of the warp and weft of life in developed and in developing countries. We should not think that sophisticated branding or corporate presence is solely the preserve of fashionable shopping districts. The global brands reach out to most parts of the world.

In some circumstances, however, people experience companies as their employers (with their letterheaded notepaper and logos), even if in other places they are experienced primarily as manufacturers or as shops or as service providers. The emotional interaction with companies that act as employers is a different one from an interaction based solely on being a consumer of their products. The workplace is a place that provides people with a living wage or community or a sense of self. Importantly, again, the company that acts as an employer stands for something incredibly significant in the human mind as though it actually existed as a distinct person.

Thinking calls companies into life, as though from a blank sheet of paper

Nevertheless, it is important to remember that the company is only a device into which we can pour effort, ideas and investment so that they help us to achieve our goals, to sell our products or to organise our affairs. A company is something that is created.

Imagine a blank piece of paper. With that piece of paper you could do a great many things. You could write a poem on it, or a love letter, or an essay; or you could plan the rest of your life and so keep that letter always around you; or you could write a grocery shopping list on it and discard it in a few hours; or you could write a revision timetable on it and gaze at it regularly in a mixture of fear and awe through the springtime leading up to your exams. The blank piece of

paper is a tool for you to use for an infinite number of different purposes. A company is very similar. It is a device that can be customised to suit an infinite number of purposes. A company can be created to be a vehicle for a multinational trading business, or it can be created to hold assets for an individual, or it can be used to operate a charity, or for any other lawful object. This company is in effect a blank piece of paper that can be used for an infinite number of purposes.

In English law a company is a legal person distinct from all other people in the world (*Salomon v A Salomon & Co Ltd* (1897)), as discussed in Chapter 2. That means a company can own its own property, it can make contracts and it can do almost everything in law that an adult human being can do. There are laws governing the way in which a company is brought into being and how it must be operated, but most of those laws provide that a constitutional document governing the company's activities (principally, the 'articles of association') is pre-eminent in deciding how the company is to be run formally. Much of company law restricts particular types of undesirable activity (many of which have their roots in frauds that occurred in previous ages). A large part of company law is concerned with companies providing all sorts of information to the public about their financial circumstances, their directors, their shareholders and so on, to minimise the possibility of fraud. Importantly, company law describes the limits on the liability of the human beings who invest in a company (the shareholders) in the event that the company goes into insolvency, so as to encourage people to invest in companies without fear that they are putting all of their personal wealth in jeopardy precisely because their personal liability as investors will be limited if the company should fail. These ideas are considered in detail in Chapters 1 through 6 of this book: for the moment, we only want to understand the big picture.

At the heart of much company law thinking is a person known as an 'entrepreneur': that is, an individual possessed of insight, energy or commercial acumen who wants to start up a business. A company protects entrepreneurs by limiting that entrepreneur's personal liability to a nominal amount if the business should fail. By offering an entrepreneur limited liability in the event that her business fails, it is hoped that we can encourage entrepreneurs to set up businesses, to take risks and to help our economy to remain vibrant.

That a company is treated by company law as being a legal person in its own right means that a company can create contracts and so on in a way that makes business dealings much more straightforward. Before there were companies with legal personality, it was necessary when creating a contract or transferring land to a business for all of the managers of the business (under partnership law, or agency law, or under trusts law) to be a party to the contract and for dealings to be very complex indeed. It was difficult from the outside to know how the business was organised internally between all of the various business partners. By creating the company, English law made it possible for outsiders to deal only with the company as a single entity, instead of those outsiders (that is, all of us) having to worry about the goings-on inside the company. With a modern company, a

contract can be signed on behalf of the company and can be enforceable against the company; property can be sold to a company and bought from a company directly. Furthermore, companies can also use novel ways of raising capital from the public by means of shares and bonds and so forth. All in all, the company offers a much more efficient and attractive way of doing business for commercial people. Company law grew up so as to formalise the ways in which companies were required to operate, as considered in the early chapters of this book.

Companies and the motivations for creating them

Nevertheless, in spite of all the detailed rules that we consider in this book, a company is still a blank sheet of paper on which human beings are able to design their perfect future. An entrepreneur wanting to create a business may choose to create a company because company law will limit her personal liability for any losses from her business to the amount of capital that she chooses to invest in the business herself. If she is lucky or skilful, she may manage to procure investment capital from banks or outside investors so that she has to risk very little of her own money. If the business fails and the company goes into insolvency, the entrepreneur can walk away with her personal property intact. Many captains of industry who are in business today have seen early businesses go into insolvency and they have merely come back to the market again and again with new business ideas until they have had success. This suggests that the company preserves the possibility of entrepreneurs making a success of themselves, whereas if their personal property had been at risk, they might have been ruined by their first business failure.

Alternatively it may make us think that there is potentially something immoral about our company law model if the entrepreneur may bear little or no risk (except for wounded pride) if her business goes into insolvency. We may think that there is ‘moral hazard’ here: that is, the possibility that people will take unconscionable risks in the management of their companies because they know that they bear little personal risk of loss. We might also be concerned about all of the third parties who traded with that company and who will never be paid what they are owed because the company went into insolvency, even though the entrepreneur is allowed to start up another business after the short period of forced inactivity that is required by insolvency law.

This fear about the ethical problems with limited liability for entrepreneurs may become heightened when we realise that companies are also used simply to hold assets and often to *hide* assets. Most companies in existence do not trade. Instead they exist solely to help organise people’s affairs. Suppose Myra owns property that she does not want other people, like Her Majesty’s Revenue & Customs, to know that she owns because it generates income on which higher rate tax would be payable. Because a company can own property, Myra could simply create a company and transfer this property to the company. If Myra retains control of the company by means of owning a majority of the shares in it, the outside world may

never realise her relationship to that property, but she will nevertheless be able to retain effective control over it by means of her shareholding. This is a very simple example of how people use companies to organise their affairs. The company that Myra sets up could be created in the UK so as to attract a lower rate of tax, or it could be even be established in another jurisdiction where no tax is payable.

It is possible, for example, for a company registered in low-tax jurisdictions like the Cayman Islands to own land and other property in the UK. The tax rules in these situations are too complex for us to consider in this book, but the possibility of manipulating those rules may be the reason for the creation of a company. The more we study company law and notice these things, the stranger that world will begin to seem. Importantly, however, we shall also notice that the potential uses of companies are almost endless.

However, to keep our story simple, let us suppose that the company is established in the UK. There is a legal requirement that shareholdings in companies established in the UK are registered with Companies House, and that the register can be consulted by anybody. Companies are also required to lodge accounts with Companies House. (These detailed rules are considered in Chapter 6.) Therefore, we might think that there is little practical concern about Myra's attempt to avoid tax, nor any risk of her managing to hoodwink her creditors because that register can always be searched. Myra's business creditors could also check up on the company. However, this registration requirement means that the outside world must act as detectives in all of their dealings with companies in that they are required to search the register at Companies House. It may be difficult to know who the controllers of the company are if, for example, Myra decides to conceal her involvement. She might use her friend Amanda as a clandestine holder of Myra's shares (possibly holding them on trust for Myra) and as a director of that company. Using Amanda as a director might be useful. Outsiders might not be able to guess that Amanda is acting as Myra's stooge. Amanda might be acting under an arrangement that does whatever Myra asks in return for a fee. The result would be that it would be very difficult to know that Myra was really in control of the company. (The Fourth Money Laundering Directive will require legislation in the UK to identify all of the 'beneficial owners' of shares in companies in this way.) If Myra was someone who had a bad reputation in business circles, then her involvement in the company might be important to potential trade creditors and to investors. In consequence, much of our company law is concerned with the sorts of information that must be made public so as to avoid fraud or sharp practice of this sort. Nevertheless, companies can clearly be used simply to achieve clandestine motives in the real world.

Before we get carried away with the idea that companies are only used for reprehensible purposes, we should remember that it need not always be like this. Companies can be formed for very positive social reasons. Most obviously in this regard, companies can be used as charities in England and Wales if they are operated for charitable purposes in the public benefit. Many companies operate businesses that make profits, which therefore pay taxes that fund important social

services, and that gainfully employ a large number of people. There are many who would say that operating companies for profit is in itself a good thing because that provides employment for the populace, and the profits they make mean more taxes are being paid, with the result that a virtuous circle of productive economic growth is created. Companies may pursue avowedly positive goals, like The Body Shop did when it began business in Brighton selling cosmetics that had not been tested on animals and that were made from natural products, as well as naked profiteering (whatever one may think of profiteering, naked or otherwise).

What company law does is to set out the template that companies must use to receive the support of the law. If the members of a company want the support of company law and all of its benefits, then they must follow the rules on the use and operation of companies. As a result, our company law will sometimes be concerned to prevent the abusive use of companies and it will sometimes be concerned simply to set out the formalities that must be performed for a company to be run lawfully. What company law is doing, therefore, is one of two things. Company law may be regulating the use of companies so as to prevent abuse – whether in the form of fraud or abuse of financial markets or whatever – or so as to provide means for compensation or redress for some wrong. Generally, however, what company law is doing is to provide us with a model. Like contract law or express trusts law, company law is saying, ‘if you organise your company in the following way, then the courts will enforce your rights, your contracts, and so on’. In that sense, company law offers us a template. Provided we obey the formal rules requiring that we register and operate our company appropriately, then the law has given us a template to use so that we can achieve our goals.

Creation, Frankenstein and the modern company

The analogy that I am going to use to describe this creation of a company in this book is that of Dr Frankenstein. Mary Shelley’s novel *Frankenstein* tells the story of Victor Frankenstein, a Genevese student, who discovered the ability to harness electricity so as to give life to inanimate body parts that he had sewn together into a travesty of a human body. What Frankenstein was trying to do was to create something artificially that would appear to act like a person. When we create a company, we are doing something similar. What a person is doing when creating a company is to create something artificially that would appear to act like a person. In English law a company is treated by company law as being a legal person in the same way that an adult human being is treated as being a legal person.

In the following passage from *Frankenstein*, the young chemistry student had just made a breakthrough when he realised that he could create life artificially so as to mimic ordinary life:

When I found so astonishing a power placed within my hands, I hesitated a long time concerning the manner in which I should employ it. Although

I possessed the capacity of bestowing animation, yet to prepare a frame for the reception of it, with all its intricacies of fibres, muscles, and veins, still remained a work of inconceivable difficulty and labour. I doubted at first whether I should attempt the creation of a being like myself, or one of simpler organisation; but my imagination was too much exalted by my first success to permit me to doubt of my ability to give life to an animal as complete and wonderful as a man. . . . I was encouraged to hope my present attempts would at least lay the foundations of future success.

I would suggest that creating a company gives us this exact same power. We can create anything our minds can imagine. Sometimes we may even create monsters. The company gives us great power thanks to our company law. The company can open a bank account, acquire land, employ human beings, create contracts with suppliers and buyers, and so on. While the company is a blank sheet of paper at the outset, once the company begins to conduct business, then the company *as a company* will appear to have a life of its own which is entirely separate from the human beings who have created it. The original human beings who began the company may die or they may sell the company to other people, but the company continues in existence ostensibly as though nothing had changed.

As I suggested earlier, we have emotional and automatic connections with companies very often in our daily lives whether as customers, employees or simply as people occupying the same lifeworld as those companies. In that sense the company exists separately because we as human beings interact with that company. Our reactions cause its existence. If we ignored Nike and their products, Nike would cease to exist. But the very fact that we have a reaction to the Nike brand and its products means that the Nike corporation exists: whether that is because we covet their trainers as birthday presents or even dislike people who wear their tracksuits as though they were fashionable leisurewear. Our company law causes these companies to exist also precisely because it grants companies legal rights (even human rights in our modern jurisprudence!) and so imposes obligations on the rest of us. Therefore, in that sense, *companies exist*.

Company law causes people to believe in something that cannot be seen or touched. People come to believe that companies own property and can create contracts and so forth because the law tells us that they do. In our modern economies it is the largest public companies that are typically considered to be the most significant actors. Like young Frankenstein, the creator of a company has great power in his hands. He dreams of 'future success' through his creation just as an entrepreneur dreams that a company will create future success for her. What is also important about the company is that it can be as simple or as complicated as the creator wants, just as Frankenstein imagines how complex he could make his creation and how much he could hope to achieve with it. Similarly, companies have been brought into being through the ages by enterprising commercial people to achieve particular goals.

The development of English company law

Company law is a tremendously enjoyable subject to study. Even though it is entirely the creation of human minds, it nevertheless feels very rooted in ‘the real world’ in the sense that it is the lifeblood of much commerce. We tend to think about commercial life with its phantom companies as being somehow very ‘real’. People who argue that we should get rid of this sort of capitalism are often derided for ‘not living in the real world’. Yet, there is no proper way of understanding how company *law* is the way that it is unless one understands its history, and you will only begin to understand company law if you recognise how *unreal* companies actually are.

Our modern company law is still based on historical forms of company. The legal ideas behind those early companies have transformed into the enormous corporations we recognise today. You could think of early company law as being a small cottage to which several large extensions have been added over the centuries so that the original cottage constitutes only a fraction of the total size of the building. There has never really been a revolution in the way companies are treated by the law. Instead there has simply been a series of very large extensions built onto the original structure. Company law developed to meet commercial circumstances throughout the twentieth century by means of a number of statutes culminating in the Companies Act 2006 (and many other pieces of legislation besides), which is the longest single statute in the UK. And yet, while that may sound daunting, company law operates on the basis of a few central principles and long-standing ideas.

In essence, as is discussed in the next chapter, companies began life as contracts between people who agreed to form a partnership and to employ other people to act as their trustees in the management of their business. From that seed grew the idea that investors in a company should only bear limited liability if the company were to fail (as opposed to open-ended personal liability to meet the company’s debts) and that the company should be seen as a separate legal person (in *Salomon v A Salomon & Co Ltd* (1897)). During the twentieth century, a large bureaucracy that had grown up around the administration of companies, the way in which they raise capital, and so forth, has led to more and more law being created to meet modern circumstances. However, that small cottage of traditional legal ideas remains at the heart of the enlarged building. Consequently, understanding the basic layout of the original concepts is essential to understanding the company law we have today.

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