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Thesis (L.L.M.) – University of Central Lancashire, 2004

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IDENTIFYING AND REMOVING POTENTIAL
AREAS OF DISPUTE AND RESOLVING CONFLICT
BETWEEN DIRECTORS AND SHAREHOLDERS IN
SMALL AND PRIVATE COMPANIES

by

By Christopher J. Smith F.C.A.

Christopher J. Smith F.C.A.

A dissertation submitted to the
University of Central Lancashire
in part satisfaction of the requirements
for the degree of LL.M
in the Department of Legal Studies

2004

*No portion of the work referred to in the dissertation
has been submitted in support
of an application for another degree or
qualification of this or any other university or
other institution of learning.*

University of Central Lancashire

Abstract

IDENTIFYING AND REMOVING POTENTIAL AREAS OF DISPUTE AND RESOLVING CONFLICT BETWEEN DIRECTORS AND SHAREHOLDERS IN SMALL AND PRIVATE COMPANIES

By Christopher J. Smith F.C.A.

The small private company faces considerable hurdles as it strives to survive in a competitive and often hostile environment. Large numbers are born each year and many, like the salmon fry, have the statistical expectation of an early death.

Whilst components such as capital base, marketing prowess, product ingenuity and service quality have their place in helping to sustain and grow these infants; the guiding hands provided by the key individuals of directors and shareholders, often fulfilling both roles in these entities, is paramount to their future success. Likewise these guiding hands can have an equally key role in their failure.

The essence and strength of the small private company lies in its ability to change rapidly both in the face of outside adversity and in the pursuit of new opportunity. Much of this ability is founded in the short chain of decision making, which typifies their management and ownership, vested in the directors and shareholders for whom continuing good communication is essential.

However, whilst the individuals controlling small private companies when working in concert may have the ability to successfully manage rapid change when faced with an outside adversity, this does not suggest that they are as adept at resolving adversity from within when discord arises, or setting the conditions which are required to minimise discordant effects on the company should these occur. Historically, this province has largely been set by the law.

The aim of this dissertation is to identify how the law has developed in areas which impact on the relationships between directors and shareholders given that it is the law which is primarily setting the criteria on which these relationships are based. The dissertation then seeks to identify what problems are required to be considered in new legislation and reviews the work carried out recently by the Company Law Review Steering Group, and the subsequent White Paper which addresses the contents of their final report.

The dissertation considers critically whether the CLR or the White Paper adequately address the problems identified, and whether they propose legislative amendments incorporating suitable solutions for those problems.

Concluding, the dissertation makes its own proposals for an alternative way forward which are considered to be more appropriate to the management, identification and removal of potential areas of dispute; and are more effective in the resolution of conflict between directors and shareholders in small and private companies.

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INTRODUCTION

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INTRODUCTION

As the 21st century unfolds the private company remains an embodiment of the egalitarian dream within our society. In which other way can small groups of people combine so easily and cheaply to enable themselves with status and dignity, or seek to fulfil many other significant human needs, whilst at the same time having the potential to earn a living and create wealth?

In the thirty years since qualification as a Chartered Accountant the author has worked in, and been associated with, many such companies in different capacities and remains firmly of the belief that private companies retain the capacity to deliver exceptional rewards to those who seek to participate in them.

Within those thirty years the author has gained perspectives on their operation from various standpoints including that of auditor, shareholder, director, company secretary and accountant. Added to these are other perspectives gained including those of promoter, expert witness, petitioner, respondent, litigant in person, and third party observer.

In witnessing at first hand the manner in which relationships evolve between shareholders and directors, together with insight into and experience of the particular stresses and strains individuals running these companies are exposed to, the author has profound concern as to the suitability of the methods employed by which disputes are sought to be avoided, and if unavoidable, how they are resolved.

Without exception it has been the author's experience that when a significant dispute arises, which cannot be readily resolved by the parties directly involved, the first course of action is to obtain advice from the legal profession. In all but one case this has resulted in the dispute escalating to the point of steps being taken down the litigation trail. In most of these cases the legal profession took an adversarial standpoint on behalf of their client and used techniques which sought to advantage their client with postured threat in order to gain a stronger relative position for them. In no case did a full trial of the issues take place, and matters were eventually

resolved in all cases by negotiation of the parties after considerable time delay and legal costs had been incurred. In some cases the companies involved did not survive the trauma.

With the motivation provided by these personal experiences the author embarked on a supervised research program in order to seek a better understanding of the issues and legal principles involved with a view, if possible, to suggest an alternative way forward. At this juncture an outline research project was formulated and submitted.

The adoption of discourse analysis as the research methodology proved a milestone from which followed a series of significant decisions, and the use of hermeneutics provided an intriguing background objective from which to consider content in order to enhance understanding.

Whilst still being able to follow the main outlines of the original research program the adoption of discourse analysis shifted the emphasis of the work to be undertaken and made more relevant the author's experiences. From that turning point the way forward was clear and no particular problems were encountered and broadly, the timetable once revised to incorporate this change, was achieved subject only to external constraints.

The primary research material gained through the lived experience provided the author with a considerable start-point in his quest and he considers himself fortunate that before embarking on his structured research the Company Law Review Steering Group delivered their final report to the Secretary of State, followed shortly thereafter by the Government's White Paper.

The decision of the author to rely heavily on these two secondary research materials helped to provide a research framework within which to follow the methodology adopted.

The Company Law Review was initiated by Government as a wide-ranging review of company law incorporating a significant consultation process. Additionally, the Review initiated its own empirical research and expert reports where it felt appropriate, and drew upon previous recent reports of authority on specific issues such as Law Reports. The entire documentation of this

process, together with responses to consultation, was published and available for analysis and critical review.

The secondary research material from both the Company Law Review and the White Paper is felt to represent most accurately the current state of affairs of the law in the UK, together with opinion formers' views as to its limitations, and reflect the direction in which the law is most likely to move forward.

It is considered by the author to have been an advantage to overlay the primary research of the lived experience onto this secondary research template in order to produce a work which it is hoped carries a degree of continuity which is readily understandable and in context, such that it carries the discourse a stage further forward. However, it is recognised that the use of secondary research material covering this subject area has limitations, not least because it is unlikely to have been primary research of those compiling it, nor subject to any large measure of first hand experiences of those persons. The overlay of the author's experience seeks to mitigate these limitations, and it is felt that it succeeds in this endeavour.

With this in mind the reader is now invited to form their own opinion as to the validity of the assumptions made, and review for themselves the conclusions drawn.

¹ A person carrying out the functions of director, by whatever name described. See also Chapter 1, 1.33, p.15 for further details of director and shadow director definitions.

² The Company Law Review Steering Group, 2001, *Modern Company Law for a Competitive Economy: Developing the Framework*, p. 24, 4.6 - The term also includes and covers any intermediate bodies for the purpose.

³ As defined by the number of members of the company. Companies, however, may not be ruled by other criteria such as a narrow, acute controlled or members of employees.

⁴ In which cases is stated in controlling directors and in which there are other substantial persons involved.

“ALMOST BY ACCIDENT” THE LAW DEVELOPS TO DATE

A précis of:

- the key principles of law involved,
- the rationale behind the development of the law,
- the current remedies available for the removal and resolution of conflicts.

1.1 Introduction

In detailing below the development of the law to date the author has regard to the specific criteria on which he has framed his area of research in so far as it attempts to:

- identify and remove potential areas of dispute, and
- resolve conflict between directors¹ and shareholders², limited within
- small³ and private companies⁴.

As this is the stated aim, the development of the law from the author's perspective shall only concern seeking out and identifying those aspects of the law which he believes will enable the discourse on this subject to be moved forward.

In setting the scene for this work it is worth going back only so far in time as is necessary to establish the birth of the current entity we call a private company.

¹ A person carrying out the functions of director, by whatever name described. See also Chapter 1, 1.23, p.10 for further details of director and shadow director definitions.

² The Company Law Review Steering Group, 2000, *Modern Company Law for a Competitive Economy: Developing the Framework*, p. 84, 4.6 - The term shareholder and member are interchangeable for this purpose.

³ As defined by the number of members of the company. Companies, however, may not be small by other criteria such as turnover, assets controlled or numbers of employees.

⁴ In which power is vested in controlling directors and in which there are often substantial minority interests.

“Until 1907, there was just one basic type of company under the Companies Acts”⁵ even though the term private company was used prior to this date⁶. These forerunner companies generally⁷ deriving their origins and or status from the Joint Stock Companies Acts of 1844 to 1900, and the Limited Liability Act of 1855, and it is to the Acts of 1844 and 1855 that we can reasonably refer as the origin of future companies’ legislation by statute.

The birth of the private company in 1907 was “almost by accident”⁸ as the focus then was on the public capital raising entities⁹ with the requirements of the small private concern¹⁰ being relegated to addenda. Passing time for the most part has not changed the direction of this focus until perhaps fairly recently when the small private company has become the object of public policy goals, and consequently gained an enhanced profile.

It is therefore worth making the point that for the first 60 or so years of incorporated life¹¹ the private company did not exist, and did not figure to any significant extent in the minds of those developing the law to that time, although some fundamental principles from that period of legal development still apply to private companies to this day¹².

In considering what law the small private company, together with its directors and members, are subject to requires both a review of current statute¹³ and a review of relevant case law authority.

However, much of this has already been considered in some depth by the Company Law Review Steering Group set up by the Government in 1998. The CLR produced its final report in

⁵ Farrar, J.H. et al., *Farrar's Company Law*, 1991, p.44.

⁶ Farrar, J.H. et al., *Farrar's Company Law*, 1991, p.528 - Re British Seamless Paper Box Co (1881) 17 Ch D 467 at 478, CA.

⁷ Excluding those companies set up by Royal Charter or under Act of Parliament for example.

⁸ Farrar, J.H. et al., *Farrar's Company Law*, 1991, p.44.

⁹ The Department of Trade and Industry, *Companies in 2002-2003*, 2003, p.38, Table A2 identifies 11,800 public companies on the GB companies register at 31st March 2003.

¹⁰ The Department of Trade and Industry, *Companies in 2002-2003*, 2003, p.38, Table A2 identifies 1,627,900 private companies on the GB companies register at 31st March 2003.

¹¹ Starting with those companies registered under C.A. 1844.

¹² See e.g. The rule in *Foss v Harbottle* (1843) 2 Hare 461 concerning the proper litigant of wrongs done to a company.

¹³ C.A. 1985, as amended.

July 2002¹⁴ and this was followed in July 2003 with the publication of the Government's initial White Paper comments and clause drafting¹⁵.

The work carried out by the CLR forms the core reference material for this thesis and from which analysis will be made¹⁶ in order to provide further objective comment on the issues arising and pertinent to the problems sought to be resolved in the final chapter of this thesis.

1.2 The key principles of law involved

1.2.1 - From the perspective of the company

The company is a separate legal entity¹⁷ in that it has a separate identity from its members and by law has rights given to it, and obligations to discharge, during its lifetime. It also has defined lawful purpose¹⁸, which it needs to fulfil and if it fails to fulfil that defined purpose to the satisfaction of either the law or its members¹⁹, then it will cease to exist as a separate legal entity and be wound up²⁰.

The company obtains its rights, fulfils its obligations and performs its purpose through the joint actions of its members and directors who are variously charged by law with carrying out those aspects of its functions required to be done by human intervention and action.

¹⁴ The Company Law Steering Group, 2001, *Modern Company Law for a Competitive Economy: Final Report Volume I & Final Report Volume II*.

¹⁵ The Secretary of State for Trade and Industry, 2002, *Modernising Company Law & Modernising Company Law – Draft Clauses*.

¹⁶ Chapter 3, p.36:64 charts the proposals and recommendations of the CLR in detail.

¹⁷ C.A. 1844, LXVI steered the way for this separation by establishing that execution of a judgement must first be made with due diligence against the property and effects of the company, before execution against a member if it remained unsatisfied by the company. This pre-dated the Limited Liability Act 1855 which removed this particular member liability, but see also the landmark case: *Salomon v Salomon & Co Ltd* [1897] A.C.22, H.L.

¹⁸ In the Memorandum through its objects clause. C.A. 1985, s.2(c) as amended.

¹⁹ Judged under a number of criteria and including the “just and equitable principle” Insolvency Act 1986, 122(1)g. See also *Ebrahimi v Westbourne Galleries Ltd* [1973] A.C. 360; [1972] 2 W.L.R. 1289; [1972] 2 All E.R. 492, H.L. dealing with loss of reasonable expectation.

²⁰ *Re Thomas Edward Brinsmead & Sons* [1897] 1 Ch. 45; 406 (C.A.).

Much of the law characterises the roles of director and of member as being separate and distinct. The directors are charged with the day to day management of the company²¹ whilst the shareholders are brought in by the law at mostly infrequent but regular intervals²² to discharge, usually in a formal setting, their statutory duties.

Interestingly “it would be constitutionally possible for the company in general meeting to exercise all the powers of the company”²³ and indeed until 1948 a private company was not required to have any directors²⁴.

In practice this is often what happens within a small private company without the formality of a general meeting being called. The distinctions between members’ roles and directors’ roles are blurred and indistinct and an outsider hearing a day to day discussion concerning the company’s affairs between these two parties might find it difficult to identify who was which. Factually, these discussions place little credence on formal titles in what is often essentially a partnership operation, fulfilled within the vehicle of a private limited company.

The wellbeing, continuing existence and development of the company therefore relies on two key propositions:

- the suitability of the law under which it exists, and
- the quality of the actions and decisions taken by its human participants, the control of which lies ultimately in the hands of the directors and shareholders.

It is interesting to note that the Companies Act defines a private company not as a purposeful entity in its own right, but as “a company that is not a public company”²⁵ and one wonders how the needs of a private company can be properly served by defining it in this way?

²¹ Table A art.70; C.A. 1985, s.35 and subject to s.36.

²² C.A. 1985, s.366 – The Annual General Meeting.

²³ Davis, P.L., *Gower’s Principles of Modern Company Law*, 1997, p.15.

²⁴ Davis, P.L., *Gower’s Principles of Modern Company Law*, 1997, p.17.

²⁵ C.A. 1985, s.1(3).

Further, it would be unreasonable to expect the small private company, given its defined limited resources, to be the major catalyst for change through the courts. Decisions of the courts, reliant as they are upon cases brought before them, are therefore weighted in favour of the more financially secure and larger companies willing to be litigants and therefore the most likely users of the courts' services. In this way the specific problems of large companies may well be adequately addressed, but they are not necessarily the same problems applicable to those of their smaller brethren, so may not provide a good precedent on later application to them.

1.22 - From the perspective of the shareholder

It is commonly considered by anecdote that the shareholder is concerned principally with monetary gain by virtue of a rise in the value of their share investment in the company together with the periodic receipt of dividends. This anecdotal surmise perhaps stems largely from the little or no involvement by the shareholders in the operation of the company until such time as things appear to go wrong, or do go wrong with their company.

It may well be the case that there is a fair degree of truth involved in this sentiment, at least where shareholders of public companies are concerned. However, the motivation of the shareholder in a small private company is different. There is no ready market for their shares and therefore they stand some way apart from their public company colleague.

The author would argue that if this is the general view of the small private company shareholder as being the largely silent bystander to the corporate regime it is largely:

- an effect of the evolution of corporate law to date,
- a throwback to the origins of corporate law,
- a continuing view which helps no one.

The relationship of shareholder to company is set out in statute²⁶ and reads:

“Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the memorandum and of the articles.”

And so this rather unusual contract, defining as it does the essential relationship between company and shareholder is often not a single document²⁷, that can be referred to with ease by a lay person, but is a combination of documents the contents of which are also capable of future amendment²⁸ producing even more documents through which to enquire.

This brings into existence a contract for all shareholders whether or not they were subscribers at the time of registration²⁹, or whether they become shareholders at some later date during the company's lifetime³⁰. A legal relationship is duly created by this contract, binding on the company and its members, and members between each other. This contract is the core element of the association of individuals (the company) who are prepared to introduce their capital and accept the risks involved all in the hope that their association will bear fruit at some unknown time in the future.

It is a contract, which will be shown later to be variable largely at the will of the majority, with a few costly to achieve exceptions. It is a contract with incredibly small ‘small print’ for the unwary as it currently stands and is interpreted.

²⁶ C.A. 1985, s.14(1).

²⁷ e.g. Where Table A is adopted and not incorporated but referred to.

²⁸ C.A. 1985, s.4 ; C.A. 1985, s.9.

²⁹ C.A. 1985, s.22(1).

³⁰ C.A. 1985, s.22(2).

This unusual contract goes somewhat further as it avoids drawing in as a party the final leg of the tripartite equation, namely the directors, who otherwise feature prominently within the contract documents and on whose actions and decisions the company (and shareholders as individuals) will be dependent upon.

The author reflects on the extent to which this contract in its entirety is ever read by the people to whom it relates prior to the time it is binding on them, or the extent to which they consider obtaining suitable advice before becoming party to it?

It is suggested by the author that the persons, to whom small corporate membership is now being widely encouraged by Government and others, may have skills and knowledge in areas dissimilar to those which will be required to adequately interpret the full meaning of these contractual complexities of form and language³¹.

1.23 - From the perspective of the director

Specifically the articles, being Table A³² unless otherwise amended, will by default provision provide for the management of the company to be carried out by the board of directors “who may exercise all the powers of the company”. Any amendment of the role and authority of directors within a particular company may be made by way of amendment to the memorandum, the articles, or directions given by members included in special resolutions³³.

The directors so appointed may, however, delegate their powers in accordance with both article 71 and 72 of Table A to other persons they may nominate should they so wish. This power is provided by statute (interestingly) without recourse at the time to the members.

³¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy*, 1998, p.8, 3.2.

³² Companies (Tables A to F) Regulations 1985, 1985 no 805,2, art 70.

³³ A special resolution is a resolution of members carried by three-fourths majority of those members voting, and where notice of 21 days has been given to members by the company of the meeting at which it is to be proposed.

So with relative clarity it is confirmed what the powers of the directors are, but this certainty is somewhat reduced as it only applies to companies registered post C.A. 1985. For older companies the retention of an earlier version of Table A, in force at the time they were incorporated, is allowed³⁴ and this includes companies formed under C.A. 1948 and previous Companies Acts, if applicable.

With less clarity is the definition of directors' duties established. Directors' duties are currently defined within a considerable volume of case rather than statute law and there is no statement by statute of what precisely these duties are, and to whom they are owed. The debate is ongoing to establish with more precision both elements³⁵.

Additional uncertainty currently exists in terms of who is to be regarded as a director. Clearly the persons properly registered on incorporation as directors, are directors, and those subsequently appointed in accordance with the terms of statute and the company's constitution are also directors, but the Act³⁶ envisages the situation where a person not known by the term 'director' may well, dependent on the facts, be classed as a director and therefore subject to those rules, principles and duties governing directors' acts (or indeed omissions). The Act³⁷ goes on to define a 'shadow director' for persons not formally recognised as being a director but who, under the terms of the definition, are to be regarded as such³⁸.

Suffice to say that the term director can encompass persons, including bodies corporate for the time being, who may or may not be persons strictly appointed by formal means, but may be appointed by their actions or the perceived response to their actions by others³⁹, as the court may subsequently judge.

³⁴ C.A. 1985, s.8(1).

³⁵ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, 1999, p. 126.

³⁶ C.A. 1985, s.741.

³⁷ C.A. 1985, s.741(2).

³⁸ See Chapter 1, p. 4, note 1.

³⁹ C.A. 1985, s.741(2).

A director is not precluded, by virtue only of the following, from also being a member of the company in which he serves as director. Nor is a member precluded from becoming a director, and frequently this dual role is still envisaged⁴⁰ but it is not now mandatory.

The Act of 1844 required a director to hold at least one share⁴¹ in the company, which of course at that time was an unlimited corporation and the members **were** personally responsible for its debts⁴². It was therefore of significant commercial expediency on the part of the other members for the directors to share their burden and be bound as members, so becoming potentially tied by personal liability to the fortunes or otherwise of the company. A not unreasonable pragmatic solution at the time but perhaps flawed in the precedent it set for the future?

1.3 The rationale behind the development of the law

In determining the rationale behind the development of the law it is essential to recognise that the law has tried to ascribe to this tripartite relationship between member, director and company, a role for each which will allow positions to be acted, power to be vested, and objectives to be fulfilled albeit on the basis that, as they apply to the private company, these roles have been created essentially from principles developed with the public company in mind, protection for the investing public a priority, and conceived in an age long gone. In summation a pedigree of compromise which subjects itself on the private company of today.

The separation⁴³ of roles, duties and power was rather implicit from the nature of the creations brought into being under the Act of 1844. This can be demonstrated with an analysis by type of the 910 companies registered under it from assent to 1856 and included: Insurance 219, Gas and Water utility 211, Markets and Public Halls 85, Shipping, 46 and Lending 41.⁴⁴ This suggests

⁴⁰ C.A. 1985, s.291(1).

⁴¹ C.A. 1844, XXVIII.

⁴² See Chapter 1, p.6, note 17.

⁴³ Excluding the requirement to hold at least one share as required by C.A. 1844, XXVIII.

⁴⁴ Farrar, J.H. et al., *Farrar's Company Law*, 1991, p.20.

little evidence of representation from small private businesses and indeed the contrary was the case, presumably fulfilling the expectation on the part of legislators⁴⁵.

Succeeding periods from 1862 to 1899 show total registrations aggregating to some 69,900⁴⁶ over half of which occurring in the period 1890 -1899 and we should be reasonably confident that the momentum for this increase was brought about by the benefits seen to be afforded from the Limited Liability Act of 1855.

In these early companies the need to establish boundaries and division of duties was paramount in order to avert further public scandal. Indeed the Select Committee of 1841 under the chair of Gladstone had as a remit “to enquire into the State of the Laws respecting Joint Stock Companies (except for Banking), with a view to the greater security of the Public”⁴⁷ and this primarily meant the investing public as members of these essentially large capital raising ventures.

One can see from the chart provided on the following page comparisons between the 1844 and 1985 Acts and how certain governance requirements remain to this day, for example:

⁴⁵ For instance in C.A. 1844 the definition of a Joint Stock Company “shall comprehend every partnership which at its formation, or by subsequent admission... shall consist of more than twenty-five members”.

⁴⁶ The Department of Trade and Industry, *Companies in 2002-2003*, 2003, Table A4.

⁴⁷ Farrar, J.H. et al., *Farrar's Company Law*, 1991, p.19.

Requirement	C.A. 1844	C.A. 1985
Making periodic returns of members details to the Registrar	XI	364
Requirement to file with the Registrar the company's constitution	VII	10
Requirement to hold periodic members meetings	XXVII(6)	366(1)
The requirement to appoint independent auditors	XXXVIII	384(1) ⁴⁸
The requirement to appoint directors	VII	282(1)
Directors' interests in contracts	XXIX	317 ⁴⁹
Defect in the appointment of a director	XXX	285
The filing of accounts with the Registrar	XLIV	241(3)

By contrast one can also identify governance issues that have been removed or had their effect diminished:

Requirement	C.A. 1844	C.A. 1985
The deed of settlement, and further amendments must contain a covenant of all shareholders individually	III ⁵⁰	14(1) ⁵¹
The requirement to appoint not less than three directors	XXV	282 ⁵²
The right of members to inspect the books of account of the company	XXXVII	No Right ⁵³
Contracts entered into by the company to be in writing	XLIV	36
The signing of cheques by two directors and the secretary	XLV	37

⁴⁸ C.A. 1985, s.388A provides appointment exemptions following audit exemptions provided by s. 249A et seq.

⁴⁹ The current provision requires disclosure to a meeting of directors, not to members as required by C.A.1844.

⁵⁰ C.A. 1844, III - "The Word 'Shareholder' to mean any Person entitled to a share in a Company, and who has executed the Deed of Settlement, or a Deed referring to it ..."

⁵¹ C.A. 1985, 14(1) - A deemed signatory for each member is assumed.

⁵² C.A. 1985, s.282 requires the appointment of at least two directors except for private companies who shall have at least one.

⁵³ Any such right that a company might provide would be required to be specifically included within the Articles by the members, but it is not given by statute specifically.

In addition to the foregoing comparisons and contrasts it is worth pointing out two further key and crucial matters which emanate from the former statute and have a significant bearing on the current discourse.

1. The Act of 1844, subject to its own regulations⁵⁴ and subject to any regulations contained in the Deed of Settlement, provided the right for every shareholder to sell and transfer their shares without any right of interference by the directors. The directors were merely required to “cause a Memorial of such Instrument of Transfer, when produced at the Office of the Company, to be entered into a Book to be called ‘The Register of Transfers’.”
2. The hypothesis that the intention of the 1844 Act was to create a professional management, known as directors⁵⁵, who would have no influential proprietary rights in the company⁵⁶, nor dual roles to cause conflict, and that this Act, whilst recognising that it did not seek to make these managers personally liable for their legitimate actions⁵⁷, nevertheless sought to increase governance of them by the legislatively simplistic route of requiring them to hold at least one share in the company⁵⁸. The share qualification nicely bringing them at that time **within the scope of unlimited personal liability**.

Under this hypothesis legislators were able to achieve an immediate goal of public policy which they seemingly failed to unravel eleven years later when it became otiose under the Limited Liability Act of 1855. Another accident?

⁵⁴ C.A. 1844, LIV.

⁵⁵ C.A. 1844, III “The Word ‘Directors’ to mean the Persons having the Direction, Conduct, Management, or Superintendence of the Affairs of a Company.”

⁵⁶ An alternative reason given by Lindley M.R. in *Re North Australian Territory Co*, Archer’s Case [1892] 1 Ch 322 at 337, CA. being (according to Farrar 1991, p.345) “that it ensures that management have a personal commitment to the company and its wellbeing.”

⁵⁷ C.A. 1844, XLV.

⁵⁸ C.A. 1844, XXVIII.

1.4 The current remedies available for the removal and resolution of disputes

Allowing a wide interpretation of the above, the current law acts on three levels to remove or resolve disputes by:

- providing a framework for information flow and discussion between shareholders and directors to take place,
- providing statutory relief for transgressions under the Companies Act, and
- providing recourse to the Courts.

1.41 - Providing a framework for information flow and discussion

Methods by which the current law tries to provide a framework can be seen from the following three examples:

1. C.A. 1985, s.366 (1) requires every company each year⁵⁹ to hold a general meeting as its annual general meeting. This general meeting of the company is a forum where discussion can take place and questions can be raised by members to the directors.
2. C.A. 1985, s.368 (1) (and subject to (2)) aligns with the above a statutory power enabling members to requisition a general meeting of the company. This provision in practice would generally apply under s.368(2a) from members with not less than one-tenth of the paid-up capital of the company carrying the right to vote at general meetings at the time. This power consequently removes a route to discussion of a smaller minority.
3. C.A. 1985, s.241(1) requires the directors, in respect of each financial year, to lay before the company in general meeting copies of the accounts of the company and s.241(2) requires the reading out of the auditors' report (on those accounts) and for it to be available for inspection by the members at that meeting.

⁵⁹ C.A. 1985, s.366(2) details the allowed exemption.

The laying and delivery⁶⁰ of accounts is required to be done within 10 months of the ending of the company's relevant accounting reference period, but the requirement of a company to appoint auditors and have an audit conducted on its financial statements need no longer apply to small private companies⁶¹. However power is reserved⁶² for the appointment of auditors where a single member or member group so wishes, subject to that section's qualifying provisions.

As can be seen from the above, information in the form of the accounts⁶³ in specified format⁶⁴ is required but this information is less than is provided to H.M. Inspector of Taxes to determine the annual burden (if any) of corporation tax liability of the company⁶⁵! Should the needs of the owners be subordinated in this manner?

Whilst a limited forum for discussion is available, the ability of the members to obtain documentation from the company is severely restricted⁶⁶, and severely restricts any ability they may have to properly hold an authoritative discussion on the company's business. Generally, the ability to obtain documents on which sensible discussion can be based arbitrarily rests on the directors' goodwill towards the respective request. In as far as this is true, it would perhaps seem unusual (or incompetent) for such a release of documentation to be made where valid criticism exists directed towards the controlling interests!

As can be seen from example 3, the members do have the right to receive copies of the company's financial statements, but this can be up to 10 months following the financial period

⁶⁰ to the Company Registrar at Companies House.

⁶¹ C.A. 1985, s.388A - the appointment of auditors; C.A. 1985, s.249A - exemption from audit.

⁶² C.A. 1985, s.248B(2).

⁶³ A Profit and Loss account and a Balance Sheet.

⁶⁴ C.A. 1985, s.227.

⁶⁵ A significantly more detailed profit and loss account is required by HMI for example.

⁶⁶ C.A. 1844, XXXVII allowed members the inspection of the books of account of the company. C.A. 1844, XXXIII allows the members at "all reasonable times" to inspect the books of proceedings (minute books), including those of the directors subject to provisions in the deed of settlement. No such power is afforded to them now and such matters remain secret.

end⁶⁷. It is difficult to see how meaningful discussion can take place on these documents at that stage, or without knowledge of the considerable judgements⁶⁸ that may have been made in preparing them, but which are not disclosed within or with them.

1.42 - Providing statutory relief for transgressions

Of the above instances exemplified the following statutory remedies are available:

- C.A. 1985, s.366(4) “the company and every officer of it who is in default is liable to a fine.”
- C.A. 1985, s.368(6) allows for the “reasonable expenses” of the meeting requisitionists to be repaid by the company to them, and for those sums to be retained by the company out of sums due to the directors in respect of their services.
- C.A. 1985, s.243(1) provides for a fine to be levied on a director found guilty of an offence and (4) for fines to be levied against the company where the default is in respect of the requirements to deliver accounts to the registrar in accordance with s.241(3).

These remedies are, in the author’s experience, largely illusory⁶⁹ except in the instance of C.A. 1985, s.242(2) where the agency⁷⁰ currently responsible has developed a computerised system to ensure compliance and levy the appropriate fine. This punishment selectivity may stem more from the identification of a useful revenue source at low administrative cost, rather than a more altruistic reason.

⁶⁷ Even though under C.A. 1985, s.221 companies are required to keep accounting records that (1) “disclose with reasonable accuracy, at any time, the financial position of the company at that time, and (2) enable the directors to ensure that any balance sheet and profit and loss account prepared under this Part comply with the requirements of this Act as to form and content of company accounts.”

⁶⁸ Controlled as they are within various accounting concepts and conventions such as “historical cost” for example.

⁶⁹ Details of the prosecutions brought and convictions gained under C.A. 1985, s.242(1) and (2), and C.A. 1985, s.363(3) and (4) for the periods from 1998-99 to 2002-2003 are published in The Department of Trade and Industry, *Companies in 2002-2003*, 2003, p.51, Table D3.

⁷⁰ Companies House.

1.43 - Providing recourse to the courts

Ultimately, should a conflict prove incapable of resolution by other means, statute provides an aggrieved shareholder remedy through the court. This remedy is normally commenced under either of the following:

- application of a member by petition to the court under the grounds envisaged in C.A. 1985, s.459 "that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of some part of the members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial."
- by a member by petition under the Insolvency Act 1986, s.122(1)g for the winding up of the company on the grounds that it is "just and equitable"⁷¹ for the court to so do.

In the former example the court, finding in favour of the petitioner shareholder, has wide discretion in the exercise of its powers⁷² which contrasts with its limited power of remedy under the latter example where it is only able to order the winding up of the company⁷³.

Further discussion in the use of these court strategies will, the reader is assured, later show how inappropriate they are deemed to be in relation to the needs of resolving conflict between shareholders and directors of small private companies.

⁷¹ Origin - Partnership Act 1890, s.35 per Lord Wilberforce. See also Chapter 1, p.6, note 19.
⁷² C.A. 1985, s.461(1) provides power for the court to make such orders as it think fit whilst s.461(2) details a selection of examples.
⁷³ Colloquially speaking: Killing the goose which lays the golden egg.

1.5 Conclusion

In this brief outline the author has sought to provide the reader with a general feel for the current legal position without developing at this stage any argument for or against the measures evolved through the years by statute and court decision.

As will be argued later during the course of this thesis the fundamental premise on which the current statute law is framed is insufficiently focused towards providing suitable remedies applicable to the small private company where much of the rationale for its being is based on informality of operating structure, close personal and or working relationship of its directors and members, and the need to speedily obviate discord between these parties.

Bearing the above in mind, it is perhaps worth considering the scope of the “just and equitable” principle envisaged by Lord Wilberforce⁷⁴ and ask how statute could further embrace this principle to greater effect in future legislation concerning the small private company?

When looking at the data available from the DTI two particular raw statistics suggest all is not well:

- 1.24 m. companies in England & Wales had an issued share capital of £100 or less⁷⁵,
- the average age of companies on the GB register is only 9.5 years⁷⁶.

And these statistics might raise the following questions:

1. Why do shareholders commit so little financial resource to their company’s formal capital base?
2. How is the relative lack of corporate longevity impacting on overall economic performance to the detriment of public policy goals?

⁷⁴ *Ebrahimi v Westbourne Galleries Ltd* [1973] A.C. 360; [1972 2 W.L.R. 1289; [1972] 2 All E.R. 492, H.L.

⁷⁵ The Department of Trade and Industry, *Companies in 2002-2003*, 2003, p. 41.

⁷⁶ The Department of Trade and Industry, *Companies in 2002-2003*, 2003, p. 40.

3. Are these two simple statistics an indication of a flawed corporate model for which the key to improvement is legislative action bringing about change in the way the relationship between shareholders and directors is viewed, and then managed by the law?

Whether or not the birth of the private company was indeed "almost by accident" is poor reason to perpetuate inadequate legal solutions to the problems the author has identified in the following chapter; and the early years of the 21st century suggest global competition has little respect for perpetual inadequacies, nor jurisdictional confines should those inadequacies persist.

IN THE CAULDRON OF CORPORATE PROXIMITY THERE EXISTS PROBLEMS

2.1 Introduction

When attempting to define the problems and provide a synopsis of those problems, it is perhaps worth revisiting the type of organisation to which this work refers. It is the small private company as defined in the introduction to Chapter 1.

It is the company which is small with regard to the number of shareholders; and private because power typically is vested in controlling directors. It is specifically companies which have minority shareholder interests which therefore excludes single member companies¹.

The author believes it is particularly important to understand this definition and for the reader to grasp that it applies to a corporate stock of some considerable significance².

The author further believes that it is paramount to recognise the typical nature of these companies and how they essentially differ from larger companies outside the above definition. He feels the reader needs to be able to envisage the implications for shareholders and directors³ running these companies in the day to day realities of the commercial world, and from that standpoint be in a position to empathise with the participants involved.

¹ The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p221, 6.8 & 6.9: In its research the CLR defines the majority of companies within the definition applicable to this work. Of the survey sample 79% (582,724) of companies have at least one minority shareholder. The base data for this calculation is contained in its commissioned report: I.C.C. Information Ltd, 2000, *Account of ICC Report*, Table 1 and applies to companies as of 9th July 1999.

² The I.C.C. report referred to in Chapter 2, p.22, note 1 also provides details of these companies in terms of net asset size and turnover. I.C.C. Information Ltd, *Account of ICC Report*, 2000, Tables 2 & 3.

³ Remembering shareholders and directors are often one and the same individuals.

2.2 Throwbacks to the accident of birth

2.21 - Scope: The shy, unremarkable, retiring face of the body corporate

Although the author has provided a definition of the type of company to which he refers this definition is unfortunately flawed and imprecise. The difficulty revolves around the use of the word "small" and whilst he has used it in the context of the number of shareholders involved it is also used variously to signify the number of employees involved, the amount of assets controlled, and the volume of turnover generated to give some examples of the diversity in which this word is used. The confusion this creates is highlighted in the critique contained in Chapter 5, and a solution to this dilemma is proposed in Chapter 6.

However, for the moment this is not critical in assessing the broad scope of companies to which this work refers and acknowledging that defects in the law and its capacity to deliver suitable solutions will impact adversely on a very 'large' number of individuals and wealth creating companies⁴. It could be very well argued that these are the unremarkable companies in every neighbourhood who attract little publicity whilst conducting their affairs.

The use of the word 'small' does however have another unfortunate side effect in that it also conveys the derogatory meaning of being insignificant, and perhaps unworthy through lack of size.

Whilst this might sound trite it should be remembered that this discourse is taking place because "...the Act is largely structured around the needs of large public companies. It assumes a separation of ownership (the shareholders) and control (the directors), putting in place formal mechanisms to ensure that shareholders can call directors to account"⁵, and as outlined in

⁴ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 1999, p.423, Annex D, notes 2 & 3: Approximately 1.01 million companies have 9 or less employees. Only approx. 7,000 companies have more than 250 employees. Only 12,000 companies on the 1997/98 Companies House register are public limited companies.

⁵ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.221, 6.10.

Chapter 1, the Act⁶ to which the above quotation refers is in fact only following the same basic legislative threads that previous Acts going back into the nineteenth century first established.

It is therefore suggested that this belated acknowledgment cannot be considered a ringing endorsement for the early recognition of the differences between 'small' private and large public companies. Indeed no such assumptions are valid in relation to separation, and perhaps this does illustrate how our use of language can distort our views regarding worth.

2.22 - Misconceptions: Lifting the veil from the cauldron

Taking the argument outlined above a stage further it is felt important here to ensure there is adequate understanding of what it means to be 'small' and its use will continue in order to avoid any further confusion.

The small private company is far removed from the environment of the Stock Exchange listing with its day to day market for shares, or the variance analysis of departmental budgetary control prepared by the corporate accounting function, or the lunch in the directors' dining room, or even the relative certainty of knowing that employees' salary cheques will be paid on time at the month end.

Instead we are in the environment of fire-fighting⁷, multi-tasking⁸, extreme cash control⁹, customer complaints and supplier 'stopped'¹⁰ accounts. These are all just part of the day to day ritual of the small company's business reality, and it can be a culture shock to the unknowing. It

⁶ C.A. 1985 as amended.

⁷ e.g. Re-arranging production schedules when an employee (representing a fifth of the total company workforce) phones in sick.

⁸ e.g. *Completing the period VAT return, whilst taking customer calls, and chasing a late supplier delivery.*

⁹ e.g. Re-calculating the company's supplier payment priorities in order to balance cash resources to fund the payroll.

¹⁰ i.e. The suspension of deliveries by a supplier for non-payment of a credit account. The account is said to be 'On Stop'.

is an even bigger shock to realise these small business entities are now seen as the foundation of our UK economic welfare, and on which much more is expected in the future¹¹.

Of course all businesses are subject to irritations to a greater or lesser degree whilst engaged in their profitable¹² pursuit, but the difference for the small private company is that overcoming these irritants is invariably the day to day workload of the directors, perhaps with the sword of Damocles¹³ hovering over them and skewing their judgement.

Consider now the shareholder. Anecdote might have us believe that these are sophisticated corporate animals with an eye to maximizing yield¹⁴ or growth¹⁵ on their invested capital; ready, at the drop of a hat, to move their funds into new ventures identified as more appealing.

Unfortunately our anecdotal shareholder does not ordinarily exist within the Register of Members of the small private company¹⁶. Instead the small company shareholder is more typically looking at their investment over the long term¹⁷ as a means of securing employment in later years perhaps, or trying to realise a personal ambition of ownership and management, or a combination of any number of other reasons believed valid by them prior to making their investment¹⁸.

¹¹ The Company Law Steering Group, *Company Law for a Competitive Economy: The Strategic Framework*, 1999, p.14, 2.19; p.56, 5.2.2 outlines the importance of small companies and provides further statistical evidence of their significant role in job creation and overall UK economic activity.

¹² There is no given right to profitability and these irritants apply even more so when trading at a loss. The I.C.C. Company Shareholders database, *Account of ICC Report*, 2000, Table 2 provides details of companies with negative net assets to affirm the point.

¹³ Personal guarantees on company bank or other loans, or a second mortgage on the family home, are often required from directors to secure borrowings used by their companies.

¹⁴ The return on capital invested.

¹⁵ The amount an investment will increase in value.

¹⁶ Not least because they know their investment cannot be easily realised.

¹⁷ The Department of Trade and Industry, *Companies in 2002-2003*, 2003, p.40, Table A5 gives an average life expectancy of only 9.5 years for all companies on the register at 31st March 2003.

¹⁸ The investment is not necessarily limited to share ownership but may include providing loan capital and unpaid working involvement in the company's affairs.

Legislation and the Courts have, to a degree, recognised the need to treat small private companies as essentially different from their plc. counterpart. Recognising to an extent their often quasi-partnership nature, where ownership and management are in the hands of a very small group of people, and where the boundaries and formalities (the law has created) between ownership and management are often blurred, interchangeable, and largely ignored¹⁹.

From the foregoing it is hoped that those without intimate knowledge of the workings within small private companies will at least recognise the lack of institutionalization associated with them and begin to empathise with the culture surrounding the individuals driving them.

Additionally, it is hoped they will also recognise the degree to which those individuals involved directly in small private companies are reliant upon each other to perform tasks directly affecting corporate success, the capacity this has to affect personal relationships between them, and the informality it both requires and breeds.

The misconceptions also relate to the peculiar dynamics of the human relationships which can exist within the cauldron of corporate proximity these companies generate, and it is only when there is insight into and understanding of the world of these small private companies that we become more likely to appreciate the problems to which this chapter refers, and which the law needs to now adequately address²⁰.

¹⁹ The Department of Trade and Industry, *Companies in 2002-2003*, 2003, Table F4: provides an indication as 146,961 private companies received civil penalties totalling £31.48 m. for contravention of C.A. 1985, s.242A (failure to file accounts on time). See also The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, p.24, 2.5 which describes the reasons for non-compliance.

²⁰ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, 1999, p.14, 2.19 states "Company law, however, makes little attempt to respond to the peculiar needs of small firms, either in accessibility and simplicity of operation or in substantive provision."

2.3 Potential areas of dispute

2.31 - Outline

The CLR in its wide-ranging review of company law addresses in detail the areas of law creating the problems required to be tackled. Their detailed proposals and solutions are charted in Chapter 3 of this work, with solutions adopted or amendments proposed by Government contained in Chapter 4. It is not proposed here to repeat in detail those matters addressed elsewhere, rather it is here that the author seeks to set the scene for an approach which he believes is capable of delivering law and process applicable to the identification and removal of potential areas of dispute, and laying the foundations for resolving conflict once they arise.

The problems are well known, it is the mind-set required to produce appropriate pragmatic solutions which have eluded us legislatively so far.

There is a certain inevitability of disputes arising in any human interactivity ongoing over more than the short term. The small private company, like a marriage, lends itself to intensity of feeling where human frailties and strengths manifest themselves easily. Like a marriage heading for divorce; the ability to disengage from a dispute however arising becomes ever more difficult as the parties consolidate their respective polarising positions. So it can be with the relationship between directors and shareholders of small private companies, as emotions begin to run counter to common sense, and further stoke the corporate cauldron.

It is argued here that the concern of law makers, as it applies to this thesis topic, should be directed towards encouraging the best attributes of human entrepreneurial²¹ spirit whilst at the same time recognising how that very risk-taking ethos, likely to be present in both shareholder and director, can manifest itself in less beneficial forms of behaviour generally, and particularly in times of dispute. The law should not add fuel to this fire.

²¹ The Concise Oxford Dictionary 2002 defines an Entrepreneur as – “a person who sets up a business or businesses, taking on greater than normal financial risks in order to do so.”

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When seeking to identify the problems required to be tackled by legislation and the courts it is suggested the answers may well lie within the following:

- Exercise of power,
- Unfairness,
- Unreasonableness,
- Injustice,
- Misunderstanding,
- Bad Luck.

It will be noted that much of the above is subjective in nature, and relates to the expression of human feeling. It should also be noted that each item listed does not necessarily arise by itself. Unreasonableness can lead to injustice, misunderstanding can lead to unfairness. Exercise of power can result in unfairness, unreasonableness and injustice. The matrix is infinite when degrees of cause and effect are brought into account and all the above could equally be seen as reasons put forward by parties to a divorce. Indeed one can readily envisage the conversations between client and attorney charting the alleged unreasonableness, unfairness, broken promises and general injustices metered out by the other party whether they were describing their experiences as a shareholder, or as a wife²².

2.32 - Exercise of power

Within the corporate structure, power is exercised by both directors and shareholders. The law formally seeks to ascribe to each how and when the given powers are exercised by laying down duties to be adhered to, and responsibilities to be discharged. Over the years it has sought to achieve this by a mixture of revisions to statute, and development of law by the courts²³.

²² The terms shareholder and director, wife and husband, are equally interchangeable.

²³ Chapter 1, p.4 to 21 previously describes some of the main developments that have occurred.

However, within the informality of the small private company it is the power exercised on a day to day basis within real human relationships²⁴ which provides a likely route to discord coupled with the interchange of roles each party may have as they switch between acting in their capacity as shareholder, and alternatively director.

The potential problems this role switching creates can be identified as:

- Are the powers given to directors recognised and understood?
- Are the powers given to shareholders recognised and understood?
- Are there adequate sanctions against abuse and are they effective?
- Is the ongoing balance of power subject to change and if so how can that change be successfully managed?

2.33 - Unfairness

Having regard to the informal entrepreneurial culture within small private companies and the dependency they have for their success on good working relationships between key individuals:

- Does the law deal fairly with each party?
- If the law is fair, is it transparent?
- Do directors and shareholders consider the law to be fair and applied fairly?

2.34 - Unreasonableness

Again, having regard to the culture within small private companies:

- What mechanisms are in place to ensure continuing reasonableness?
- Where unreasonableness is encountered what mechanisms does the law provide to negate its effect?

²⁴ The author seeks here to convey that actions are frequently taken in a face to face environment between directors and shareholders i.e. people with known differing objectives.

2.35 - Injustice

Recognising the likely capacity²⁵ of the parties involved in small companies:

- Does the law provide cost effective solutions to resolve disputes?
- Does the law provide, so far as it can, a level playing field for all parties?
- Does the law adequately enable equitable pragmatic solutions?

2.36 - Misunderstanding

Again, recognising the capacity of the parties involved:

- Does the law act to reduce complication and avoid misunderstanding?
- Does the law have a mechanism for education?
- Does the law have certainty and consistency?

2.37 - Bad luck

This could be considered a 'catch all' category for circumstances not falling within any of the above, but equally it could include matters substantially affecting a company or its key individuals that are outside their direct control and influence.

In their report to the Law Commissions on directors' duties²⁶ an interview with a banker is reproduced as follows:

"you can be diligent as a director, but still be very unlucky and as a lending banker, you accept that you can do all the checks on the market, the financials, you have a group of competent managers and it can still go wrong. So I would not want to see anything which meant that if a company that got into serious difficulties, that necessarily reflected on the professional competence of managers. Sometimes it is sheer bad luck. It happens. On the other hand, I do think that the standards which directors have to keep to have not been particularly onerous up to recently and I think it is absolutely right that there should be hurdles which directors, both executive and non-executive, should reach." ²⁷

²⁵ Individuals of ordinary means, and with no particular legal or business training.

²⁶ Deakin, S., Hughes, A., *Directors' Duties: Empirical Findings*, 1999, Item.7 - The Duty of Care.

²⁷ Perhaps the banker had the experience of 16th September 1992 (Black Wednesday) and the interest policy that preceded it in mind when suggesting things can still go wrong?

- Does the law provide adequate flexibility to address unusual circumstances?

2.4 Legal solutions: perfection or pragmatism

It is clear the Government is seeking to pursue a long-term policy to increase the number of small private companies established in the UK and encourage more individuals to follow this route as their preferred business model²⁸.

However in furthering a preferred policy goal, care must be had to ensure the directional move required to achieve that goal does not prejudice those individuals already in situ, or those who are encouraged to join.

Additionally, if the expansion of the small private company sector is seen as being in the best interests of the UK economy then it should be the continuing logic of policy that small private company resources²⁹ are kept for their own use, and not fruitlessly dissipated³⁰.

The problem identified here is that public policy is ill-served by legal solutions which are costly to achieve in terms of the resources they take out of this economic sector. If the argument is put forward by policy makers that promoting entrepreneurial activity is good public policy, then it would seem counter productive to relieve that sector of resources by creating a framework of law which contrives to do just that.

Where perfection in law comes only at a price which the recipients deem largely unaffordable, pragmatism may conjure its own solutions for remedy and one should be moved to ask the question:

²⁸ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, The preface by the Secretary of State states: "Now our challenge is to build on this by promoting enterprise and raising productivity. Market frameworks drive enterprise and productivity, and company law is a key part of that framework."

²⁹ i.e. All their resources including capital, labour and any other resources.

³⁰ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 1.6 & 1.7 expresses the view that proceedings (referring to C.A. s.459 actions) particularly impacted adversely on "small owner-managed companies".

W - How can this be in the interests of shareholders, directors, companies or indeed the furtherance of good public policy?

2.5 Legal solutions: the danger of following the prescribed remedy

The Law Commission has considered the question of the remedies available to shareholders³¹ and without revisiting their report in its entirety it is worth highlighting some salient points applicable to the small private company:

The Law Commission, following consultation³², identified two main problems:

1. "The obscurity and complexity of the law relating to the ability of a shareholder to bring proceedings on behalf of his company."³³
2. "...relates to the efficiency and cost of the remedy which is most widely used by minority shareholders to obtain some personal remedy in the event of unsatisfactory conduct of a company's business. This is the remedy for unfairly prejudicial conduct contained in ss. 459-461 of the Companies Act 1985."³⁴

The first main problem highlights an example of how the law has become largely inaccessible to those who rely on it for remedy. Other than through specialist intermediaries, who themselves testify to its difficulty, few would venture along this tortuous route with the uncertainties the veil of obscurity and complexity casts over it. When faced with circumstances which might give rise to a derivative action in a small private company there seems little reward for the shareholder taking the right, rather than the pragmatic, view.

³¹ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997: The online version is at < <http://www.lawcom.gov.uk/276.htm> > [Accessed 6th May 2004].

³² The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 1.18: The Law Commission received 109 responses to its consultation paper.

³³ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 1.4.

³⁴ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 1.5.

With regard to the second main problem the Law Commission went on to say “The dissatisfied shareholder can obtain a variety of types of relief but the most popular is a court order requiring the majority shareholder(s) to purchase his shares.”

They also commented³⁵ that their statistical survey of petitions in the High Court in London, filed under section 459, indicated the following:

- 97% related to private companies,
- 93% related to companies with 10 or fewer members,
- 76% involved companies where all or most of the shareholders were involved in the company management,
- 64% included an allegation of exclusion from management.

Concluding the pertinence with regard to the s.459 remedy they state “...it is often used where there is a breakdown in relations between owner-managers of small private companies...”

1.6 Conclusion

It is clear, without exploring the reasons why a breakdown in relations occurs, that the Law Commission considered there to be considerable defects³⁶ in this area of law and the process by which relief is sought so much so that it made the following main recommendation:

“A draft regulation should be included in Table A to encourage parties to sort out areas of potential dispute at the outset so as to avoid the need to bring legal proceedings.”³⁷

³⁵ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 1.5.

³⁶ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para.1.6: Including: “a significant cost on the taxpayer.” but referring only to High Court costs, and not more wider costs which the taxpayer may suffer.

³⁷ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 1.23(iv).

It is this recognition of sorting out areas of potential dispute at the outset, and through the mechanism of the company constitution, which has wide implications³⁸ and are considered in more detail in Chapter 6 where alternative solutions are also suggested.

The author puts forward a view here of how this recommendation could be reasonably paraphrased in order to reveal the underlying message being conveyed:

The Law Commission believe the courts are ill-equipped to deal with disputes arising in small private companies and no great matters of legal principle are generally involved. The costs of obtaining the remedies the law currently provides outweigh the real interests of the parties seeking them, and any wider public interest is not being well served.

In essence the unfair prejudice remedy is horribly inefficient and horrendously costly. None of which exactly provides the warm glow of contentment users of this legal solution would like it to provide.

2.6 Conclusion

As previously stated this chapter has not tried to identify clauses in statute, or rules in case law, which are believed to particularly cause problems and from which disputes arise. In the author's experience very little regard is given by either directors or shareholders to the law until such time as a dispute exists between these parties. Only then do they consider what rights they have, and how their rights can be adequately enforced in the manner which best enables them to pursue their current purpose. Rather, this chapter purposefully directs the reader to consider matters which are not easily solved by recourse to the courts but do require changes to the basic understanding of the human dynamics involved and on which statute governing small private companies needs to be framed.

³⁸ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 1.11 provisional conclusions included a "... 'self help' remedy (or range of remedies) to avoid the need for shareholders to resort to the court to resolve disputes."

The principle tenet of the CLR is the “Think Small First” concept which the author applauds as being a start in the process of identifying and removing potential areas of dispute. He would, however, have liked to add the caveat “in the style of an empathic entrepreneur” because when considering legislative amendments in this area of the law he believes the answers will lie in turning empathic understanding of the problems into pragmatic solutions.

3.1 Introduction

In this way being able to reach the ‘bottom line’ fast at minimum cost should be regarded as a pre-requisite legislative goal best able to serve the interests of directors, shareholders, companies, and the wider public policy aims of Government.

The reform of law, the details of which are covered in this chapter as they apply to small and

The next chapter affords the reader the opportunity to consider the proposals and solutions provided by the CLR to the problems it perceives, and whereas this chapter has largely dealt with general concepts and clarifying understanding, Chapter 3 relates the CLR’s views in more detail within specific legislative heads.

In an introductory section recognises that “the current framework of company law is essentially

It is hoped the combination of these two diverse approaches will not only better inform, but also act to polarise opinion with regard to the changes required.

Modern companies are not in the throes of a
approach to competitiveness, and we are often asked to consider the
law’s framework of company law which is up-to-date, competitive
and designed for the 21st century, a framework which facilitates
enterprise and promotes transparency and fair dealing.”

This consultation paper identifies a number of “current issues” with clarity the use in our law of
over-formal language, excessive detail, over-regulation and complexity of structure. It identifies
obsolescent or ineffective provisions, anomalies dating back to the 15th century and obstacles to
progress where modern efficient practices are not easily facilitated.

It looks at the international picture in brief, recognising both the shift to globalisation of
economies and the development of other countries’ commercial laws tailored to their own local
circumstances, and to highlight issues whereby our laws as they were

DISPLACING THE VICTORIANS THE LAW REVIEW REPORTS

3.1 Introduction

3.11 - Setting the scene: The Government perspective

The reform of law, the details of which are charted in this chapter as they apply to small and private companies, is the consequence of a process started in March 1998 by the then President of the Board of Trade Margaret Beckett, when she published “Modern Company Law – For a Competitive Economy”.

In her introduction she recognises that “Our current framework of company law is essentially constructed on foundations which were put in place by the Victorians in the middle of the last century.” Going on to state:

“Modern companies are one of the three key pillars of our approach to competitiveness; and we are determined to ensure we have a framework of company law which is up-to-date, competitive and designed for the next century, a framework which facilitates enterprise and promotes transparency and fair dealing.”

This consultation paper identifies a number of “current issues” including the use in our law of over-formal language, excessive detail, over-regulation and complexity of structure. It identifies obsolescent or ineffective provisions sometimes dating back to the 19th century and obstacles to progress where modern efficient practices are not easily facilitated.

It looks at the international picture in brief, recognising both the shift to globalisation of economies and the development of other countries’ commercial laws tailored to their own local circumstances, and no longer based primarily on our laws as once they were.

It seeks in its terms of reference to direct the review exercise:

- To consider how core company law can be modernised in order to provide a simple, efficient and cost-effective framework for carrying out business activity.
- To consider whether company law, partnership law and other legislation, which establishes a legal form of business activity, together provide an adequate choice of legal vehicle for business at all levels.
- To consider the proper relationship between company law and non-statutory standards of corporate behaviour.
- To review the extent to which foreign companies operating in Great Britain should be regulated under British company law, and
- To make recommendations accordingly.

Already at this stage of the discourse is the suggestion that it might be desirable to have a small company statute "which assembled in one place the particular requirements for small firms"¹ and defines the scope of the review in the following terms:

"Broadly speaking, the task of the review will be to develop a legal framework, based on the principles reflected in the Companies Act, which covers the requirements for the birth, existence, and death of companies. Thus it will identify the fundamental rules governing the procedures for incorporation, the basic constitutional structure, and cessation of existence. It will examine the rights and responsibilities of the entity and its participants and identify in which areas there should be mandatory rules to protect the interests of shareholders, creditors, employees, and other participants."²

In summary this consultation paper recognises that "...although company law may reasonably be regarded as a specialist area, the issues it addresses are in fact of wide public interest."³

¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy*, 1998, p.15, 5.5.

² The Company Law Steering Group, *Modern Company Law for a Competitive Economy*, 1998, p.17, 6.2.

³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy*, 1998, p.22, 9.1.

3.12 - Setting the scene: The CLR perspective

At the heart of its review the CLR identifies three core policies⁴:

- Think Small First,
- An open, inclusive and flexible regime for governance,
- The appropriate institutional structure for law and other rule-making and enforcement.

which it intends to pursue and within the first policy area of "Think Small First" their recommendations cover four areas⁵:

- Simplification of Administration,
- Preservation of minority rights (whilst limiting inappropriate action),
- Deregulatory provisions,
- Identifiable legislation.

into which are interwoven the remaining two core policies.

Given the importance placed on the four areas the CLR highlights this work now reviews each in detail.

⁴ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.39, 3.1.
Also at <http://www.dti.gov.uk/cld/final_report/index.htm> downloadable in .pdf format [Accessed 30th April 2004].

⁵ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.24, 2.6.

3.2 Simplification of administration⁶

“Our main objective has been to simplify the decision-making process to reflect the special needs of small companies. That process needs to cater for three different situations:

- Closely-held companies where the members and directors (often the same individuals in both capacities) operate in harmony and by consensus. Here, decisions should be capable of being made with minimum formality;
- Companies where there is a greater element of debate between the members and directors. Here, the procedures should allow productive debate and afford a voice to the minority without inhibiting business; and
- Companies where the working relationship between members has broken down. Here, the legislation should allow the relationship to be restored, or disentangled if necessary, but if possible, in a way that does not risk the welfare of the company or its business. Under the current arrangements, *the costs of a dispute can sometimes ruin the company*⁷.

An additional objective has been to make it as simple as possible to form a company, by limiting the rules that apply to such companies by default (i.e. automatically under the Act unless steps have been taken to agree otherwise) to the minimum necessary to protect members and those dealing with a company.”

And, by the following are these ideals to be brought into force:

3.21 - Unanimous consent⁸

The recommendations prescribe for any decision the company has power to make, can be made by the unanimous agreement of the members without observing any of the formalities of the Act or the company’s constitution. The CLR notes that such agreement shall be fairly obtained and that current general law will need to be retained to overcome abuses.

The CLR in considering the Unanimous Consent Rule⁹ (as recognised by the courts and a matter

⁶ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.27, 2.13.

⁷ Emphasis not in the original text.

⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.28, 2.14.

⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.156, 7.17.

currently of common law) proposed within Developing00 to retain this rule but not embody it within legislation. In Structure00 they reported general agreement to this rule being retained informally, because it had value for small companies in legitimising decisions taken in good faith.

On considering the further responses, although the majority did not favour codification¹⁰, they have decided to recommend codification believing that it would provide significant benefit to small companies particularly, providing them with certainty for the decisions they may take by this method. The CLR in making this decision for codification did recognise the possibility of some loss of flexibility that the move to a statutory provision might entail.

3.22 - Written resolutions¹¹

Where unanimity is not possible the CLR believes that decisions can still be made without the formality of a general meeting. In this case their proposals recommend the use of a written resolution regime based on the current written resolution procedure¹² which they believe provides a "...quick and efficient means of passing resolutions without the need to convene a general meeting."¹³

They further believe and recommend that written resolutions should be brought into line with the lower special resolution and ordinary resolution majorities (as opposed to the current position of unanimity for written resolutions) as a means whereby "the usefulness of the procedure will be greatly improved with a lower requisite majority, *so that a minority shareholder cannot block a resolution where he or she would be comfortably out-voted at a meeting.*"¹⁴

¹⁰ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.157, 7.19.

¹¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.28, 2.15.

¹² C.A. 1985, s.381A to 381C.

¹³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.65, 4.3.

¹⁴ Emphasis not in the original text.

The CLR's full recommendations are¹⁵:

- The general requirements for unanimity for written resolutions should be replaced with requirements that special and ordinary resolutions be approved respectively by 75% and a simple majority of those eligible to vote.
- The resolution and any notification that has been passed should be sent to shareholders.
- Complex notification requirements should be avoided in order to maintain the simplicity and immediacy of the procedure.
- Companies should be able to adopt stricter procedures in their constitution, including higher requisite majorities and more stringent notification procedures.
- The current requirements to notify the auditors of a written resolution, which serves no useful purpose, should be abolished.
- All resolutions should be capable of being passed by written procedure with the exception of the two current exceptions where a third party has a right to be heard by the general meeting – removal of a director under section 303, and removal of auditors under section 391.

3.23 - The default regime¹⁶

This proposal is principally concerned with modifying the current status of the 'Elective Regime' whereby companies are able to elect to adopt certain procedures, principally dispensing with an AGM¹⁷ and the laying of the accounts before a general meeting¹⁸.

The recommendation is for the current 'Elective Regime' of dispensations to be the default position on incorporation. However, the CLR recognises that companies change through their lives and members may wish in future to opt out of the dispensations granted on incorporation,

¹⁵ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.65, 4.3(i) – (vi).

¹⁶ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.29, 2.16.

¹⁷ C.A. 1985, s.366A; C.A. 1985, s.379A(1)(c).

¹⁸ C.A. 1985, s.379(1)(b).

and into the additional requirements. They believe the legislation should cater for this by ordinary resolution, should the members so wish.

Alternatively, where companies are not subject to the dispensations they may opt into them by special resolution "in order to protect the rights of *any large minority*¹⁹ that may wish to continue to hold AGMs."²⁰

Deliberating further they seek to maintain the right of *an individual shareholder*²¹ to insist on the holding of an AGM, the laying of accounts, and demand a meeting to propose the removal of the auditors, recommending that new legislation in any one year "...should provide the means for this voice to be heard so that potential disputes may be resolved before they escalate."²²

Their recommended default regime for a new company would be for the following not to apply²³:

- the requirement to hold an AGM²⁴,
- the requirement to lay accounts annually in general meeting²⁵,
- the requirement to re-appoint the auditors annually in general meeting²⁶.

In addition, the majority required to agree to the giving of short notice of meetings would reduce to 90%, rather than the current requirement of 95%; and the requirement for directors to obtain

¹⁹ Emphasis not in the original text.

²⁰ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.30, 2.18.

²¹ Emphasis not in the original text.

²² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.30, 2.19.

²³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.72, 4.17.

²⁴ C.A. 1985, s.366.

²⁵ C.A. 1985, s.241.

²⁶ C.A. 1985, s.385.

authority from the company in general meeting to allot shares²⁷ should not apply to small companies.²⁸

Finally, the CLR sought to update the definition of what constitutes a General Meeting and the timing thereof. It recommends that:

- The law should allow the company to hold a general meeting at more than one location, with two-way real time communication between participants. In order to effect this change a power should be given to effect the necessary rules regarding the requirements of such meetings²⁹.
- For consistency with its other recommendations, the AGM of private companies should be held within ten months of the financial period end³⁰.

3.24 - Directors' duties

The CLR recommends³¹ for the current common law, which imposes most of the duties of directors, to be codified into a general statement of directors' duties and in making their recommendations they recognise the current difficulty for both directors and shareholders alike in identifying precisely, and with certainty, what legal obligations are owed by directors.

The current case law rules provide for³²:

- obedience to the company constitution,
- loyalty to the purposes of the company in securing the interests of its members,
- independence of judgement,

²⁷ C.A. 1985, s.80.

²⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.73, 4.18.

²⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.154, 7.7.

³⁰ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.154, 7.8.

³¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.31, 2.20.

³² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.40, 3.5.

- avoidance of conflicts of interest,
- fairness between members,
- care, skill and diligence.

In recognising the list above the CLR also reflects that "...the duties in their present form are widely misunderstood, and unclear or imperfect in a number of areas."

A further key element in the consultative and deliberation process has been the wider debate concerning to whom these duties should be owed? The CLR asks further questions for authoritative guidance³³:

- For whose benefit do directors run the company?
- The nature and standards of care and skill to be demanded from directors?
- What is the position of stakeholders such as creditors and employees to the company?
- Over what time-scale horizon should director decision-making be concerned?

They believe that in the modern economy these companies need to take note of such things as the need to foster good relations with creditors, customers, employees, the community at large and the wider working environment; and that the codification of directors' duties should reflect these wider debate issues.

The "trial draft" statement of directors' duties "was almost universally welcomed"³⁴ and they were further "encouraged" by the positive views of the Parliamentary draftsman that such a statement could be effectively drafted, and drafted in an accessible form fit for the statute book.

Accordingly a draft of directors' duties, prepared by Parliamentary Counsel, is provided with their report³⁵.

³³The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.40, 3.7.

³⁴The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.41, 3.10.

³⁵The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.343, Annex C & Schedule 2.

3.25 - Other deregulatory measures³⁶

- The abolition of the position of company secretary,
- The abolition of the need for shareholder authorisation for the allotment of shares; and
- The creation of a new, simpler model constitution, written in plain language.

At present all companies require the appointment of a company secretary³⁷ however, the present position occupier in a private company is not required to have any appropriate experience or qualifications for such a position³⁸. In recognising, amongst other things, that in small companies the vacancy is often filled by a family member, the CLR acknowledges the ineffectual nature of this role in the majority of these companies.

Accordingly, the recommendation is to remove the statutory requirement of the position of company secretary for private companies³⁹.

As a product of the implementation of the Second Directive⁴⁰ the CLR seeks to remove the current requirement dealing with shareholder authorisation of directors in the allotment of shares⁴¹, although they do however seek that the requirement should continue to apply if, after the issue, the company has more than one class of share. This continuation is to prevent any unauthorised change in relative power of different classes of shares⁴². In addition, the CLR recommends that directors should be able to determine the redemption terms of redeemable

³⁶ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.31, 2.21.

³⁷ C.A. 1985, s.283(1).

³⁸ C.A. 1985, s.286 deals only with the qualifications required for a public company appointee.

³⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.68, 4.7.

⁴⁰ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.67, 4.5 – applicable only to public companies but imposed on private ones.

⁴¹ C.A. 1985, s.80.

⁴² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.67, 4.5(ii).

preference shares and that these terms should be included in the return of allotments delivered to Companies House⁴³.

In order to gain a flavour of the manner in which the CLR envisages simplification and clarity can be achieved, it is worth viewing the Draft Model Constitution⁴⁴ it has prepared.

3.3 Preservation of minority rights

3.31 - Introduction

As could be expected the CLR in arriving at its conclusions and recommendations has explored the issue of Minority Rights in detail. Its commissioned research⁴⁵ has shown that over 70% of companies have only one or two shareholders, and some 90% of companies have fewer than five shareholders⁴⁶. In presenting the statistics in this way they seem to miss an important point.

The research report covers an aggregate of 742,195 companies of which only 159,471 (21%) were single member companies, **therefore 79% of companies surveyed have at least one minority shareholder**. Indeed extrapolating this statistic further would reveal the existence of many times the number of minority, rather than majority, shareholders in the world of small companies. This is a significant point of democratic principle worth noting when taking a macro view of the small private company's role within the UK economy, and indeed when answering the question above; for whose benefit do directors run the company?

⁴³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.67, 4.5(iii).

⁴⁴ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.476 et seq.

⁴⁵ Research data available at < http://www.dti.gov.uk/cld/other_information.htm#e > and *Account of ICC Report* .pdf download file [Accessed 26th April 2004].

⁴⁶ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.221, 6.9.

Inevitably when considering shareholder rights, whether of the majority or minority⁴⁷, the debate encompasses the very nature of the association of individuals called a company, and the basis on which it was formed, and then proceeds to carry out its functions.

3.32 - Questioning the relationship the law establishes

In Developing⁴⁸ the CLR questioned the contractual nature of the constitution derived from C.A. 1985, s.14(1) which it describes as “obscure and misleading”. This section states:

“Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the memorandum and articles.”

They raised the question⁴⁹ : Would you support a scheme to deal with the issues of personal rights on the following lines:

- (a) Rather than deeming the constitution to be a contract (albeit of an unusual kind), the Act should expressly set out (i) the extent to which it gives rise to rights and obligations binding upon the company and enforceable by the company’s members, thus conferring personal rights which are unaffected by ratification; and (ii) the remedies which are available for the enforcement of such rights?
- (b) These rights should be enforceable by the company and by members in their capacity as such and not as outsiders, and outsiders should have no rights under the constitution?
- (c) Former members should also not have such rights?
- (d) The rights which are to be enjoyed personally should be defined in the Act as including rights: to be entered in the register of members; to transfer shares; to vote and participate in members’ meetings; to receive dividends properly declared or capital payments validly determined; and to exercise pre-emption rights; and any other right

⁴⁷ The term minority needs care in understanding as it may include substantial equity holdings.

⁴⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.109, 4.72.

⁴⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.118, Question 4.4.

breach of which gives rise to direct harm to the member and not indirect or collective harm suffered as a result of damage done to the company as a whole?

- (e) It should be made clear that the court may dismiss an action which is trivial or where recognition of the personal right would not have made a material difference?
- (f) The position should be the same whether the shareholder brings the action in advance to restrain the breach or after the event?

Of the (only) 26 listed as responding to the above questions⁵⁰ the overwhelming majority giving an opinion, rather than referring their position⁵¹, supported the CLR proposals, however minority opposition from the legal profession⁵² gave the CLR cause to rethink this approach and in Structure00⁵³ the question of the juridical character of the constitution was again raised.

Largely defending its position the CLR argued that its original suggestions as to the relationships created were more a matter of "nomenclature rather than substance"⁵⁴ and cited the unusual nature of the section 14 contract described by Lord Justice Steyn⁵⁵.

"By virtue of section 14, the articles of association become, upon registration, a contract between a company and members. It is, however, a statutory contract of a special nature with its own distinctive features. It derives its force not from the bargain struck between the parties but from the terms of the statute."

⁵⁰ A .pdf downloadable file of responses can be found at <http://www.dti.gov.uk/cld/reviews/urn00656.htm> ; 4.1 - 4.5 [Accessed on 27th April 2004].

⁵¹ Including the I.C.A.E.W. who comment "we believe it is more appropriate for lawyers to respond to this question."

⁵² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.161, 7.33.

⁵³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, 2000, p.93, 5.68.

⁵⁴ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, 2000, p.93, 5.69.

⁵⁵ *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCLC 693.

The CLR sought to achieve its desired aim by proposing "...to suggest that the desired result should be explained to the draftsman and the best way of expressing it then explored in drafting."⁵⁶

The sum of the proposals contained in Structure00⁵⁷ is:

- The guiding principles to be applied in developing the legislation in this area should be those set out in Developing00⁵⁸.
- On personal rights, section 14 should be replaced by a provision which sets out the present position subject to the following changes and clarifications:
 - the constitution creates mutual rights and obligations between the company and its members, and between the members themselves;
 - the fictional deed and the "speciality" character of debts under the constitution should be replaced by normal contractual limitation periods;
 - the constitution confers rights on members and not on others, and not on former members;
 - the court should have discretion not to enforce personal rights where the matter is trivial, or where the enforcement would make no substantial difference to the outcome;
 - whether the juridical basis of the constitution should be changed from the contractual to a statutory one should be explored with the draftsman in the context of developing a regime which best reflects the existing substantive position as proposed to be modified by these proposals; and
 - all members should have a personal right to enforce any obligation under the constitution (unless it excludes such enforcement by its terms) whether against the company or against a fellow member; specific enforcement should be available in advance, as should damages for the consequence of a

⁵⁶ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, 2000, p.93, 5.69.

⁵⁷ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, 2000, p.91, 5.63 to 5.67.

⁵⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.106, 4.70 & 4.71.

breach, but only to the extent of the loss suffered directly, and not derivatively via damage to the company; lawful amendment of the constitution removing the obligation, or ratification, has effect prospectively, but cannot remove the right to damages accrued prior to the change; this rule should apply to all companies whether formed before or after the coming into operation of the relevant provisions.

3.33 - Questioning the remedies

In preserving any such rights as the minority shareholder may have, there is then the question of the remedies available by which those rights can be upheld, and suitably compensated for when they are unfairly prejudiced.

Opening the debate on this topic the CLR stated that it saw the introduction of the remedy available under C.A. 1985, s.459 as being “of great value”⁵⁹ as it appears to provide an additional remedial route independent of rights available under the company constitution.

The CLR during its deliberations considered the work done by The Law Commission⁶⁰ concluding that much of its own discussions and proposals relied heavily on that work⁶¹.

Additionally, they recognised not only that actions by minorities “is a highly sensitive component of the governance system”⁶² but also that much of the law is contained in old and obscure cases beginning in 1843 (Rule in Foss v Harbottle). Regardless of the legal detail they do however implore lay people, especially from the business community, to comment on the issues raised as being of wide importance⁶³.

⁵⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.119, 4.100.

⁶⁰ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997.

⁶¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.104, 4.65.

⁶² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.104, 4.66.

⁶³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.105, 4.66.

3.34 - The Law Commission remedy reform proposals

Given the declared reliance on the work of The Law Commission related above it is perhaps worth here providing a brief tabulated overview of the recommendations of that commission⁶⁴.

More active Case Management including:

- Power to dismiss claim or part claim or defence which has no realistic prospect of success,
- Power to adjourn to facilitate ADR,
- Pro-active use of power to determine facts,
- Exclusion of issues from determination,
- Costs sanctions,
- Presumptions in proceedings under section 459 of unfair prejudice by reason of exclusion.

Other Reforms recommended:

- Imposition of limitation period,
- Addition of winding up remedy,
- Power to determine relief between respondents,
- No advertising of section 459 petitions,
- Provision of exit article in constitution⁶⁵,
- Provision of a new more flexible derivative action determining availability, notice and abrogation of common law action.
- Application by shareholder to proceed with derivative action where company fails to pursue proceedings diligently, and other matters appertaining thereto.

Considered and recommended as follows:

- No Reform of Section 14,
- No extension to the right to disclosure of documents for shareholder proceedings.

⁶⁴ The Law Commission's full summary can be found at < <http://www.lawcom.gov.uk/library/lc246/pt8.htm> > [Accessed on 27th April 2004].

⁶⁵ The full draft exit article can be found at < <http://www.lawcom.gov.uk/library/lc246/apc.htm> > [Accessed on 27th April 2004].

It is perhaps unfortunate that The Law Commission published its report in September 1997 as a significant further factor in the use and benefit of section 459 as a remedial route for shareholder action was considered by the House of Lords in 1999⁶⁶.

3.35 - The CLR journey and remedy reform proposals

It is in the context of the restriction imposed by the Lords ruling affecting the remedies previously thought available under section 459 that the CLR framed its consultation questions and asked⁶⁷:

- (a) Should the decision in *O'Neill v Phillips* be reversed by declaring that unfairness may be regarded as arising on the basis of the facts, rather than because of some breach of agreement or infringement of some principle of Equity in relation to the constitution, or on the basis of the legitimate expectations of the petitioner, or in some other way?
- (b) Should section 459 be left as it is, accepting the *O'Neill* ruling, but with the addition of specific remedies for the cases identified as falling outside the principle including the Law Commissions' presumption in favour of a member excluded from management, economic harm to class interests and unfair refusals of transfers? Are there any other areas where such specific remedies should be added or should those cases be dealt with by extending the definition of personal rights?

The CLR again lists 26 responses⁶⁸ to these questions, the majority of which were from professional bodies⁶⁹ and large corporations rather than the hoped for response from lay and business people.

⁶⁶ *Re A Company* (No 00709 of 1992) [1999] 1 WLR 1092) referred to subsequently as *O'Neill v Phillips*.

⁶⁷ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.123, Question 4.5.

⁶⁸ A pdf downloadable file of responses can be found at <http://www.dti.gov.uk/cld/reviews/urn00656.htm> ; 4.1 - 4.5 [Accessed on 27th April 2004].

⁶⁹ The I.C.A.E.W. again referred its position stating "We believe it is more appropriate for lawyers to respond to this question."

In making their proposals the CLR posed the following questions for consultation⁷⁰:

1. Would you support a rule to the effect that a member may enforce personally any obligation imposed by the constitution against the company by specific enforcement or in damages, so far as he has suffered loss personally, and not derivatively via the company, from the breach, but that such a remedy should be subject to bar at the discretion of the court on the ground that the breach was trivial or the remedy would be fruitless in practice?
2. Do you agree that the same should apply in relation to enforcement against a fellow member?
3. If so, do you agree that any amendment of the constitution to remove the source of the breach should operate prospectively but not have effect to remove the member's right to damages, and that this provision should apply to all companies, whether or not formed after its coming into operation?
4. Would you support a new rule requiring the directors exercising a power to refuse to register a transfer of a share to give reasons, and if so should this apply in all companies or only in ones formed after commencement?
5. Do you agree that the powers of the majority should be constrained (subject to the proposals on personal rights, section 459, ratifications of corporate wrongs and the derivative action) only by the following rules:
 - (i) resolutions to change the constitution, or at class meetings to change class rights, should be subject to the requirement that the decision should be taken *bone fide* in the best interests of the members as a whole, or, as the case may be, in the best interests of the members of the class as a whole;
 - (ii) there should be no additional provision constraining the power of the majority to alter the constitution in cases of interference with proprietary rights;
 - (iii) where a member has an interest, or is subject to substantial influence by a person having such an interest, in an actual or threatened wrong against the company he should be disqualified from voting on a resolution to facilitate or

⁷⁰ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, 2000, p.109, Questions 5.2 to 5.6.

- condone that wrong whether as a member of an ordinary or qualified majority or a blocking minority; and
- (iv) no special provision should be made in the legislation for the consequences of the carrying out of resolutions which are unlawful in consequence of a breach of these provisions, invalidation of the resolution apart?

The CLR received the following responses⁷¹ although not all respondents provided answers to all questions:

Question Number	No. of Responses
1	29
2	26
3	24
4	32
5	31

Again the response to their proposals was majority positive, save for the legal profession, and the CLR refers to this approach as "...being cautiously welcomed."⁷² Accordingly their recommendations follow this approach.

The CLR believes its recommendations will allow companies to operate informally and thereby reduce the decision making lead-times whilst at the same time "preserving procedures to respect the voice of the minority *where appropriate*."⁷³

They acknowledge that there will nevertheless be occasions when the relationships within a small company break down. To this they state that their objective has been "to ensure that the

⁷¹ A .pdf file of responses is available at < <http://www.dti.gov.uk/cld/reviews/compstruct.htm> >; Chapter 5 [Accessed on 27th April 2004].

⁷² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.161, 7.33.

⁷³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.32, 2.23 – emphasis not in the original text.

rights of the separate parties are respected while allowing, *wherever possible*, any dispute to be resolved without terminal damage to the business of the company.”⁷⁴

They go on to state:

“There are two aspects to this issue:

1. establishing clear boundaries to the circumstances where the minority may take action to assert its rights or those of the company as it perceives them; and
2. establishing an efficient procedure for the resolution of disputes.”⁷⁵

and

“Our guiding principle has been that the normal proper remedy is action under the constitution of the company. Only where constitutional power is abused and there is a breakdown in the operation of the constitutional machinery in place to deal with such cases should the minority have power to intervene.”⁷⁶

Additional proposals include⁷⁷:

- A restriction of members to take action under section 459 to where there has been a breach of the constitution, some other breach of duty, or some sort of agreement that makes it inequitable to confine the member to his strict rights under the constitution.
- Putting derivative actions onto a statutory basis and making provision for the circumstances in which a member may take action on behalf of the company where the directors fail to do so.
- Clarification of the company’s constitution including certainty of rights enjoyed by members personally under the constitution.

⁷⁴The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.32, 2.23 – emphasis not in the original text.

⁷⁵The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.32, 2.24.

⁷⁶The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.32, 2.25 – emphasis not in the original text.

⁷⁷The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.32, 2.26.

3.36 - The demand for a litigation alternative

The CLR states that “Our consultation on this issue has shown that there is significant demand for action to reduce the burden of litigation in shareholder disputes.” adding,

“We are convinced that all forms of alternative dispute resolution (ADR) should be encouraged, and we believe that our reforms to the law on minority rights and on directors’ duties will reduce the complexity of cases and, therefore, make disputes more amenable to ADR.”⁷⁸

They recommend the Government to take two steps:

1. It should increase awareness of and accessibility to ADR through publicity and the establishment of referral mechanisms.
2. It should work with arbitration providers in order to establish an arbitration scheme designed specifically for shareholder disputes.

Consultation had shown significant demand for action to reduce the burden of litigation in shareholder disputes. The CLR:

“...noted the creation of ADR (including arbitration) schemes was the key to solving the problem, and that, if tailor-made schemes were available, it would be easier for both those involved in disputes and the courts to seek or encourage access to them; in such circumstances, a statutory presumption in favour of ADR or cost sanctions against those who unreasonably failed to use ADR would probably prove unnecessary.”⁷⁹

Following the publication of Structure00 the CLR held further discussions with some of the main ADR providers. These discussions they say have shown that facilities for ADR in shareholder disputes already exist to offer companies and shareholders the means to resolve their disputes. They also spoke with the Law Society who “has expressed an interest in facilitating ADR for shareholder disputes.”⁸⁰

⁷⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.33, 2.27.

⁷⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.69, 4.10.

⁸⁰ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.69, 4.11.

In putting forward their recommended position of non-statutory encouragement in the use of ADR the CLR do however cite a statutory presumption in favour of ADR previously reviewed and finally rejected by the Law Commission⁸¹, although originally recommended for inclusion as an amendment to Table A in its consultation paper.

The main conclusion the CLR has drawn from these consultations is that facilities exist to resolve disputes quickly and with the minimum necessary costs. They believe that two main steps⁸² must be taken to enhance confidence in ADR and encourage its take-up:

- “first, awareness and accessibility of ADR should be greatly increased, so that participants will choose it at the earliest stage as an alternative to litigation. The committee believes that the ADR providers already have many of the resources necessary to make available methods such as mediation, which could defuse and resolve many disputes before they escalate. They recommend that the Government use its own resources, such as the Small Business Service, and those of non-government bodies, such as the legal profession and trade associations, to set up a program of publicity and referral machinery to ADR before disputes reach the stage of litigation; and
- second, where cases have reached the stage of litigation, the parties must be encouraged to take a step back and use ADR wherever possible. We believe that the new civil procedure rules provide the means for the courts to apply such encouragement and we recommend that this approach should be proactively used in appropriate cases. If the Government undertakes the program that we have suggested above, confidence of litigants in all forms of ADR will be increased. However, *it is at the stage of litigation*⁸³ that we believe it is necessary to improve confidence in arbitration in particular. If one or more arbitration schemes exist that are respected by the courts and the legal profession, the use of arbitration will be seen as an increasingly attractive option, especially where a dispute has progressed beyond the scope of other forms of ADR. We recommend that the Government work with arbitration providers in order to establish an arbitration scheme designed specifically for shareholder disputes.”

“If these steps are taken, we believe that encouragement in the Act through a statutory presumption or costs sanction will not be necessary.”⁸⁴

⁸¹ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, Part 5 at < <http://www.lawcom.gov.uk/library/lc246/pt5.htm> > [Accessed 27th April 2004].

⁸² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.69, 4.11.

⁸³ Emphasis not in the original text.

⁸⁴ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.70, 4.12.

3.4 Deregulatory provisions

3.41 - Capital maintenance

The CLR states that the current provisions are complex and “of limited practical relevance to the smallest companies.”⁸⁵

They make two recommendations:

1. Provisions of the current Act concerning financial assistance for the acquisition of own shares should no longer apply at all to private companies.
2. All companies, whether private or public, should be able to reduce share capital without the approval of the court.

3.42 - Accounting and audit for small and private companies

Whilst stating that small companies already enjoy a separate regime in this area the CLR proposes greater flexibility with the aim of reducing the accounting and audit burden whilst increasing the usefulness of information on public record. They recommend⁸⁶:

- Extending the limits to EU maximums thereby increasing the numbers of companies falling into the small category⁸⁷
- Simplifying the format and content requirements of the published accounts (those on public record at Companies House) and removing the ability to file ‘abbreviated’⁸⁸ accounts. These new format accounts should be entirely set by standards.
- Shortening the time limit for filing accounts to 7 months after the financial year-end⁸⁹
- Raising the audit threshold.

⁸⁵ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.34, 2.29.

⁸⁶ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.35, 2.32.

⁸⁷ S.I.2004:16 available at < <http://www.hmso.gov.uk/si/si200400.htm> > [Accessed 30th April 2004].

⁸⁸ Essentially a Balance Sheet only, with no Profit and Loss account.

⁸⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.286, 8.40: The CRL sought to reduce this further to 5 months after the financial year-end. The I.C.A.E.W. in its consultation response said “We consider that 5 months is an unrealistic deadline” Responses to consultation on this can be found at < <http://www.dti.gov.uk/cld/reviews/urn00656.htm> > [Accessed 30th April 2004].

Their final proposals in this area⁹⁰ are for small companies to be subject to one of the following alternatives now the Government has raised the audit threshold to £1 m. turnover below which a company needs neither an audit, nor any other form of financial review.

Depending on the outcome of current field trials being undertaken by the APB, the CLR proposes all other small companies above the audit turnover threshold are subject to the lesser requirement of an IPR, or alternatively a total exemption. They further recommend that the regulatory regime for the IPR, if this is the route to be followed, would be the existing audit regulation structures⁹¹.

The CLR confirms the need to continue to apply certain requirements to small and private companies as they apply to all companies⁹²:

- the requirement to keep accounting records,
- the requirement to prepare accounts giving a true and fair view and complying with standards,
- the requirement to file accounts,
- the requirement to circulate accounts to members.

The qualification of small in this area is recommended as meeting any two of the following criteria:

- turnover of no more than £4.8 million,
- balance sheet total of no more than £2.4 million,
- number of employees of no more than 50.

⁹⁰ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.36, 2.33.

⁹¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.83, 4.52.

⁹² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.75, 4.26.

With the further recommendation that the limits apply in the usual way for parents of small groups⁹³.

They recommend the form of report is delegated to the Accounting Standards Board (ASB) to make detailed provisions⁹⁴. The CLR envisage the ASB would be given power to set different provisions for small companies, that their requirements would be underpinned by statute, and become a part of the revised FRSSE⁹⁵ but that the precise details would be determined by the ASB in due course⁹⁶.

A final recommendation is for the deletion of the directors' report in its current form for all accounts and the suggestion that standing data is included on a simple cover sheet⁹⁷.

In so far as the present 'abbreviated accounts' dispensation is concerned the CLR recognises these to be unsatisfactory and recommends this facility is abolished. Future accounts would be required to be filed in standard format⁹⁸.

With regard to filing requirements the CLR recommends reducing the filing period to 7 months following the year-end, which they believe will aid transparency⁹⁹. They also recommend accounts distribution to shareholders should be brought into line with the recommendation on accounts filing for companies following the default regime proposed and not wishing to hold an AGM¹⁰⁰.

⁹³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.76, 4.31.

⁹⁴ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.77, 4.34.

⁹⁵ The Financial Reporting Standard for Smaller Entities (FRSSE).

⁹⁶ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.77, 4.35.

⁹⁷ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.78, 4.37.

⁹⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.78, 4.38.

⁹⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.78, 4.39.

¹⁰⁰ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.79, 4.40.

For those companies wishing to hold an AGM they recommend that this is held within 10 months of the year-end, but accounts would still be required to be distributed within the 7 month filing timetable, or 14 days prior to any AGM held within 7 months of the year-end¹⁰¹.

3.5 Accessible legislation: The “Think Small First” concept

3.51 - Overview

The CLR puts great weight on the principal of “Think Small First” in relation to the drafting of new legislation believing that their proposals for private companies will lead to legislation based on the needs of private companies. In addition they give three principles to be followed by Government¹⁰²:

1. the law should be clear and accessible, but
2. accuracy and certainty should not be sacrificed unduly in an attempt to make law merely superficially more accessible, and
3. the legislation should be structured in such a way that the provisions that apply to small companies are easily identifiable.

The CLR provides two examples of what it means by using the above principles in action and states that the method they have described “is at the heart of our recommendations, where, we believe, both substance and form together embody the “think small first” approach.”¹⁰³

The CLR regards the other two core policies¹⁰⁴ at the heart of their Review to be closely related and it is worth here providing a verbatim account of their views:

¹⁰¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.80, 4.42.

¹⁰² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.37, 2.34.

¹⁰³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.37, 2.37.

¹⁰⁴ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.39, 3.1: 1) an open, inclusive and flexible regime for corporate governance, and 2) the appropriate institutional structure for law and other rule-making and enforcement.

“Our proposals on governance involve allowing a very large measure of freedom in the arrangements for controlling and organising the operations of the company’s business, within a realistic, inclusive decision-making framework. This puts heavy onus on the ultimate powers of control of shareholders to ensure that this freedom is not abused. For this approach to work effectively, shareholders need timely and high quality information to enable them to assess the performance of the company and the directors’ stewardship of the assets. For large companies this must include information about the forward-looking and qualitative aspects of the business, its governance and its systems for addressing issues of risk and setting its direction.”¹⁰⁵

3.52 - The model constitution¹⁰⁶

The proposals outlined here provide a further example of the aspiration of accessibility and transparency the CLR seeks in its reforms to company law, and they highlight again the six principles previously set out in Developing00¹⁰⁷:

- (i) the model constitution should provide a set of default rules which are neutral, workable and which it is thought the majority of companies will want to have;
- (ii) there should be nothing in the model constitution which we would be unwilling to see companies amend or exclude.
- (iii) there should be a presumption against the new model constitution simply repeating provisions, which are to be found in the Act or other legislation.
- (iv) there should be a presumption against laying down alternative default provisions on the same issue;
- (v) provisions in Table A which apparently make up for deficiencies in the Act should be transferred to the Act; and
- (vi) the provisions should be modernised to reflect changes in the law.

¹⁰⁵ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.39, 3.2.

¹⁰⁶ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.70, 4.13.

¹⁰⁷ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.248, 7.70 to 7.85.

They also recommend that three sets of regulations in the current Table A should be deleted.

- Regulations 8 to 22 concerning liens and calls on shares and forfeiture.
- Regulations 73 to 80 on retirement of directors by rotation.
- Regulations 32, 34 and 35 requiring authorisation by the articles on certain transactions now unnecessary under their latest capital maintenance proposals.

They concluded by proposing that companies should be required to prepare and file consolidated versions of their constitutions rather than adopting regulations by means of reference. This recommendation reported as going against concern from parts of the legal profession¹⁰⁸.

3.53 - Part X: Conflicts of interest¹⁰⁹

Helpfully the CLR, having considered the views of consultees, recommends that the anomalous requirement to disclose a material interest or potential interest in a contract with the company leading to a potential conflict of interest with their company¹¹⁰ should be disappplied in respect of sole directors.

3.6 The distinction between public and private companies

The CLR considered the question of the distinction between public and private companies¹¹¹, its basis, purpose, and fitness for purpose. It concluded by recommending that the prohibition on private companies offering their shares to the public should remain.

It is mentioned here for completeness.

¹⁰⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.72, 4.16.

¹⁰⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.68, 4.8 & 4.9.

¹¹⁰ C.A. 1985, s.317.

¹¹¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.83, 4.54 to 4.62.

3.7 Conclusion

It is clear from the foregoing synopsis that the CLR has considered this wide and complex area of the law in some depth and that, under its terms of reference, it was required to consider matters more generally than this work.

The choice made by the CLR of its three core policies¹¹² pre-determines to a large extent the manner in which its work will proceed and it is perhaps here where the author takes the greatest issue.

The “Think Small First” core policy adopted by the CLR lends itself to the classification of an appetising sound-bite useful in future to convey the impression that the needs of the ‘small’ have not been consumed by the power of the mighty. This is an attractive slogan on which many can align themselves but, as will be suggested later¹¹³, is it the correct core policy to adopt?

The author has distinct reservations on this matter and believes that it simply perpetuates a problem which has existed since the birth of the private company “almost by accident” and which has not been satisfactorily determined since.

Whilst the remaining two core policies can be concurred with as being wholly applicable to companies of all size and classification the “Think Small First” concept, whilst looking highly attractive on the surface, does not sit quite so comfortably when exposed to a more detailed examination and it is felt, fails to deliver in key areas of governance and control of power.

¹¹² Chapter 3, 3.12, p.38.

¹¹³ Chapter 6, 6.2, p.93.

Putting the foregoing reservations aside for the moment and when considering the terms of reference under which this work is drawn, it is suggested that whilst there are certain measures recommended by the CLR which will prove useful none, either individually or combined, provide a clear direction or legal framework which substantially displaces the Victorian ethos on which our law is currently founded.

Unfortunately, in some ways what might be regarded as useful Victorian values have been further eroded¹¹⁴ whilst little has been put in their place as an alternative. It is therefore envisaged that large sections of 'small' corporate life are destined to become less accountable, and less open to any ongoing third party involvement in their day-to-day activities. It is hard to see how governance of private companies will be improved by these recommendations, and if so, how this will help to reduce potential areas of dispute and alleviate conflict.

The concern is that perhaps the emphasis of the CLR work in this area has been to accept the reality of disputes and seek to cope with their resolution by their ADR proposals, rather than address more fully how to remove the potential for disputes arising in the first place.

In concluding this chapter it is felt that the aims of this thesis have not been greatly enhanced by the recommendations forthcoming from the CLR to Government. It is suggested that this is possibly the result of the CLR not seeking to explore the arguments for and against the categorisation of companies within the terms of private and public as being the essential differentiating factor, rather than small and large.

The author's view is that power and control, and the governance issues that flow therefrom, is more easily conceptualised when the distinction is made in this way. Further, this distinction more accurately reflects the practicalities to be found in the management and ethos directing these companies, which has been previously outlined in Chapter 2.

¹¹⁴ e.g. the erosion of internal control mechanisms. See Chapter 1, 1.3, p.14. See also Chapter 6, 6.52, p.120: Shareholder information access.

However, regardless of the deficiencies perceived, Chapter 4 now considers the Government's White Paper response to the proposals made and any further proposals which they deem necessary to make.

WHITE PAPER KNIGHT THE GOVERNMENT RESPONSE

It is hoped that the opportunity existing to devise bold and imaginative law which will be appropriate to the needs of the 21st century small private company will still not be lost.

In publishing the White Paper the Government acknowledges that it is taking the "first step" in its response to the issues raised by the CLR. It is not clear however whether all the recommendations the CLR has made, and which have not been addressed in the White Paper will ultimately be accepted.

It would seem there is some uncertainty as the White Paper has requested further consultation on certain issues.¹ These consultation responses were received by 29th March 2004, however, have not yet produced any comment from Government, nor have any further draft clauses been published.²

Subject to the above, the general feeling of the author is that the White Paper is consistent with the CLR's final report, follows their three main policy objectives³, and contains no major surprises.

In preparing this analysis of the Government's response the author has followed the same designations as those used in Chapter 3, and included in this chapter cross-references to it, for the readers' convenience.

¹ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.8.

² The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.117, provides a full list of the questions for consultation. Response can be viewed and downloaded at < <http://www.dta.gov.uk/cld/modernisingcompanylaw> > [Accessed on 30th April 2004].

³ A report from the Government on its progress in legislation (updated March 2004) can be found here < <http://www.dta.gov.uk/cld/revision.htm> > [Accessed 30th April 2004] Chapter 3, 3.12, p.38.

WHITE PAPER KNIGHT THE GOVERNMENT RESPONSE

4.1 Introduction

In publishing the White Paper the Government acknowledges that it is taking the “first step”¹ in its response to the issues raised by the CLR. It is not clear however whether all the recommendations the CLR has made, and which have not been addressed in the White Paper, will ultimately be accepted.

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⁴ A report from the Government on its progress to legislation (updated March 2004) can be read here < <http://www.dti.gov.uk/cld/review.htm> > [Accessed 30th April 2004].

⁵ Chapter 3, 3.12, p.38.

4.2 Simplification of administration⁶

The CLR identified the need to simplify the decision-making process and identified three situations a simplification process needed to cater for, ranging from those companies where members and directors operated in harmony and consent, to those where the working relationship had broken down.

With these three situations in mind they set out their recommendations under the following:

4.21 - Unanimous consent⁷

The CLR recommended a codification of the rule on the grounds of providing certainty, but noted that such codification might lead to a loss of flexibility.

The Government response, after exploring possible methods for codifying this rule, concluded that the anticipated benefits of certainty the CLR hoped for would not be forthcoming, and the anticipated loss of flexibility was undesirable. Accordingly it has not felt able to follow this recommendation⁸ but agrees that the common law rule should be preserved.

4.22 - Written resolutions⁹

The CLR recommended that even in the absence of unanimity, decisions could still be made without the need for a general meeting. Their recommendation was to propose a continuance of the written resolution regime, but reduce the threshold by which resolutions are passed to that of existing special and ordinary resolution majorities.

⁶ Chapter 3, 3.2, p.39.

⁷ Chapter 3, 3.21, p.39.

⁸ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.22, 2.31 to 2.35.

⁹ Chapter 3, 3.22, p.40.

The Government response¹⁰ accepts this recommendation and the draft Bill allows private companies to pass written ordinary resolutions with an ordinary majority, and written special resolutions with a 75% majority of total eligible votes. There is also provision in the drafting for both of these written resolution majorities to be determined differently by the company constitution¹¹.

In furtherance of this written regime the Government also recognised that current legislation already allows communication covered by the Electronic Communications Act 2000¹² where there is agreement between the company and its member. In this instance however the Government says it has drafted the forthcoming legislation appertaining to written resolutions¹³ so that “electronic communication can only be used where the resolution can be received in legible form, or a form (agreed between a company and the member in question) which can be converted by the recipient into a legible form.” They state: “For example, a resolution may be proposed through e-mail, text on a website or a text message on a mobile phone, but not through an oral telephone call, an audio file on a website, or by sending an audiotape.”¹⁴

The CLR made further procedural recommendations¹⁵ in an effort to ease the burden on small private companies. These include:

- ***The resolution and any notification that has been passed should be sent to shareholders***

The Government “...aims to maintain the current simplicity of the written procedure whilst also ensuring that all members receive adequate information about written resolutions.”¹⁶ They go on

¹⁰ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.21, 2.26 to 2.30.

¹¹ The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002, p.83, c.170.

¹² Including communication in non-legible form and orally.

¹³ The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002, p.84, c.172(2).

¹⁴ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.22, 2.30.

¹⁵ Chapter 3, 3.22, p.41.

¹⁶ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.21, 2.28.

to state “In particular, we believe that companies should send proposed resolutions to all members at the same time, as far as is practicable.” And they note:

“While it will be possible for a resolution to be agreed by the requisite majority before some of the members have seen the resolution, the Bill¹⁷ is designed to give full information to all members entitled to take part in the decision-making process and to prevent companies from deliberately excluding some members.”

- ***Complex notification requirements should be avoided in order to maintain the simplicity and immediacy of the procedure.***

In responding to this recommendation the Government proposes¹⁸ to “effectively abolish the extraordinary resolution as a separate category” and replace it with a requirement for a special resolution. This replacement feature would apply in existing situations where a company requires an extraordinary resolution.

The proposal goes further by bringing into line the required notice period for special resolutions¹⁹ and for **all** meetings of companies²⁰ to 14 days, whilst retaining the right of companies to hold meetings at shorter notice given the agreement of the required member majorities.

- ***Companies should be able to adopt stricter procedures in their constitution, including higher requisite majorities and more stringent notification procedures.***

The Government states “The members of a company will be able to amend the constitution by special resolution. They will also be able - if they all agree - to make it more difficult to make changes, by requiring a higher majority or even unanimity.”²¹

¹⁷ The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002, p. 84, c.172(3).

¹⁸ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.20, 2.21.

¹⁹ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.20, 2.22.

²⁰ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.19, 2.17.

²¹ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.17, 2.3.

- *The current requirements to notify the auditors of a written resolution, which serves no useful purpose, should be abolished.*

The Government does not seem to have specifically taken this recommendation on board in its preamble to the Bill however this recommendation may well be included when further draft clauses are released²².

- *All resolutions should be capable of being passed by written resolution excluding the two current exceptions²³.*

In these two specific exceptions the Government states "...the present law provides for a special procedure requiring notice to be given to the person affected. We propose to retain similar provisions."²⁴

4.23 - The default regime²⁵

As outlined in Chapter 3 the CLR recommended that the current 'Elective Regime' covering the holding of an AGM, the requirement to lay accounts in general meeting, and the requirement to re-appoint auditors annually should be made the default position on incorporation.

The Government agrees with these proposals²⁶ and the Bill will remove each of these requirements with the proviso that members by ordinary resolution²⁷ may opt into the additional requirements should they so wish²⁸.

²² This is still believed to be the case at 29th April 2004.

²³ Removal of a director under C.A. 1985, s.303; Removal or non-reappointment of an auditor under C.A. 1985, s.391A.

²⁴ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.20, 2.23.

²⁵ Chapter 3, 3.23, p.41.

²⁶ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.18, 2.11.

²⁷ The CLR recommended these additional requirements be opted into by special resolution.

²⁸ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.18, 2.21.

The Government also provides in the Bill²⁹ provision to empower a single member³⁰ to require the company to hold an AGM, lay accounts and reappoint auditors in any year (as currently allowed) but “believes there are serious disadvantages with such a power for individual members to require the holding of an AGM in any given year” and asks for further views on including these draft clauses in the Bill.

With regard to the CLR recommendation that the majority required to agree to the giving of short notice of meetings be reduced from the present 95% to 90%, this seems to be covered (although not accepted) by the Government in its statement “As now companies can hold meetings at shorter notice if holders of a sufficient majority of shares (or voting rights where the company has no shares) agrees.”³¹

Additionally the recommendation by the CLR that C.A.1985, s.80³² should not apply to small companies seems not to have been accepted, or simply not addressed as a separate issue.

Of the final two recommendations the CLR made under this sub-section the Government is considering whether the retention of a power to allow general meetings to be held at more than one location is the best means of achieving the objective given the need to “...ensure the rights of members, and the accountability of directors, are fully equivalent to those applying now in the case of AGMs and EGMs.”³³ However, on the recommendation to hold the AGM within ten months of the financial period end, this is accepted with the proviso that the AGM must be held on time regardless of whether the accounts have been laid³⁴.

²⁹ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.18, 2.12; The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002, p.65, c.136 to c.139.

³⁰ An auditor is also empowered to requisition an AGM.

³¹ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.19, 2.17.

³² The requirement for directors to obtain authority in general meeting to allot shares.

³³ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.19, 2.15.

³⁴ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.19, 2.16; The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002, p.64, c.135(2)(b) subject to c.141.

4.24 - Directors' duties³⁵

In considering the recommendations of the CLR the Government has accepted their basic tenet that the law should be codified³⁶ along the lines proposed, but with some changes. They state the codification will replace both the existing common law and C.A. 1985, s.309³⁷.

They further agreed with the CLR that the basic goal of directors should be the success of the company in the collective best interests of shareholders whilst recognising:

“as the circumstances require, the company’s need to foster relationships with its employees, customers and suppliers, its need to maintain its business reputation, and its need to consider the company’s impact on the community and the working environment.”³⁸

Additionally, the Government considers that the same set of general duties should apply to all directors regardless of any such other particular duties each may have under their conditions of employment³⁹.

Whilst providing a statement of these duties⁴⁰, stated as being essentially the version in the Final Report of the CLR except for the removal of the final two paragraphs⁴¹, the Government addresses the issues of both decision timeframes⁴², and the level of skill and care to be brought in exercising judgements by directors.

³⁵ Chapter 3, 3.24, p.43.

³⁶ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.26, 3.5.

³⁷ Directors and shadow directors must have regard for the interests of employees in general whilst carrying out their functions. The duty is owed however by them to the company (and the company alone).

³⁸ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.26, 3.3.

³⁹ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.26, 3.5.

⁴⁰ The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002, p.112, Schedule 2.

⁴¹ Dealing with duties relating to creditors and the interaction of provisions in the Insolvency Act 1986.

⁴² Directors must consider both the short and long term consequences of their actions.

However, in arriving at their drafting⁴³ the Government seeks further detailed consultations by raising the following questions:

1. Does the draft statutory statement provide a clear and authoritative guidance for directors?
2. Does it strike the right balance between modern business needs and wider expectations of responsible business behaviour?

The final version of the Government's intent is therefore still awaited⁴⁴.

4.25 - Other deregulatory measures⁴⁵

Proposals are set out in the Bill for the following further deregulatory measures:

- The abolition of the requirement to appoint a company secretary in private companies, whilst retaining the right for private companies to continue to appoint to the position should they wish⁴⁶,
- The ability to 'entrench' specific provisions in the constitution alterable only by unanimity or higher than special resolution majority⁴⁷,
- An unlimited capacity⁴⁸ to deal with third parties with the removal of the requirement to include an 'objects clause'⁴⁹,
- New provisions regarding the registration of charges⁵⁰,
- A coherent package of sanctions, criminal, civil and administrative⁵¹,
- Transitional arrangements to benefit existing companies⁵².

⁴³ The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002, p.10, c.19; and p.112, Schedule 2.

⁴⁴ As of April 2004 no further drafts have been forthcoming from Government.

⁴⁵ Chapter 3, 3.25, p.45.

⁴⁶ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.51, 6.6.

⁴⁷ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.50, 6.2.

⁴⁸ The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002, p.1, c.1(5) gives companies the following status – “A company formed under this Act has unlimited capacity.”

⁴⁹ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.50, 6.2.

⁵⁰ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.54, 6.18 to 6.20.

⁵¹ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.55, 6.23.

⁵² The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.56, 7.1 to 7.5.

4.3 Preservation of minority rights⁵³

As will be recalled from Chapter 3 the CLR sought to clarify the relationship of members to their company, and to their fellow members. Specifically they sought modification to C.A. 1985, s.14(1) concluding the current “obscure and misleading” contractual character of that peculiar clause, as deficient.

Additionally, they recognised the propensity of the law in this area to be based on principles in old and obscure cases, rather than on rights and obligations provided with clarity under statute.

In making their recommendations for reform the CLR were minded towards both clarification of the rights being provided to members, and the circumstances in which those rights can be exercised. Of significant concern to the CLR was the manner in which such given rights could be pursued through court action to the possible detriment of the company.

Running with this theme the CLR recommended a considerable expansion in the use of ADR as a means of reducing litigation and resolving disputes more speedily.

The White Paper appears silent for the moment on the issue of the nature of the relationship statute should establish between members and the company, and members between members but with regard to the ADR proposals made by the CLR, the Government “intends to consult with ADR providers to identify the best way forward, and in particular to undertake a cost-benefit analysis⁵⁴ for any new arbitration scheme⁵⁵.”

⁵³ Chapter 3, 3.3, p.46.

⁵⁴ The reader might like to consider the benefit of this process in light of the analysis and comments made by the author in Chapter 5, 5.32, p.86 concerning Regulatory Impact Assessments.

⁵⁵ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.22, 2.36: As of April 2004 no further details have been forthcoming on these issues from Government.

4.4 Deregulatory provisions⁵⁶

4.41 - Capital maintenance⁵⁷

Of the two recommendations made and noted in Chapter 3 the Government has concurred with the view of the CLR as it applies to small private companies and have provided suitable clauses or will consult on clauses for future inclusion⁵⁸:

- the provisions on financial assistance in the purchase of own shares will be removed,
- the removal of the special procedure by which private companies may redeem or purchase their own shares out of capital.

Continuing, the Government seeks to:

- abolish the requirement to have an 'authorised share capital',
- codify the 'distribution' rules,
- replace existing court approval with a 'solvency' statement by the directors when seeking a capital reduction.

4.42 - Accounting and audit for small and private companies⁵⁹

All the recommendations made in Chapter 3 under this sub-head have been adopted in the White Paper:

- the limits by which a small company is defined are to be increased to EU maximums⁶⁰,
- the audit threshold to be increased⁶¹,

⁵⁶ Chapter 3, 3.4, p.59.

⁵⁷ Chapter 3, 3.41, p.59.

⁵⁸ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.51, 6.5.

⁵⁹ Chapter 3, 3.42, p.59.

⁶⁰ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.36, 4.19: The definition of small company has since been revised. See note 61 below.

⁶¹ Following the publication of the Final Regulatory Impact Assessment on the Audit Exemption Threshold the Government announced in Jan 2004 (S.I.2004:16) audit threshold increases on the basis of its preferred option i.e. to increase the threshold to those now allowed by EU law of £5.6 m. turnover and £2.8 m. balance sheet value. The FRIA can be viewed at < http://www.dti.gov.uk/cld/final_aet_ria_v3.pdf > [Accessed on 29th April 2004].

- the abolition of abbreviated accounts⁶²,
- a simpler accounting regime entirely set by standards⁶³,
- the substitution of the directors' report for a supplementary statement to the accounts⁶⁴,
- the filing of accounts within 7 months of the financial year-end⁶⁵,
- the laying of accounts at a general meeting within 10 months of the financial year-end⁶⁶.

4.5 Accessible legislation: The "Think Small First" concept⁶⁷

The Government agrees with the CLR "that the starting point for company law should be the small firm, with additional or different provisions for larger companies where necessary."⁶⁸

In furtherance of this, the Government also accepts the recommendation of the CLR for a new model constitution⁶⁹ whilst noting a definitive version cannot be drafted until the Bill itself has been fully prepared⁷⁰.

"The Government shares the overall approach recommended by the Review" with regard to directors' conflicts of interest⁷¹ confirming that it intends to "...consult in this area in due course."

⁶² The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.37, 4.26.

⁶³ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.36, 4.20.

⁶⁴ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.35, 4.15 to 4.17.

⁶⁵ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.37, 4.24.

⁶⁶ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.37, 4.25.

It is not clear whether Government intends to adopt the further recommendation made to bring into line distribution to members and filing, both at 7 months of the financial year-end.

⁶⁷ Chapter 3, 3.5, p.61.

⁶⁸ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.15, 1.3.

⁶⁹ Chapter 3, 3.52, p.62.

⁷⁰ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.17, 2.5.

⁷¹ Chapter 3, 3.53, p.63: Part X – Conflicts of Interest.

4.6 Other matters of note

4.61 - Sanctions

The Government proposes to ensure its sanctions regime for criminal, civil and administrative penalties are consistent with the principles set out by the CLR in its final report⁷². It proposes, for criminal offences, a series of standard combinations of mode of trial and maximum penalty⁷³ and requests further comment.

4.62 - Jurisdictional migration

Whilst not particularly relevant to the small private company alone it is felt worth considering here given the author's comments previously⁷⁴ regarding jurisdictional confines.

The CLR proposed the introduction of provisions that would allow companies to move from one company law jurisdiction to another. This proposal has not been adopted by Government owing to tax concerns⁷⁵, amongst other things perhaps?

4.7 Conclusion

Undoubtedly, it would have been preferable for the White Paper to have been inclusive of all matters appertaining to any forthcoming legislative amendment. The fact that it is incomplete does not, however, overly detract from the validity of this work, although it has left a part of the discourse incomplete for the moment.

The question is now posed, and critiqued in the forthcoming chapter, whether the White Paper can be viewed as a 'White Knight'?

⁷² The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.357, Annex D.

⁷³ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.58, 3.

⁷⁴ Chapter 1, 1.5, p.20.

⁷⁵ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.54, 6.21 & 6.22.

CONSULT, EXTRAPOLATE AND ESTIMATE A PROCESS CRITIQUE

5.1 Introduction

There are a number of ways in which to critique the work of others in what is hoped to be a fair and reasonable manner. One approach might be to concentrate on outcomes, for example, the recommendations of the CLR. A critique would then be formulated based upon those recommendations.

A difficulty anticipated by following the above example is the possibility that the arguments put forward in the critique may have no greater substance than the recommendations themselves, and the reader is left with the opinion that the choice to be made is one based on the authority and standing of the participants, in the absence of suitable empirical evidence to guide the way.

In response to the above the author has sought an alternative and looks here to formulate his critique by disregarding recommendations¹ and instead seeks to identify whether the review process to date has both rigour and integrity.

The following critique covers firstly the work of the CLR, and then separately the Government White Paper.

¹ Particularly as in the Government's case their recommendations are still incomplete as at 20th July 2004.

5.2 The Company Law Review Steering Group

5.21 - Introduction

At the commencement of this analysis it is suggested that any review process of this kind will be determined on a number of factors decided at the outset including:

- the terms of reference,
- the experience, expertise and standpoint of the members of the review,
- the questions raised by the review for consultation,
- the manner in which consultation is sought,
- the degree of influence consultation has on determining policy.

5.22 - Terms of reference

The terms of reference for the review can be found in Final I² and it will be immediately noted that no reference is made to the size of an organisation under consideration in those terms. The question of business size only arises within the notes included with the proposed terms³ published some three years earlier.

Within the terms of reference the reader is also guided towards item (ii). It is suggested that this term may compromise⁴ their future work on small companies particularly if the CLR were to have knowledge that an adequate alternative choice of vehicle was or might be available for a small business. So the question immediately arises: Has their work in recommending suitable new law for small private companies been compromised?

² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.335, Annex A.

³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy*, 1998, p.15, 5.4 & 5.5.

⁴ The Company Law Steering Group, *Modern Company Law for a Competitive Economy*, 1998, p.20, 7.7 considers the work of the Law Commissions in their review of Partnership law.

5.23 - Review composition

The composition of the Review⁵ consisted of 12 Steering Group members who, with a further 29 individuals, formed the Consultative Committee. The Steering Group was chaired by the Director, Company Law and Investigations, DTI.

Working groups were charged with particular topic areas within which to work and Working Group A was charged with - "The scope of company law and the needs of small and closely-held companies". Working Group D was charged with - "The small private company and company vehicles". These appear to be the only two working groups specifically relating to small company matters.

Working Group A⁶ consisted of 7 members including the chairman, calling on 2 outside experts concerned with the scope of company law, and 5 outside experts concerned with the needs of small and closely-held companies.

Working Group D⁷ consisted of 3 members including the chairman, 10 outside experts and a further 6 outside experts for the not-for-profit sub group.

The reader is directed to the names and designations attributed to those individuals should they wish to form their own view as to the breadth of skill and expertise of all those members and experts directly involved in small company issues. The author notes that the Managing Director (Chemicals), British Petroleum plc; the Chairman, John Lewis Partnership plc; and the Chief Economist, PricewaterhouseCoopers are amongst those listed as 3 of the 7 Steering Group members of Working Group A.

⁵ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, Annex A: see also The Company Law Steering Group, *Modern Company Law for a Competitive Economy*, 1998, p.19, 7.2 & 7.3 for the original proposals.

⁶ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, 1999, Annex A.

⁷ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, Annex A.

5.24 - The consultation process

1. The Government stated its “wish to ensure that the review process is handled with maximum openness and independence and on the basis of wide consultation.”⁸

The results of general CLR consultations are tabulated here in terms of the number of responses received at each stage, the total number of questions asked (A), and the number specifically described as applying to small companies (B):

Document and reference to questions On which responses are invited	Number Responding	A	B
Modern98, p.22, 9.3	159	1	None
Framework99, p.148 to p.158	137	58	6 ⁹
Meetings99, p.30 to p.35	97	58	None ¹⁰
Formation99, p.55 to p.64	55	94	None
Developing00, p.369 to p.397	449	141	26 ¹¹
Structure00, p.339 to p.364	196	167	12 ¹²

The following questions are posed:

- Is the level of consultees responding indicative of successful wide consultation?
- Is the fact that questions appertaining to small private companies¹³, but not denoted as such, indicative of (a) a flaw in the manner in which questions were posed¹⁴ and (b) the difficulty in adopting the approach of combined legislation?

⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy*, 1998, p.19, 7.1.

⁹ The subhead used for these questions was “small and closely-held companies”.

¹⁰ Questions raised differentiate only between public and private companies. This applies also to questions raised in Formation99 (The Company Law Steering Group, *Modern Company Law for a Competitive Economy, Company Formation and Capital Maintenance*, 1999)

¹¹ The subhead used for these questions was “small and private companies”.

¹² The subhead used for these questions was “small and private companies”.

¹³ Note the variation in definitions of small companies.

¹⁴ The flaw suggested is that although small company questions were segregated sometimes, it required consultees to review all questions to ensure they could respond to all matters covering small private companies. i.e. the structure was inconsistent and unfriendly.

2. An analysis of all the questions raised in this consultation process shows that no questions were specifically asked concerning:

- (i) An exit clause,
- (ii) A share valuation clause.

Both of which are highly relevant to the small private company, and particularly to this work.

What might these omissions tell us? Might they be due to the work carried out by the Law Commission¹⁵ and the consultations it had already made on the subject? And if so, does their consultation process adequately discharge the obligations resting with the CLR?

When considering whether the Law Commission consultations are appropriate it lists¹⁶ 137 persons and organisations responding including 94 in or directly associated with the legal profession, and 24 representative or government bodies. Whilst this list certainly has eminence, does it also have the width in the same terms as the CLR consultation process hoped for?

Finally, is the absence of consultation by the CLR on exit and share valuation clauses indicative of these two matters having already been put to bed?

3. Two questions were raised by the CLR this time concerning ADR, another highly relevant issue:

- (i) “Would an arbitration scheme along the lines of that outlined in paragraphs 7.44 – 7.69 help to encourage private companies to make greater use of arbitration?”¹⁷

¹⁵ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997.

¹⁶ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, Appendix K.

¹⁷ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.391, 7.15.

- (ii) "If you support the encouragement of arbitration, should this be further strengthened by a statutory presumption in favour of arbitration and/or cost sanctions for those who unreasonably refuse to go to arbitration?"¹⁸

Although the CLR specifically encouraged responses from people with an interest in the management of small business¹⁹ they list only 42 responses²⁰ to the first question, and 36 responses to the second.

Of the responses to question (i) nearly half provided either a one word or less than one line answer. Of the responses to question (ii) more than half provided a one word or less than one line answer. Additionally, in answer to question (i), only 9 consultees widened the scope of the question by raising the possibility of some other form of ADR.

It is suggested that the questions raised were overtly 'closed' questions and also biased in favour of adopting or otherwise a particularly narrow course of action when in fact other suitable courses of action were appropriate for consultation.

4. A further two questions pertinent to this work's final recommendations were also asked:

- (i) Should the Act be amended to provide that a company may by ordinary resolution permit its members to inspect any accounting records or other books of the company?
- (ii) If so, should this amendment apply to all companies, all companies limited by shares, or only to private companies limited by shares?²¹

¹⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.391, 7.16.

¹⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.248, 7.69.

²⁰ Responses to consultations can be downloaded at <http://www.dti.gov.uk/cld/reviews/urn00656.htm> [Accessed 5th June 2004].

²¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.395, 10.5.

The CLR lists 29 consultees responding to this. Again it is suggested that these are 'closed' and heavily biased questions.

If, for instance, a consultee answers yes to the first part without any qualification it is assumed that they are satisfied also with the requirement of the ordinary resolution. On the other hand if they answer no because of the ordinary resolution qualification, but actually feel that inspection is a good idea, then they are required to add a further qualification in order to express their true position. A further difficulty arises in the second part in so far as it leads the consultee onwards only if an affirmative answer is given in the first part. If they do answer the second part the categorisation of companies does not include the one category of company supposedly pre-eminent in the mind of the CLR namely, the small private company.

It is the author's view that these are particularly tortuous questions and framed as they are, they do not allow an affirmative answer to be easily given which can be satisfactorily understood. Indeed, judging by the responses received they seem to have been widely misunderstood.

5.25 - Conclusion

In the author's opinion the above demonstrates a lack of process rigour, and at least the possibility of a loss of process integrity. The expectation of "wide consultation"²², if measured²³ by response numbers, remains unfulfilled and it is hard to see how opinion can have been formed from a broad base, and then brought to bear on the recommendations made.

Whilst the above does not invalidate any of the CLR's recommendations it does suggest that they should be viewed with suitable caveats.

²² The Company Law Steering Group, *Modern Company Law for a Competitive Economy*, 1998, p.19, 7.1.

²³ One could of course argue the contrary that indeed wide consultation had taken place in so far as there are many representative organisations with large memberships providing contributions. It is a matter of definition as to how "wide consultation" is interpreted.

5.3 The Government and White Paper

5.31 - Introduction

In July 2002 the Government published its response²⁴ to the Final Report²⁵ of the CLR. In addition, it produced a Small Business Summary²⁶ in which it outlined its proposals in this area.

This critique focuses on the Small Business Summary and follows a process of extrapolation and estimate in its support.

5.32 - A justification for the proposals being made

The Small Business Summary provides details showing "...yearly potential savings for small private companies of around £168 million."²⁷ The potential savings were derived from its draft Regulatory Impact Assessment²⁸ which it also published at that time.

The RIA, together with the detailed individual RIAs, identified the potential yearly savings within the following categories:

- codification of directors' duties	£65 million
- simpler law for small companies	£32 million
- small company governance	£65 million
- removing requirement for company secretary	£5 million
- small company accounting regime	£1 million

²⁴ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, & The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002.

²⁵ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001 & The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume II*, 2001.

²⁶ Department of Trade and Industry, *Modernising Company Law: Small Business Summary*, 2002.

²⁷ Department of Trade and Industry, *Modernising Company Law: Small Business Summary*, 2002, Costs and Benefits.

²⁸ The RIA can be found at < <http://www.dti.gov.uk/companiesbill/ria.htm> > [Accessed 7th June 2004].

In arriving at their assumptions, the Government consulted through the DTI the potential effects on the business community in terms of the potential costs and savings²⁹. It is felt worth highlighting how some of these calculations have been formulated.

In the detailed RIA concerning codification of directors' duties it is stated that there are some 5 million directors in the UK and that the statutory statement will apply to all directors. From their sample survey it suggested that advice on directors' duties costs some companies an average of £500 a year. They extrapolate this by saying that "If 10% of small and private companies no longer seek such advice because of the proposed statutory statement and additional guidance, this will result in a saving of £65m per year."

Clearly the calculation is based on numbers of companies rather than directors so the question is: What number of companies are they using in this calculation?

It is suggested the answer is to be found in the overarching RIA where in paragraph 5 it states "There are some 1.3 million active private companies (of which over 1.2 million have five or fewer shareholders and nearly 1.2 million have an issued share capital of under £1000; in other words nearly all private companies are "small")."

Using the 1.3 million companies multiplied by 10% not now requiring advice of £500 per annum, the figure of £65 million potential savings can be calculated, however a number of problems arise with this calculation:

- The definition of 'small' by reference to shareholder numbers or issued share capital is not one which is used to define 'small' elsewhere³⁰. The normal definition is on turnover, asset values and employee numbers. Why has this definition switch occurred?

²⁹ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.113, 12.

³⁰ So far as the author is aware this is true throughout the whole CLR process.

- By using the figure of 1.3 million companies they are actually using all private companies both large and small because this is the total population of both these types of companies, yet representing the findings as specific to 'small' private companies.
- Is the £500 per annum cost of advice inclusive of advice sought by directors in a personal capacity which is not properly an expense of the company even though it might be charged to their companies?
- How reliable is the 10% assumption? Could it equally have been 8% or 12%?

In the detailed RIA concerning small company governance the 1.3 million active private companies has now become "...some 1.3 million active small, private companies"³¹ which as noted above is the total population of all private companies.

The calculation which appears to be used is the total population of private companies (1.3 m.) x the estimated cost saving (£100) x the assumed % number of companies taking advantage of the new proposals (50%). The point being raised is to recognise the sensitivity of the small individual cost saving of £100 and ask whether this figure is in any way reliable.

All the individual RIAs on which the overarching RIA published cost-saving benefits are based follow the same difficulties in terms of reliability on which the assumptions are made.

5.33 - Conclusion

It is a neat trick of presentation, not unknown to the accountancy profession, to portray an estimate with an authority which masks its real pedigree. The figure of £168 million suggests exactness whereas in fact it is merely a summation of a series of crude estimates.

³¹ RIA: Small Company Governance < <http://www.dti.gov.uk/companiesbill/ria.htm> > [Accessed 7th June 2004].

The concern for the author is in not knowing just how much credence is placed by Government on these 'cost-savings' calculations and how this may impact on the attitude it has towards implementing or rejecting particular legislative recommendations.

What can be said is that these calculations, in the opinion of the author, are flawed and provide no proper basis for making judgements and should not be used in publicising the case either for or against proposed new legislation.

5.4 Summary

When attempting to evaluate the likely effectiveness of the White Paper proposals it is disconcerting to the author to identify that both the CLR and the Government seem to confuse themselves as to what actually constitutes a small private company and that confusion leads them to describe it in slightly different terms, and use different criteria for its definition.

Further, the absence of any conclusions in the White Paper focused on s.459 considerations may suggest that this is a difficult area on which they require time for further consideration.

Alternatively, it may suggest that it is a difficult area which doesn't fit neatly into an RIA cost saving calculation which can enhance publicity for their small business proposals!

However, overriding all of the above in arriving at a sensible conclusion of the likely effectiveness of the White Paper proposals is the absence of a completed White Paper on which to judge. The indications so far, are not felt to be encouraging.

In addition to the above, and when added to the comments contained in the separate conclusions to this chapter, it is felt that there is sufficient doubt cast on the process followed to leave scope for alternative suggestions to be made from a perspective more aligned to the one the consultation process specifically requested.

The concluding chapter of this work seeks to provide those alternative suggestions from the perspective of an individual committed to the small private company, believing fully in its worth, and who has continued to be active in their ownership and management during the better part of a working lifetime.

The final chapter therefore seeks to address the problems identified in Chapter 2, and charts a detailed and radical approach for their solution which is believed suitable for the 21st century.

6.11 - The journey so far

The economic importance of small private companies, and the encouragement of the players who risk their capital and livelihoods working within them, deserve no less than the framework of good, effective and appropriate corporate law.

In Chapter 1 the development of the law from its "blatant by accident" routes in the 19th century and onward its progress to date

Chapter 2 seeks to provide an overview of the style of companies to which this work refers and sets a landscape upon which the shareholders and directors play their parts. Chapter 2 also seeks to identify how this particular landscape provides the potential for disputes

In Chapter 3 the work of the CLR in its review of company law is analysed and a synopsis of its recommendations for the small private company is provided, whilst in Chapter 4 the Government's response to these recommendations is considered.

The work carried out by the CLR and the Government is the subject of the criticism in Chapter 5, which concludes that the proposals and solutions they provide are by no means the definitive way forward, and they leave sufficient room for alternatives to be aired.

EMPATHIC PRAGMATISM A CRITICAL EVALUATION OF THE SEARCH FOR NEW SOLUTIONS

6.1 Introduction

6.11 - The journey so far

In preparing for this concluding chapter the author has sought to provide a compendium of the legal discourse applicable to small private companies. In Chapter 1 he has outlined the development of the law from its “almost by accident” routes in the 19th century and charted its progress to date.

Chapter 2 seeks to provide an overview of the style of companies to which this work refers and sets a landscape upon which the shareholders and directors play their parts. Chapter 2 also seeks to identify how this particular landscape provides the potential for disputes.

In Chapter 3 the work of the CLR in its review of company law is analysed and a synopsis of its recommendations for the small private company is provided, whilst in Chapter 4 the Government’s response to those recommendations is considered.

The work carried out by the CLR and the Government is the subject of the critique in Chapter 5, which concludes that the proposals and solutions they provide are by no means the definitive way forward, and they leave adequate room for alternatives to be aired.

6.12 - The ongoing journey: setting the scene

In formulating the recommendations and solutions contained in this chapter the author follows three guiding principles:

- If a thing is worth doing, it is worth doing now,
- The interests of justice and fairness should be judged in a wide context,
- The path of failure is followed by contested litigation.

In attempting to identify and remove potential areas of dispute the argument is structured over the three key areas¹ of the relationship between shareholders and their directors:

- The birth,
- The ongoing existence,
- The death.

Whilst these expressions are used here to define the time points or time periods of the human relationships being played they may also, although not necessarily, accord with the normal understanding of them as they would be applied to the company itself.

The purpose of making the above distinction is to ensure that potential areas of dispute are identified and removed for both situations, and solutions are formulated likewise. So on the one hand, there is the ebb and flow dynamics of the human relationships between the individuals occupying the positions of directors and shareholders and on the other hand, there is the continuity of the company and need to foster its wellbeing throughout its life independent of the individuals involved.

However, over-arching all of the foregoing is the need crucially to establish to whom exactly this work relates and it is here the ongoing journey begins.

¹ These three key areas take their designation from the definition of the scope for the CLR work: see Chapter 3, 3.1, p.37 and Chapter 3, p.37, note 2.

6.2 For whom doth the bell toll

6.21 - A dilemma of definition: the determined reliance on size

It is clear when reading the discourse taking place that a dilemma exists. The CLR has tried to address this dilemma in the “Think Small First” concept of framing future legislation.

The White Paper continues this theme by agreeing “...with the Review that the starting point for company law should be the small firm.”² The Government goes on to consider the possibility of a separate and distinct legislative structure for small businesses and concludes “The problem with this approach is that it requires a definition of small, for example a maximum number of shareholders, number of employees, turnover or assets.”³ This further creates a set of difficulties a company would have when it crossed and/or re-crossed whatever thresholds were established.

In practice, whether it is “Think Small First” or separate ‘small’ company legislation there are significant problems⁴ remaining unsolved by focusing on the term ‘small’. Neither the CLR nor the Government appear to have overcome this definition dilemma; instead it has been side-stepped with a compromise of switched definition⁵ which blurs the problem, and takes the eye away from identifying a sound solution.

However, it is argued that this failure in itself creates problems, and many possible advances which might otherwise be achieved in legislation fail to pass the first hurdle of recommendation because they are size focused, and therefore contribute to a difficulty in legislative formulation.

A proposed legal advance may well be appropriate in one ‘small’ situation, but wholly inappropriate in another ‘small’ situation. Clearly the Victorians haven’t been fully displaced, and our determined reliance on size to define remains.

² The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.15, 1.3.

³ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.15, 1.5.

⁴ Chapter 2, 2.3, p.27 – Potential areas of dispute.

⁵ Chapter 5, 5.32, p.87: Defines small in terms of the number of shareholders. Contrast this with the audit threshold definition for small contained in Chapter 3, 3.42, p.59.

6.22 - In search of an alternative

If the size definition is the cause of the dilemma and results in a constraint on the framing of law with specificity then an alternative suitable definition should be sought which removes the compromise and purifies the outcome. Given the nature of the companies laid out in the landscape envisaged in Chapter 2⁶, and the perceived style in which they are owned and managed; the search commences.

It is here where the judgement in *O'Neill v Phillips*⁷ by the House of Lords can perhaps help us in determining a criterion which isn't size related, and has the merit of transcending without difficulty thresholds size creates. In the words of Lord Hoffmann⁸:

"I do not suggest that exercising rights in breach of some promise or undertaking is the only form of conduct which will be regarded as unfair for the purposes of s.459. For example, there may be some event which puts an end to the basis upon which the parties entered into association with each other, making it unfair that one shareholder should insist upon the continuance of the association. The analogy of contractual frustration suggests itself. The unfairness may arise not from what the parties have positively agreed but from a majority using its legal powers to maintain the association in circumstances to which the minority can reasonably say it did not agree: *non haec in foedera veni*. It is well recognised that in such a case there would be power to wind up the company on the just and equitable ground (see *Virdi v Abbey Leisure Ltd* [1990] BCLC 342) and it seems to me that, in the absence of a winding up, it could equally be said to come within s.459."⁹

Perhaps here we have the seeds of a criterion that can be applied?

⁶ Chapter 2, 2.2, p.23: The author attempts to provide the reader with a feel for the culture, lack of formality and relationships existing within these companies.

⁷ *O'Neill v Phillips* [1999] 1 WLR 1092.

⁸ *O'Neill v Phillips* [1999] 1 WLR 1092, Judgement -1, (5) "Unfairly prejudicial".

⁹ *O'Neill v Phillips* [1999] 1 WLR 1092: Lord Hoffmann continued his judgement by confirming: "...it does not arise in this case."

The simplicity of this solution requires only two ingredients to be recognised:

- 1) "...some event which puts an end to the basis upon which the parties entered into association with each other" and,
- 2) "Something else" which is over and above the purely commercial association of the individuals concerned, and is a part of the basis upon which the parties entered into association with each other or have later developed.

If we scroll back this "some event" to the root of its origins then it is suggested that the event is caused by the removal of this "something else" and if we then enquire what this "something else" might be, then we may find it to be family ties, existing friendships, or indeed something else which remains undefined. However, it is something which acts in addition to pure commercial interest and provides a link between some at least of the shareholder and director participants which distorts the commercial approach adopted in the running of their companies.

If we now scroll forward we can envisage the "some event" as being the breaking of the link, or termed another way; the irretrievable breakdown in a relationship between two or more individuals who are associated through common ownership in the company.

It would seem on close examination that this criterion could apply to all private companies large or small however defined¹⁰; and could apply whether all the directors are shareholders or not; and whether all shareholders take part in the management or not; and even applied to private companies whether they have shares or not.

If this definition criterion is satisfactory in regard to precisely which private companies we are addressing then the question arises: How can this definition thread its way into the legal framework?

¹⁰ O'Neill v Phillips [1999] 1 WLR 1092: recognised by Lord Hoffmann when elaborating on equity principles "...which as equity always does, enable the court to subject the exercise of legal rights to equitable considerations ..."

6.3 The empathic regime

6.31 - Introduction

The 'Empathic Regime' takes as its basis the concept of the "something else" and recognises that this is a fundamental ingredient which exists in the company and acts in motivation of the participants involved in that association.

Accordingly, and in its recognition, a set of legal provisions would be formulated which presuppose that the "something else" exists, and would also reasonably assume a higher level of trust and co-operation between the participants than when the "something else" is absent.

In this way the 'Empathic Regime' becomes a fundamental co-determinant of how the company is managed and controlled.

6.32 - Threading the empathic regime into the existing legal framework

It is suggested that this could be achieved in a relatively simple procedure via an 'entrenching provision' in the constitution¹¹. The 'Empathic Regime' entrenchment would be by declaration that the company was to be operated as an 'Empathic Regime' company. The declaration clause would also define the required specified majority (above 75%) for its change to allow the company to revert back to being an ordinary private company.

The legislative requirement would then be to put in place such mandatory provisions as appropriate (such as the exit clause for example) which would become automatically adopted and integrated into that company's constitution.

¹¹ The Secretary of State for Trade and Industry, *Modernising Company Law – Draft Clauses*, 2002, p.11, 21.

From a practical legislative perspective there are a number of variables which need to be addressed for instance:

1. Would it be preferable for the mandatory provisions to be guiding rather than fully defined?
2. In order to create legislative flexibility should the mandatory clauses be integrated into the constitution, or perhaps be sectioned into a separate schedule?
3. Should the 'Empathic Regime' be declared at incorporation so that Companies House carries a record of that fact? Subsequent adoption of the regime would then also be recorded, as would reversion.

It is suggested that whatever practical requirements are deemed necessary to implement such a regime, they do not represent an insurmountable obstacle.

6.33 - Examples in action: enabling democracy to work

Adopting the 'Empathic Regime' allows speculation into some interesting examples of how this regime may work in practice and a detailed example, together with its justification of how this concept might apply, is in the area of accounts filing and accounting disclosure.

In the absence of the 'Empathic Regime', the argument is put forward that the time for filing should be shortened in the interests of good shareholder communication¹² whereas there are competing good reasons¹³, which are also in the interests of shareholders and the company, for delaying accounts publication. Adoption of the 'Empathic Regime' would solve this opposed viewpoint by allowing shareholders the right of access to information¹⁴ thereby removing the pressure to publish sooner on their behalf¹⁵.

¹² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.159, 5.20.

¹³ An example might be the desire on the part of the directors to retain a greater degree of flexibility in their judgements on issues which may affect taxation payable.

¹⁴ Chapter 6, 6.52, p.120 discusses the issue of a statutory right of information access for shareholders.

¹⁵ But there may still be pressure from other stakeholders, most probably unsecured creditors.

Similarly, with accounting disclosure requirements such as the supplementary statement¹⁶ replacing the directors' report. For companies adopting the 'Empathic Regime' the supplementary statement could direct its 'fair review' towards wider stakeholder issues. The presumption being that shareholders are already aware of matters concerning them directly by virtue of their rights of access to information, as described above.

It is suggested that corporate democracy is enabled when better information availability exists, and on further consideration this way forward suggests it is likely to breed other democratic enabling deregulatory benefits, currently stuck in the dilemma of definitional controversy, which would become less contentious and therefore more capable of easier adoption.

Such matters as an exit article, a valuation article, and a mediation regulation, discussed in greater detail below¹⁷, all fit neatly within a framework which recognises the "something else" concept rather than being embedded within legislation which acts across the broad spectrum of all private companies.

6.34 - Litigation and the empathic regime

In consideration of the issues surrounding shareholder remedies, the adoption of the 'Empathic Regime' by a private company might also make it easier to devise simpler and more cost effective litigation procedures, capable of fast-tracking the current process.

The participants of an 'Empathic Regime' company could be steered by the legal process towards separate suitable resolution solutions including specially designed pre-action protocols and practice directions for the courts to apply. The legal process recognising from the outset¹⁸ that the litigants belonged to a company run within these principles.

¹⁶ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.35, 4.15 to 4.17.

¹⁷ Chapter 6, 6.42, p.103: discusses these other potential shareholder rights in more detail.

¹⁸ The outset is envisaged to be pre-litigation and prior to any dispute existing.

An example of this might be the operation of litigation under s.459, where it is known that current petition drafting tends to cite all previous acts of purported unfairness and director transgression in a catalogue of minutiae¹⁹. The existence of the 'Empathic Regime' would simply recognise the "some event" consideration identified by Lord Hoffmann²⁰.

The unfair prejudice criterion Parliament²¹ has chosen by which the court judges whether to grant relief or otherwise would become otiose, and attention would focus simply on the relief being sought, which would normally be the share buy-out proposals²².

Interestingly, it is also worth considering the situation for an existing company in which the 'Empathic Regime' had not been adopted.

In these cases the court might seek to enquire of s.459 participants whether the regime should have been implemented by the company, as a first stage judgement. An affirmative decision by the court might dispose of the litigation more easily.

6.35 - Enabling further legal development

The 'Empathic Regime' is envisaged to go further in its contribution to company law by recognising that companies subject to its provisions are distinct from other private companies, and by design do not have a ready market for their shares²³.

The advantage of this construction is that it opens the route for the law to develop along different and more flexible lines for those other private companies in a way which could make

¹⁹ Chapter 6, 6.61, p.126 outlines the adversarial route litigation takes producing lengthy petitions and defences.

²⁰ O'Neill v Phillips [1999] 1 WLR 1092: see also Chapter 6, 6.22, p. 94 for Lord Hoffmann's judgement referring to "some event".

²¹ C.A. 1985, s.459(1).

²² Chapter 6, 6.421, p.108: The table of statistics in that section provides evidence of the relief sought.

²³ Other than via the exit clause obligation.

their shares or securities more marketable, whilst still retaining their private status²⁴.

On the other hand, one can also envisage how the law might encourage the development of specific financial products for 'Empathic Regime' companies which could attract more suitable funding, particularly in consideration of the inherent contingent obligation²⁵ of the majority becoming an actual liability brought about by the requirement to purchase minority held shares.

Again, the above are but examples of how the adoption of the concept of 'Empathic Regime' might enable further legal development to evolve.

6.36 - Conclusion

In concluding, it is perhaps fair to ask the question: Why would individuals choose the 'Empathic Regime' for their company?

The answer is most likely to reside in the recognition of its worth by Government and how it can be used as a tool to further their public policy goals²⁶. In this way it could be attractively promoted as a motivating cornerstone for 21st century entrepreneurial corporate activity.

For example, it is not difficult to envisage legislative incentives of further de-regulation to induce acceptance. It is suggested that the argument for such additional de-regulation is greatly enhanced when focused on companies already accepting of open and inclusive governance provisions²⁷.

²⁴ It might be envisaged that the law could develop in a stepped concept starting with the single member company, through Empathic company, followed by other private company, through finally to public company. Each step laying foundations for the next into wider share ownership, and incorporating appropriate governance provisions for each stage.

²⁵ Chapter 6, 6.421, p.105 argues for a mandatory exit clause.

²⁶ Chapter 3, 3.11, p.36 sets out the policy goals applicable.

²⁷ Chapter 6, 6.54, p.126 draws the conclusion for statutory right of information access for shareholders following arguments outlined in Chapter 6, 6.52 & 6.53, p.120 to p.126.

A further example might be the use of a tax bias towards these companies, and it is suggested that they could be especially useful in providing a real alternative retirement vehicle.

If the Government adopted a pragmatic approach to the 'Empathic Regime' then it is suggested that there is considerable scope for further imaginative, dynamic and entrepreneurial aims to be achieved.

Given the evaluation so far in this chapter, the guiding principle of both the CLR and Government should now change from the "Think Small First" concept, with its implicit suggestion that a part of the thought process is the secondary consideration of other sized companies²⁸, to the focus which embraces solution identification on the basis of whether private companies adopt or otherwise the 'Empathic Regime'.

The three key areas of the relationship²⁹ between shareholders and their directors already identified are now considered within an 'Empathic Regime' framework and evaluated on that basis. Additionally, whilst considering the following, the reader is invited to envisage and evaluate how they consider the law might develop through the 'Empathic Regime' within the author's preferred route of separate legislation for all private companies.

6.4 The birth

The adage - start as you mean to proceed - would suggest a sound basis of preparation for the company and its parties, and therefore the foundations on which the originating relationships are created should merit considerable attention to detail. It is suggested that this can be considered within the following three heads: 1. Legislative Framework; 2. Shareholder Rights; 3. Education and Training.

²⁸ Defined as they are in a mixture of fashions: see Chapter 6, 6.21, p.93.

²⁹ Chapter 6, 6.12, p.92.

6.41 - Legislative framework

The thrust of both the CLR and the White Paper proposals have been highlighted elsewhere so far as they go in seeking to bring to the law a degree of clarity which had been previously absent; and whilst deliberating the merits of a separate statute for small companies³⁰, they have both declined to follow this route. It is felt that this misses an opportunity to further clarify with regard to the proposed legislation, and future clarify with regard to the ongoing amendments which will inevitably occur in the years ahead.

Whilst it is felt that this is unlikely to cause significant difficulties in the short term³¹, it is suggested that over the longer term this decision will be revisited as a watershed, where the focus of the importance of the private company and its specified derivative³² could have been more adequately addressed than the "Think Small First" principle on which they have relied whilst proceeding with combined legislation.

The resulting statute in final form will still be a lengthy tome inclusive of provisions simply not applying to the private company, and past experience³³ suggests it will grow larger and more complicated in the years to come.

In which ever way it is viewed, the likelihood of the proposed legislation becoming required reading for the new private company director, or new private company shareholder, seems unlikely.

Hand in hand with clarity goes certainty. The clearer the rules are stated, the more certainty there is of their understanding and then consistent application. This does not mean that they will

³⁰ CLR Consultative Committee meeting minutes 12th October 1998 discusses the South African Closed Corporations Act for an alternative perspective.

http://www.dti.gov.uk/cld/other_information.htm#c [Accessed 23rd May 2004].

³¹ Whilst it is devoid of ongoing amendments.

³² i.e. the private company incorporating the 'Empathic Regime'.

³³ The past experience of C.A. 1985 and 1989 for example.

be necessarily applied, and it has been exemplified previously how clear rules³⁴ can be flouted with almost monotonous regularity. However, enforcement is a separate issue.

What is argued here is that certainty acts towards removing conflict in itself, and does so even when the rule might be considered to be theoretically flawed or imperfect in other ways. No matter, the certainty removes a volume of argument because it is a known route with known outcomes and in the world of the private company this pragmatism should not be underestimated in providing workable solutions.

Owing to the fixation with the debate concerning company size, which rightly rejected separate legislation given the definitional difficulties³⁵ involved, both the CLR and Government missed the opportunity presented and did not fully debate the benefit of separate legislation for public and private companies.

We should remind ourselves that it is the private company which was originally born “almost by accident”³⁶ but then tagged onto legislation designed for the public company. It is suggested that this is the real error made which will continue to inhibit clarity and detract in making new legislation more accessible.

6.42 - Shareholder rights

By way of introduction to this section it is felt that the proposed legislation is particularly deficient in providing adequate shareholder rights. It is here where significant strides could have been made to set better foundations for the road ahead, especially considering the Law Commission work in this area with their enquiry into shareholder remedies³⁷.

³⁴ Chapter 2, p. 26, note 19: details companies incurring civil penalties for late filing of accounts.

³⁵ Chapter 6, 6.21, p.93 discusses the dilemma of definition imprecision.

³⁶ Chapter 1, 1.1, p.5; also Chapter 1, p.5, note 8.

³⁷ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997.

Having regard to the ease with which the Government in particular seeks to simplify the process of starting companies³⁸, and the CLR proposals "...encourage equity investment"³⁹, it is felt they are encumbered with an obligation to ensure appropriate rights for those individuals accepting the challenge; yet it is felt they have failed to discharge this obligation adequately.

For instance, there is little evidence suggested or presented by the CLR or Government which either recognises or seeks to correct the lack of equity investment⁴⁰ within most private companies. Surely this lack of equity investment in the majority of private companies is telling us something?

The author believes the market is telling us:

- significant equity investment is unjustified given the risks,
- equity investment is locked in and not easily realised, and
- better methods of investing are available to the potential investor in these companies.

It should be common ground amongst promoters⁴¹ of private companies to agree that equity investment is a good thing to be encouraged not least for reasons of increased company stability⁴² and flexible capital⁴³, yet the market fails to be attracted.

³⁸ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.15, 1.3 "Company law should make it easy to start and run businesses."

³⁹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.24, 2.6(ii).

⁴⁰ The Department of Trade and Industry, *Companies in 2002-2003*, 2003, Table A7: 1,300,600 companies in GB at 31st March 2003 have issued capital up to £100.

⁴¹ Promoters defined here as those seeking to expand the private company base rather than an individual involved on incorporation of a company.

⁴² The Department of Trade and Industry, *Companies in 2002-2003*, 2003, Table C1: 180,000 companies were removed from the GB register in 2002-2003; Table A5 gives the average life of a GB company as only 9.4 years.

⁴³ For example interest is not required to be paid on ordinary share capital unlike a bank or mortgage loan, nor are dividends guaranteed. This has the effect of increasing cash flow flexibility. Reported profitability is also increased owing to the different accounting treatment of interest and dividends.

The conclusion is that the legislative framework proposals will not radically affect shareholder sentiments, nor improve equity investment and corporate stability. The measures which could have effected a positive change in this area are now discussed and evaluated.

6.421 - The exit clause

The Law Commission⁴⁴ considered in detail the matter of including an exit article for shareholders. In their summary⁴⁵ they noted that the remedy is most commonly used by private companies. Their draft article⁴⁶, to be included within Table A, provided for shareholders named in an ordinary resolution passed by the company the right to require their fellow named shareholders to purchase their shares in the company. Whilst the draft gave examples of the circumstances when this might apply they did not require any specific circumstance to apply unless provided by the resolution itself. Additionally, the draft regulation provided for the independent valuation of the shares pro-rata to those in issue, and a timescale of three months⁴⁷ to complete the transaction.

The CLR⁴⁸ dismisses the recommendation thus:

“The clear conclusion⁴⁹ was that the article would not be used in practice because on commercial grounds it would not be incorporated in company constitutions by well informed founders and was inherently undesirable on grounds of flexibility - it was impossible to prescribe in advance, and for the full diversity of companies, what would be a fair exit regime. For ill-informed founders it would be a trap. We accept these views.”

It might be worth considering what the above statement might really mean and raise the following points:

1. Who are these well-informed founders; the majority shareholders perhaps?

⁴⁴ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, Part 5.

⁴⁵ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, Executive Summary, 4.

⁴⁶ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, Appendix C, Draft Regulation 119: Exit Right.

⁴⁷ Given the requirement to use their best endeavours.

⁴⁸ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Developing the Framework*, 2000, p.120, 4.103.

⁴⁹ Referring to its working groups on small firms and shareholder rights.

2. Why is it deemed to be inherently undesirable on the grounds of flexibility...for the full diversity of companies? Is the size dilemma⁵⁰ causing the undesirability?
3. If the article is a trap for the ill-informed should they remain ill-informed?
4. There is a clear presumption that the article must be discretionary. Why?
5. Would it be more preferable for the well-informed to introduce capital by way of loan which could then be more readily withdrawn⁵¹?

Within the same paragraph the CLR states "We very much support the Law Commission's proposal for stronger case management".

Are we to assume then that their alternative route to fairness is already envisaged to be court action?

Without becoming bogged down in the detail of any particular exit article, and how it might act on particular parties directly affected by it, perhaps we should seek to view the wider issues and consider what should be regarded as good public policy.

It should be common ground to state that public policy is best served in the following ways:

- encourage wider share ownership,
- encourage companies to have increased share capital, and
- discourage shareholder litigation.

It is the author's view that all three policy issues above would benefit from a suitable exit clause which increased the confidence by which potential equity investors might regard investment in private companies. Knowing there is a 'market' via the exit clause removes a considerable stall to investing either at first instance, or as a buy-out substitute, as it provides a degree of certainty for the potential equity investor.

⁵⁰ The Law Commission, *Shareholder Remedies*, Law Commission Report No. 246, 1999, Appendix C, para. 115, Exit Right.

⁵¹ The Law Commission, *Shareholder Remedies*, Law Commission Report No. 246, 1999, Appendix C, para. 115, Exit Right.

⁵⁰ Chapter 6, 6.21, p.93 discusses this size dilemma.

⁵¹ Which is likely to exacerbate corporate instability even further.

Perhaps it is assumed that it is the remaining shareholders (because the exit article is so drafted⁵²) who will bear the brunt of the capital cost of acquiring the additional shares and this is seen as potentially putting an undue strain on their finances⁵³, but this is not true as they are free to invite others to step into the shoes of the outgoing shareholder provided they do not make a public offer of the shares.

It is suggested that the real reason for a lack of enthusiasm for an exit clause is the perceived scarcity of available third party capital to enable the remaining shareholders to retain their existing equity exposure, rather than having to increase it at some unknown time in the future, triggered by the exit clause.

Clearly, if there is a lack of external capital availability then the exit clause may represent a considerable contingency on the personal finances of the remaining shareholder(s) and invariably the absence of an exit clause benefits the controlling majority by removing this contingency whilst the ongoing of the company is required.

By this analysis the problem is not with the exit clause but the lack of desirability in the company's equity from a potential investor perspective, and this is the problem that needs to be addressed in order to better serve public policy goals. Why is a slice of the action unwanted?

As an aside, and when considering the overall fairness of the situation, should the question also be asked why, at the formation of the association, did the controlling majority feel obliged to involve the minority? It can be fairly assumed that it suited their wider commercial interest to do so at that time, rather than a need for the minimal equity capital it would have raised for the company⁵⁴. Alternatively, was it "something else" which guided the formation?

⁵² The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, Appendix C, Draft Regulation 119: Exit Right.

⁵³ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 5.7.

⁵⁴ The Department of Trade and Industry, *Companies in 2002-2003*, 2003, Table A7 gives 1.3 m. companies having an issued share capital of up to £100.

When considering the certainty question it is worth evaluating the statistical evidence⁵⁵ available to the Law Commission when recommending the exit clause route.

The statistics are compiled from a review of petitions presented at the Royal Courts of Justice between January 1994 and December 1995 seeking relief under C.A. 1985, s.459. Of the 170 petitions all but 10 were inspected and 156 were found to be petitions under s.459. It is from these 156 petitions the statistics are compiled:

Status	Description	No	% of total
Petitioner	Minority shareholder(s)	113	72.4
	50% shareholder	35	22.4
Sections	459 alone	94	60.3
	459 & 122(1)(g)	61	39.1
Company Type	Private	150	96.2
No of Shareholders	2	54	34.6
	3 to 5	78	50.0
Pleadings:- A petition may include more than one pleading.	Mutual trust and confidence	51	32.7
	Continued participation	61	39.1
	Quasi-partnership	47	30.1
	Legitimate expectation	97	62.2
Allegations time-span Average = 2.9 years	Up to 1 year	58	37.2
	1 to 2 years	24	15.4
	2 to 5 years	41	26.3
Relief Sought:- Successful 122(1)(g) actions Can only result in winding up	Purchase of Petitioner shares	109	69.9
	Sale of Respondents shares	32	20.5
	122(1)(g) – Winding up	61	39.1
Time for disposal of first instance proceedings Average = 5.38 months	Up to 3 months	19	12.2
	3 to 6 months	16	10.3
	6 to 12 months	12	7.7
	Not disposed of	102	65.4

The author recognises the pertinence of the above statistics as:

- over 94% of petitioners are not majority (controlling) shareholders,
- 96% of petitions are derived from private companies of which,

⁵⁵ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, Appendix E, Statistics.

- over 84% have 5 or less members,
- each of the listed pleadings denotes a fundamental shift or breakdown in a relationship,
- over 62% of petitioners sight their allegations as ongoing for more than 1 year, and
- overwhelmingly the relief sought is a complete severance of the relationship for value⁵⁶.

It is clear from the above that a significant minority of consumers of this particular legal service, following the average 2.9 years of relationship breakdown prior to court action⁵⁷, do not much care for the company's wellbeing⁵⁸ by this stage; and overwhelmingly seek complete severance and the return of their investment through its compulsory liquidation by the court.

In conclusion, the author is firmly of the view that an exit vehicle should be mandatory for the 'Empathic Regime' company and a requirement for other private companies by special resolution.

It is argued that these requirements will, together with other recommendations below, act to highlight in the mind of the entrepreneur and the Government the capital raising possibilities open to these companies, and rather than being seen as a negative tool used simply to solve or avoid minority disputes can, in fact, be of positive future aid in the drive to raise relatively flexible and stable capital⁵⁹, readily replaceable for the well run company.

6.422 - The shareholder agreement

A considerable concern has been expressed by the CLR with regard to C.A. 1985, s.14 which forms the basis of the relationship between the company and its members, and members per se.

⁵⁶ The statistics here need care in interpretation as (for instance) the respondent's sale of shares is likely to be an alternative to the purchase of the petitioner's shares, the effect would be to remove the selling party from the company. The winding up route enables the petitioner to obtain value for their shares as an alternative to their purchase.

⁵⁷ The average stated applies to all petitioners. The applicable date is the date of the petition.

⁵⁸ All petitioners following the 122(1)(g) route are satisfied with the prospect of the company being wound-up which equates to 39% of total petitioners.

⁵⁹ Whilst capital raised to buy-out existing shareholders is not directly of benefit to a company an expansion of this source would be available for direct company investment in other circumstances, and in the enlightened regime envisaged.

The Law Commission considered this⁶⁰ and concluded “no hardship was being caused” with regard to the difficulty in the identification of personal rights concerning breaches of the company constitution. Accordingly, they recommended no reform of section 14.

The author takes a similar view with regard to the substance of the section whilst at the same time having sympathy with the CLR concern for the obscurity of the language used and the Law Commission’s acknowledgement that section 14 does not expressly state that the company is bound by its own constitution⁶¹. New legislation should rectify both points.

With regard to the individual rights bestowed on the members, the Law Commission contrasted “insider rights” with “outsider rights” and took the view that the outsider rights were beyond the scope of their terms of reference⁶² and that normally anyway, there would be a contract between the company and the member in their other capacity. The author takes the same view.

However, whilst some members may have this “other capacity” within a private company, not all are guaranteed to have one and it is suggested here that the use of a shareholder agreement covering all members of private companies⁶³ is particularly appropriate and flexible.

The Law Commission⁶⁴ suggests that the existence of an exit mechanism “may prompt registration agents to encourage their clients to consider such agreements, or even provide standard form drafts” going on to say within the topic head of shareholders’ agreement “we would encourage Companies House to consider whether reference can be made in the explanatory material which it supplies ...to the desirability of providing an exit mechanism.”

⁶⁰ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, part 7.

⁶¹ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 7.3.

⁶² The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 7.6.

⁶³ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 5.13 in consultation sought to apply the exit right to companies of less than 10 members but retracted from this position. A further example of the problems of defining in size terms.

⁶⁴ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 5.31 to 5.33.

Strangely, the CLR seems to see little use and presumably need for shareholders agreements; and when noting the suggestion of “one or two consultees” to the removal of all requirements of the Act designed purely for shareholder protection leaving it instead to the determination of a shareholder agreement commented, “...proponents of this approach did not provide a solution to the problem that companies would face when they wished to broaden their shareholder base to attract investment for growth.”⁶⁵

This seems to the author particularly dismissive and in wide variance to the facts concerning the broadening of the shareholder base. It is suggested that the CLR misses the point entirely and that the shareholder agreement, whilst not replacing the entirety of shareholder protection requirements of the forthcoming Act, does have a valuable place whereby rights can be determined with flexibility, and with specific agreement.

The author concludes that the shareholder agreement would fall within the scope of a mandatory provision of an ‘Empathic Regime’ company, and for other private companies should form part of the drive towards good governance and be promoted widely as the Law Commission suggested, albeit for a different reason as outlined in the foregoing.

6.423 - The mediation clause

The Law Commission also considered⁶⁶ the need for a regulation in Table A for an arbitration mechanism. Their stated objective was to encourage incorporators to consider providing a means of dispute resolution other than through the courts. Although a small majority of respondents were in favour, a majority of practising lawyers were against. The Commission concluded not to recommend a regulation which did not have the whole-hearted support of respondents.

⁶⁵ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, 2000, p.17, 2.36.

⁶⁶ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 5.34 to 5.38.

The author takes a different view and argues that whilst arbitration is probably going a little too far, the inclusion of a mediation regulation might well prove highly valuable in attempting to diffuse potential disputes at an early stage. As will be noted, mediation⁶⁷ allows for a less formal arrangement and is likely to be rather more attractive in airing and resolving misunderstanding, and gaining greater understanding of consequences of a dispute continuance. It is suggested that mediation would also remove objections identified by practising lawyers⁶⁸.

In fact, the envisaged role here of the mediator is far more akin to that of company mentor/business-angel who would ideally be an individual with in-depth experience of the private company sector, with additional skills and knowledge of mediation techniques. It is felt that the preferable situation would be to encourage adoption of the mentor/business-angel mediator at the outset so as to down-play the dispute role at first instance, and have an opportunity to develop trust in the relationships between all parties in a practical and constructive manner.

It could be reasonably argued that this is an excessive cost burden (and intrusion) into the internal workings of the company and something which is not warranted. The author accepts there are difficulties with this suggestion but feels that an acknowledged problem with many private company participants is the lack of preventative advice taken by them. The tendency being to obtain advice only when a particular problem has manifested itself, at which time the available solutions and courses of action become very much reduced.

The author concludes that a mediation regulation should be included as part of the 'Empathic Regime', and on balance included in the new forthcoming constitution of other private companies by special resolution majority.

⁶⁷ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 5.34: which the Law Commission considered as an example of a reason for arbitration proceeding suspension.

⁶⁸ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 5.36.

It is, however, recognised that mediation is not always successful and therefore there still remains a need for a final form of dispute resolution which is considered below⁶⁹.

6.424 - The valuation clause

The final point of note considered by the Law Commission⁷⁰ was the inclusion of a valuation procedure regulation for share sales. The Commission found this proposal received wide support but considerable concerns were expressed regarding the practicalities and because of this they recommended against inclusion of a valuation regulation.

Again, the author does not support this view and suggests that the best time to agree any such future event as a share valuation is when a share sale prospect is at its most distant, and when a dispute is not in being. Whilst the author concedes that this might not eventually result in fairness in all cases to all individuals, it does have the merit of certainty and is something which in any event is likely to be included in current shareholders' agreements.

The draft regulation⁷¹ proposed that no discount⁷² should be made for the fact that the shares to be valued formed part of a minority holding and that an independent accountant to determine fair value should be appointed, and in default the President of the Institute of Chartered Accountants may do so.

To view the difficulties envisaged and commented upon in the Law Commission report is to realise how the argument can become unmanageable, irreconcilable and to lose sight of what is trying to be achieved as an end product. The end product should be, in the opinion of the author, to establish a thoughtful basis of valuation not subject to duress on any party. This valuation

⁶⁹ Chapter 6, 6.6, p.126 evaluates the litigation and pre-litigation process.

⁷⁰ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 5.39 to 5.48.

⁷¹ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para. 5.4.

⁷² As already applies when there is a surplus which is distributed to shareholders pro-rata the shares held by each member (unless the articles otherwise provide) Insolvency Act 1986, Chapter V, s.107.

basis can then be implemented when necessary to avoid argument in the future which could seriously damage the company and, incidentally, act to reduce the share value for all parties.

Of significant importance in valuation matters is ensuring that the instruction method is valid. Whilst agreeing with the sentiment that minority shares should not be discounted because of their minority status there are other conceptual concerns to be addressed such as willing buyer/willing seller, the going concern basis, future prospects, etc.

Valuations are always only an opinion and a difficult one to arrive at in the absence of an open market to test that opinion. In the discussion concerning valuation fairness this should always be remembered when assertions are being made as to whether one way is more fair or reliable than another. Again these judgements are themselves only expressing opinion, and this has to be remembered especially when viewed in the context of the second guiding principle⁷³.

From a personal perspective the author would rather agree a basis of valuation for his share holding from the outset even if this was slightly disadvantageous⁷⁴, rather than have to go through a legal or adversarial process at a later stage which might possibly result in a more advantageous monetary outcome. The adage 'a bird in the hand' being a significant aphrodisiac in these circumstances.

There are always considerable arguments for and against, some of which have been rehearsed by the legal profession as respondents to the Law Commission consultation. The fact remains that it would be unheard of for a professional equity investor⁷⁵ not to have in place a defined exit route, including valuation basis, for their share stake prior to investment. There is no commercial sense to do otherwise.

⁷³ Chapter 6, 6.12, p.92: The interests of justice and fairness should be judged in a wide context.

⁷⁴ A 5% discount to value would not be considered unreasonable and probably more would likely be agreed given the particular circumstances. It is arguable whether an appointed valuer could achieve this level of accuracy without excessive caveats being appended.

⁷⁵ For example a Venture Capital company.

The author suggests that if the basis of a valuation regulation was constructed on the lines the court might take following a successful s.459 application, then the potential for unfairness might increase⁷⁶! It is therefore suggested that it is in the interests of all shareholders to consider this subject carefully at the outset.

Eventually someone has to stop the discussion and produce a solution. It can be left to the court, it can be left until the problem arises, or it can be tackled at a much earlier stage. It is a question of choice as to which is arguably the fairest.

On balance the author stands by the guiding principle – if it is worth doing do it now, and concludes a valuation procedure should be included subject to the same criteria he applies to the exit clause⁷⁷.

6.43 - Education and training

The law does not require any minimum standards of education, training or experience from either directors or shareholders of private companies⁷⁸. Also there is no formal means of assessment of knowledge and skill either prior to, or post role take-up for either.

Successively, the law has removed some of the balances and checks it has from time to time provided for the governance of private companies and the CLR has gone further along this route with its recommendations concerning the position of company secretary⁷⁹, and increases to the audit thresholds⁸⁰. Both of these measures further remove a third party input into the affairs of the company although their recent worth is acknowledged to have been of limited value in the case of the secretary, and a misdirected undue cost burden in the case of the audit.

⁷⁶ O'Neill v Phillips [1999] 1 WLR 1092: Lord Hoffman states (10) - The offer to buy, "The objective should be economy and expedition, even if this carries the possibility of a rough edge for one side or the other (and both parties in this respect take the same risk) ..."

⁷⁷ Chapter 6, 6.421, p.105: The author suggests the exit and valuation clauses should always be dependently conjoined and never agreed in isolation of each other.

⁷⁸ Chapter 1, 1.3, p.12, note 43: now no longer a statutory requirement for directors.

⁷⁹ Chapter 3, 3.25, p.45 and Chapter 3, p.45, note 39.

⁸⁰ Chapter 3, 3.42, p.59; see also Chapter 4, 4.42, p.76 and Chapter 4, p.76, note 61.

Considerable debate has focused on the 'stakeholder' concept of interests, where particularly the role of the director is broadened to include duties towards a much wider audience than just the shareholder interests, and as the role of the director becomes more complex with potential conflicts arising from many different quarters, and the span of seeking to balance these interests is lengthened to look over the longer term, there is little put in place to educate.

This seems very odd in an age where in other fields of working endeavour, education and assessment are seen as so important.

In the author's experience this is often where the process falls down as the education and training needs of the customer are given a very secondary position behind the good intentions of providing clear and concise legislation geared to assisting those customers. The legislative message may be sound, but if it is unread and ignored it is of little practical value.

The CLR considered the benefit of training and or qualifications for directors⁸¹, but this was centred only on the public company, with little discussion for the needs of the private company, yet it is in this economic sector where the overwhelming number of companies is positioned and from which a significant activity flows.

Whilst it is not suggested here that there should be mandatory knowledge and skill requirements for either directors or shareholders of private companies, it is suggested that a valuable educating role could be devised through the mentor/business-angel mediator route. It is suggested that an independent third party, conversant with legislative aims, could prove very effective in educating over the long term.

⁸¹ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Completing the Structure*, 2000, p.68, 4.42 for instance.

Where the author might well consider mandatory provision is when a company commits a regulatory offence⁸² such as late filing of accounts. The detection of these types of offences is already in place through Companies House and results in monetary penalties of varying amounts, with penalty increases for more persistent offences. Largely, this is seen as being cost-effective and having “the benefit of active enforcement by agencies required to operate in the public interest.”⁸³

The suggestion is made here for a link between Companies House and (say) the Small Business Service (SBS)⁸⁴ or Business Link, all of which fall under the DTI umbrella, to enhance the operation of the public interest through wider education rather than just a compliance role.

Indeed, the SBS reported its review of progress under the European Charter for Small Enterprises in September 2003 which included the action it is taking on education and training for Entrepreneurship⁸⁵ although much of the endeavour is targeted towards students or employees rather than existing shareholders and directors.

However, an education/training culture for enterprise is already established and an additional focus does not seem onerous especially when one considers the implications of the demographic statistics on self-employed persons⁸⁶ which indicates an older profile for those in business for themselves.

⁸² The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, Chapter 15 considers the sanctions regime, but does not contemplate the possibility of an education sanction.

⁸³ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.309, 15.19.

⁸⁴ The Secretary of State for Trade and Industry, *Modernising Company Law*, 2002, p.113, 12: examples the use made in the consultation process of the SBS to arrange meetings.

⁸⁵ The report can be viewed at < <http://www.sbs.gov.uk/content/regulations/reportuk2003.pdf> > [Accessed 23rd May 2004].

⁸⁶ It is acknowledged that these statistics are indicative only in relation to companies. The report “Small businesses and their role in the UK economy” can be viewed at < <http://www.sbs.gov.uk/content/analytical/evbasestatistics.pdf> > [Accessed 25th May 2004].

The points being are:

1. Any skills acquired at school may lay unused for many years (if still retained), and
2. The training program operating currently does not suggest adequate coverage of the 71% already self-employed (running businesses) in the age range 35 to 55+⁸⁷.

By the mechanism of mandatory requirement in cases of regulatory offence, a greater overall understanding of the roles played by both directors and shareholders might be conveniently enhanced and promoted. This increased awareness having the added benefit of removing potential areas of dispute by education.

This suggestion would apply to all private companies.

6.5 The ongoing existence

6.51 - Legislative framework

Much of the emphasis of the CLR has been the consideration of the 'Elective Regime' in an effort to reduce the administrative burden on private companies, and the reporting regime focused on keeping shareholders informed of their company's progress in a timely manner⁸⁸.

The 'Elective Regime' clearly does reduce the administrative burden and is welcomed as a recommended default provision, whilst retaining the power of a single member (for instance) to call an AGM demonstrates an acknowledgement that some form of "calling to account" is still required. The recommendation to remove (a) the need to file abbreviated accounts, and (b) to appoint a company secretary, is also welcomed as a further burden reduction.

⁸⁷ "Small businesses and their role in the UK economy", Chart 3.

< <http://www.sbs.gov.uk/content/analytical/evbasestatistics.pdf> > [Accessed 25th May 2004].

⁸⁸ Chapter 3, 3.2, p.39 and Chapter 3, 3.4, p.58 chart the administrative and deregulatory provisions recommended.

However, none of the above really addresses the fundamental problem of how power is developed and exercised in private companies, and how that power is to be reasonably controlled. On the one hand we have the director(s) who have access to all information, and on the other hand we have the shareholder(s) who have rights of access to very limited information⁸⁹.

Indeed the shareholder(s) only have the right to receive year-end financial statements (now recommended to be made available to them within 7 months of the end of the financial period to which they relate⁹⁰) and wholly free from any third party scrutiny in the majority of private companies.

Interestingly, whilst following the discourse on the question of accounts, the tenor of those discussions within the CLR process suggested a lack of appreciation of how accounts may be influenced by judgements made by directors, in addition to the accounting concepts and conventions over-laid on them by the accounting profession. The end-product published financial statements⁹¹, although valid within the terms and purpose for which they are prepared, may provide little information of worth to the shareholder (or other reader of them) with regard to the true nature of the underlying day-to-day assumptions the management is operating under, nor the management accounts they prepare for themselves and on which they rely to control the operations of the business⁹².

⁸⁹ Table A, art. 109 precludes a member rights of inspection, except as conferred by statute, or authorised by the directors, or by ordinary resolution. i.e. barring minority inspection by controllers who do not wish it.

⁹⁰ It is not always in the commercial interests of a company to be obliged to finalise its accounts too early after the period end, even though their composition is complete. Taxation or putting major financing arrangements in place might be valid examples of reasons for delay.

⁹¹ It should also be noted that even under the new proposals accounting information will still be between 7 and 19 months old before it reaches the shareholder. An eternity where cash flow constraints are concerned.

⁹² There is no duty to prepare management accounts which conform with published financial statements. Validly, materially different assumptions can be used when preparing either.

Given the caveats expressed above and assuming the recommendations are all enacted, and having regard to the fact that the audit thresholds have now been increased, a greater number of companies are now devoid of any sort of third party scrutiny⁹³.

The question is raised...How can adequate control be exerted, and by whom?

The answer may be provided below.

6.52 - Shareholder information access

Company Law has traditionally focused on the AGM as the forum for shareholder control and whilst this arena can enable some discussion to take place it is suggested that meaningful discussion is only likely when all parties are fully informed, and there is some means of ensuring the answers to questions raised are accurately given by management.

The question of whether directors should be required to disclose was considered by the CLR, but it was in relation to their duties towards auditors⁹⁴, which clearly does not apply to the majority of private companies.

The view is put forward here that the real fault of the present position lies in the lack of understanding on the part of legislators. They have produced legislation geared to the separation of the shareholder and director roles and this is more appropriate to public companies where such a separation of management and equity ownership is the norm, rather than private companies where it is not.

If we go back to the development of the law outlined in Chapter 1⁹⁵ and review the table of governance issues which have either been removed or diminished we will see a pattern of

⁹³ Excepting government agency scrutiny e.g. HMI or HM Customs.

⁹⁴ The Company Law Steering Group, *Modern Company Law for a Competitive Economy: Final Report Volume I*, 2001, p.204, 8.119 recommends a widening of directors' duties towards information disclosure.

⁹⁵ Chapter 1, 1.3, p.12 considers the rationale behind the development of the law.

internal control mechanisms removed. These mechanisms were originally put in place in order to assist shareholders to exercise control over the directors; either to avoid collusion, or adequately inform, or ensure proper process. This more fully goes to the heart of the problem because directors, especially controlling directors, are not now subject to these constraints.

In essence, good internal control procedures of a day-to-day nature have all but vanished. The pendulum has swung too far yet, as outlined below, access to information in other areas of our lives is seen as vital, for example:

1. The Law Commission⁹⁶ considered the matter of pre-action discovery of documents appertaining to the parties to shareholder proceedings, and in light of the Lord Woolf Report recommendations⁹⁷, concluded there was no reason to extend “the right to disclosure of documents specifically for shareholder proceedings” confirming that the Woolf Report recommendations, if carried through, were sufficient.

The enactment of the Civil Procedure Rules⁹⁸ following the Woolf Report bring the consideration of disclosure into clearer focus in so far as it encourages full co-operation between the disputing parties, and the court can apply cost sanctions against those who fail to co-operate adequately⁹⁹. The rules concerning disclosure of other party documentation are now far wider than previously was the case, including rules of required conduct before proceedings¹⁰⁰.

2. A more recent indication can be found in the Freedom of Information Act 2000, although applying to public authorities only, it gives a general right of access to

⁹⁶ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, para 7.13 to 7.16 - pre-action discovery (now re-named disclosure post Woolf).

⁹⁷ Lord Woolf, *Access to Justice - Final Report*, 1996, Chapter 12, para 37 to 52 concerning disclosure. <<http://www.dca.gov.uk/civil/final/sec3b.htm#c12>> [Accessed 25th July 2004].

⁹⁸ The Civil Procedure Rules, S.I. 1998 No. 3132 L.17. <<http://www.hmso.gov.uk/si/si1998/19983132.htm>> [Accessed 25th July 2004].

⁹⁹ The Civil Procedure Rules, 1998, Rule 44.3(4) et seq.

¹⁰⁰ The Civil Procedure Rules, 1998, Rule 44.3(5)(a).

information by any person, and to have that information communicated to them¹⁰¹.

3. A review of the Partnership Act 1890¹⁰² shows that the right to inspect the books is unfettered for the equity participant in so far as "...and every partner may, when he thinks fit, have access to and inspect and copy any of them."

Contrast the above with how information rights have diminished for companies:

The Joint Stock Companies Act 1844 gave a power¹⁰³ to shareholders to "inspect the Books of Account and the Balance Sheet of the Company, and take Copies thereof and Extracts therefrom" in the window of 14 days before, and 1 month after, the Balance Sheet is produced at the shareholders ordinary meeting. Additionally, a further power is provided by this section to allow a shareholder to inspect at other times, provided they have the authority in writing from three directors.

Having set the scene in other areas, how might this now apply to private companies?

It is the author's opinion that a statutory right of access to company information should be made available to shareholders of all private companies in an attempt to aid the interests of the company, shareholder interests generally, and that of the wider public interest. However, it is conceded that this right of access may be differently pitched between 'Empathic Regime' and other private companies given the disclosure suggestions made regarding the financial reporting¹⁰⁴.

Lack of information should, it is suggested, be seen as a disability which ultimately disadvantages everyone over the long term.

¹⁰¹ Freedom of Information Act 2000, s.1.

¹⁰² Partnership Act 1890, s.24(9).

¹⁰³ C.A. 1844, XXXII.

¹⁰⁴ Chapter 6, 6.33, p.97: Examples in action: enabling democracy to work.

Whilst this is a significant departure from current company law statute, it is suggested that the overall environment of public expectation has moved in this direction and the CPR now provide this greater degree of information disclosure anyway, and the resulting end product of disclosure could reasonably be brought forward to:

- attempt to level the playing field for shareholders without executive office¹⁰⁵,
- influence the process of good corporate governance,
- enable better ongoing understanding to be achieved,
- recognise the underlying nature of the relationships existing in these companies, and
- improve internal control mechanisms.

If this proposal for information openness was recognised in statute what might be the envisaged downside?

6.53 - Control of shareholder abuses

It might lead to:

- vexatious or repeated requests for information,
- breaches in company confidentiality,
- inappropriate influence on management action, and
- the likelihood of more disputes arising.

6.531 - Vexatious or repeated requests for information

It is agreed that a consequence of a more open information regime is the opportunity for making requests which are vexatious or repeated with the result of them being burdensome on the company, and of little intrinsic value other than as an annoyance to those holding the information. The FIA 2000 considers the remedy for this and removes the obligation to comply with such requests¹⁰⁶. It is suggested that this could apply to private companies, suitably

¹⁰⁵ O'Neill v Phillips [1999] 1 WLR 1092: Lord Hoffmann (10) stated when considering the offer to buy, "...provide for equality between the parties. Both should have the same right of access to information about a company which bears upon the value of the shares..."

¹⁰⁶ Freedom of Information Act 2000, s.14.

modified, recognising the frequency of the same or substantially similar information which might be reasonably requested from such companies¹⁰⁷.

In the event that a breakdown in the relationship between directors and shareholders manifests itself in the future, there would be an audit trail of requests and actions in response to requests, on which the court can, if necessary, make judgement and take appropriate action.

6.532 - Breaches in company confidentiality

Almost inevitably, when discussions concerning information release are encountered, the argument centres upon sensitive commercial information. The argument is put forward here:

- The release of sensitive commercial information by a shareholder may be detrimental to the company, but this impacts on the share value, and therefore contrary to their own commercial best interests. Should this preclude information being distributed?
- A statutory remedy which would make a breach of confidentiality unattractive to the shareholder could be enacted.
- A confidentiality agreement¹⁰⁸ could be entered into for those wishing to exercise their right of access to further information.

Again a breach of confidentiality in cases which may proceed to court can be considered by the court at that time, and dealt with accordingly as part of its tighter case management remit.

6.533 - Inappropriate influence on management action

It is accepted that the release of information may require the directors to pay greater attention to the reasons for taking a particular course of action in the name of the company. It is argued that this is no bad thing and it does exert a degree of influence on them (as directors) which is absent

¹⁰⁷ The author has in mind accounts which might be prepared on a monthly or quarterly basis. A request for such would not count as a repeated request.

¹⁰⁸ As part of the Shareholder agreement perhaps?

currently. However, as is put forward with regard to the derivative action¹⁰⁹, the majority has the power to exert its control when necessary to do so. At least in this context of more open information the discussion surrounding a particular action is likely to be informed when both parties are privy to the same information.

Undoubtedly, there is a balance to be struck which is better served when understanding through education is present, but the informality which often surrounds private companies suggests¹¹⁰ that where good relations exist there will already be some information flow, over and above that strictly required by statute. This contrasts significantly with public companies where relationships generally between directors and shareholders are formal. The problem remains, however, that for any reason, valid or otherwise, this informality can be removed at the will of the controlling directors, and this should not be appropriate in the 21st century.

It does not seem to the author that inappropriate influence is a prop on which directors should rely to avoid greater information disclosure in private companies.

6.534 - The likelihood of more disputes arising

Again it is accepted that there is an argument that increased information may cause a greater incidence of disputes arising between shareholders and directors than might otherwise be the case if the information flow remained restricted.

It is difficult to see that this is a valid reason to the extent that it should negate the proposal. Instead it is argued that with better education and training, as outlined above, both the shareholder and director would have a better grasp of their respective duties and obligations not only to the company, but also to each other.

¹⁰⁹ The Law Commission, *Shareholder Remedies: Law Commission Report No.246*, 1997, Part 6, para. 6.1: The majority rule principle.

¹¹⁰ This is in line with the author's experience in private companies.

If one is to accept that disputes arise owing to the breakdown of a relationship it is hard to see how, in human terms, a relationship based on secrecy is likely to foster the trust required to provide long term relationship stability. The author concludes that openness is more likely to achieve the desired aim of company longevity.

6.54 - Conclusion

In concluding this section the author is firmly of the opinion that internal control has been weakened in private companies over a long period and needs to be redressed. This weakness of governance can be addressed by enlisting the interested and informed shareholder. The interest can be best activated and maintained through education and informed by information access.

It is argued that educating and informing helps to create a working environment of trust and inclusiveness, devoid of distrust and alienation. The increase in trust and inclusiveness it is suggested assists in removing areas of dispute.

6.6 The death

6.61 - Introduction

As envisaged by the author this is very much the worst case scenario resorted to only when other methods of resolving disputes have failed. It is the unpalatable prospect which sticks in the throat with the smack of failure written all over it. However, there will still be times when, owing to the personalities involved, retreat to the courts is the only remaining option.

The two favoured routes are:

- C.A. 1985, s.459: Order on application of company member with remedies provided by s.461,
- Insolvency Act 1986, s.122(1)(g): Circumstances in which company may be wound up by the court which are just and equitable.

In attempting to understand the practical implications of actions taken under these two routes, it is necessary to read them in conjunction with the Civil Procedure Rules 1998¹¹¹, and accompanying Practice Directions which govern their operation.

The emphasis of the new rules is very much focused on active case management in order to achieve the overriding objective¹¹². In so doing, they place the court in a more inquisitorial position whilst at the same time reducing the power of the parties, including their legal representatives, to play their former adversarial role. This later innovation is achieved by requiring the parties to owe a duty to the court to "...help the court to further the overriding objective."¹¹³

This fundamental shift in nature of court procedure is important to this work because it opens an avenue of discussion which asks whether the older legislation¹¹⁴ is in sympathy with the newer role now taken by the courts.

Taking the information available to the Law Commission¹¹⁵ it can be seen that pleadings in these cases are constructed on the basis of allegations of the petitioner in typically adversarial fashion. Indeed, the basis of success for these actions contemplates proof of unfairness, prejudice or injustice by one party on another. The respondent to these allegations again typically refutes them as untrue. In each case the tendency is to incorporate allegations and rebuttals of some length¹¹⁶ each of which has to be considered by the court or otherwise disposed of by agreement between the parties.

¹¹¹ The Civil Procedure Rules 1998 (as amended) can be found at < http://www.dca.gov.uk/civil/procrules_fin/menus/rules.htm > [Accessed 1st June 2004].

¹¹² The Civil Procedure Rules, 1998, Rule 1.1: The overriding objective.

¹¹³ The Civil Procedure Rules, 1998, Rule 1.3: Duty of the parties.

¹¹⁴ C.A. 1985 and C.A. 1989.

¹¹⁵ Chapter 6, 6.421, p.108: The table of analysis of petitions presented at the Royal Courts of Justice.

¹¹⁶ In *Re Rotadata Ltd* [2000] 1 BCLC 122: the petition ran to over 30 closely typed pages and contained 121 paragraphs including 21 separate allegations.

It is suggested that there exists a dichotomy between the legislation and its aims, and the rules of court and its aims. The former constructing an adversarial route, which the latter now seeks to remove. The 'Empathic Regime' avoids this existing problem.

Rotadata Ltd¹¹⁷ provides a good example of the absurdities of the current position. Neuberger J pointed out that:

“...there would be a great deal to be said for the registrar to consider giving directions requiring parties and/or their advisers to meet with a view to narrowing the issues, identifying what issues are really important, what issues are really in dispute, how those issues are to be resolved or proved, and resolving and narrowing any other matters which in the context of the particular petition could reasonably be expected to be narrowed.”

No doubt he anticipated, if not in this particular case, that substantial movement to the respective original positions could be engineered¹¹⁸. The question arises whether the need for narrowing of issues could have been avoided had the nature of legislation on which they were based been less adversarial in the first place?

It is suggested that the appropriate remedy for actions taken within a revised provision would follow a presumption in favour of the purchase of the minority shareholding by the majority. In this way the outcome of this type of action, within the special circumstances appertaining, would be more certain. It is anticipated that this message would permeate through to advisers and their clients, and act to modify their behaviour¹¹⁹ in line with the expectations of the new CPR.

However, there still remains the problem of the parties incurring considerable expense in the preparation to court action and it is here where there is a further opportunity to improve matters generally.

¹¹⁷ Re Rotadata Ltd [2000] 1 BCLC 122.

¹¹⁸ Minded as he was of the likely costs exceeding £300,000 against a share value of similar amount.

¹¹⁹ The Solicitors Family Law Association prescribes a code of conduct and it is felt the aims of this code and association are very much in the required spirit of all shareholder actions. The code can be viewed at <http://www.sfla.org.uk/code_practice.php> [Accessed 26th July 2004].

6.62 - Pre-action protocols

Currently there is no specific pre-action protocol for shareholder actions. There is, however, a practice direction covering applications under the Companies Act 1985¹²⁰ which modifies some of the requirements of the general CPR. Actions under s.459 fall under this practice direction requiring the claimant to file a petition rather than the usual claim form. It further requires, amongst other things and following the presentation of the petition, an application notice to be filed applying for directions. Additionally, "every application under the Act ...shall be allocated to the multi-track and the CPR relating to allocation questionnaires and track allocation will not apply."¹²¹

It is considered that pre-action protocols and practice directions specific to shareholder actions have the capacity to prove highly efficient in framing preliminary conduct of the parties and their advisers, the direction of future case management, and a reduction of costs. Indeed, when referring to more active case management techniques by the courts¹²², it is here where we should look first to ensure that all is being done prior to an action arising.

It is suggested that there is considerable scope to ensure the parties have used their best endeavours to do everything possible to:

- narrow the issues on which they do not agree,
- identify issues they might refer to ADR prior to filing the petition,
- meet to further assist resolution of the dispute in whole or in part,
- agree on the need for further information disclosure to save costs,
- agree on any area of expert evidence or additional expertise required,
- agree on offers made by either party to settle the dispute in whole or in part,
- agree the conduct of future progress with a view to saving costs, and

¹²⁰ The Civil Procedure Rules, 1998, Part 49b available at http://www.dca.gov.uk/civil/procrules_fin/contents/practice_directions/pd_part49b.htm [Accessed 2nd June 2004].

¹²¹ The Civil Procedure Rules, 1998, Part 49b, c.10.

¹²² Chapter 3, 3.34, p.51: Reviews the remedy reform proposals of the Law Commission.

- subsequent to petition filing, provide to the court a disclosure of pre-action conduct, details of any agreements concluded, details of any further offers of settlement, and details of any interim orders sought¹²³ including security for costs.

The aim is to further provide an opportunity for the parties to communicate in a non-adversarial fashion with a view to resolving the dispute in part or in whole. The further aim is to provide the court, prior to making its directions, with sufficient information for it to form a view on the conduct to date of the parties and their advisers.

6.63 - Security for costs¹²⁴

There is raised here the concern that a shareholder in dispute may be particularly disadvantaged by controlling directors in so far as¹²⁵:

- they may already have been deprived of their livelihood from the company,
- they may have substantial funds locked into the capital of the company over and above the face value of the share capital they own,
- they may have loans outstanding or unpaid salary due from the company,
- there may be evidence which suggests the controllers will or are funding the dispute using company resources whether directly or indirectly including arranging unusual or significant fees, bonuses, loan repayments, charges or other devices which act to channel resources into their hands or the hands of associates, and
- the majority may be taking the route of litigation by way of attrition.

If a pre-action protocol were framed in a manner which provided the judge at first instance the information required in CPR 25.13(1)(a), and enactment in legislation complied with the requirements of CPR 25.13(1)(b)(ii), then there would exist a very powerful weapon in the case management armoury for future case conduct requirements. It would also address at least

¹²³ If the interim order required hasn't been applied for previously under CPR, Part 25.

¹²⁴ The Civil Procedure Rules, 1998, Part 25 - Interim remedies and security for costs.

¹²⁵ There will need to be early disclosure to identify whether these matters are material.

in part the over-riding objective in CPR 1.1(2)(a) “ensuring that the parties are on an equal footing.”

6.64 - Conclusion

It is suggested that few will regard the ponderous and costly nature of legal proceedings as a fair solution and even if it were to be improved by a large percentage, or even a single digit factor multiple, it would still not provide a suitable solution in the majority of cases. It is believed that this is self apparent to those involved, which is why the ADR route is appealing.

However, it is felt that the ADR route will only succeed when legal advisers and their clients do not see legal proceedings as a fall-back position. Their commitment to ADR has to be genuine, and to further that aim, the hurdle to the court moved higher.

The suggestions made in this section are geared to increasing that hurdle to court action not by increasing costs, but by putting increased pressure on the parties and their advisers to consider their actions more carefully, and at an earlier stage. The suggestions are made in an effort to modify attitudes and behaviour.

6.7 Empathic pragmatism – a way forward

The motivation for this work has been the desire in the author to identify and remove potential areas of dispute and resolve conflict between directors and shareholders in small private companies.

In trying to achieve these aims and fulfil this desire, the work is also seeking to answer the primary question: What is the purpose of the private company in the 21st century?

A clear perspective of this work is to show how the private company may be regarded as an association formed for profit and some other factor, with both parts acting as prime motivating

agents for the participants. This perspective additionally recognises the balance of these two factors is unstable during the course of the association.

A further clear perspective is the belief that the key to success of the private company is to keep in balance the two motivating factors in as many of the participants as possible, for as long as possible. Put another way - to manage all participants in the direction of both personal achievement and corporate success.

At the end of the association, whether in whole or in part, then the perspective switches to recognise that the de-motivation of one participant can permeate to the very core of the company if not quickly removed, and that the participant should be removed as speedily as practicable before serious damage is done.

The author argues for the 'Empathic Regime' to form the basis of a pragmatic solution, largely reliant on the law providing a suitable framework within which it can operate. He sees the 'Empathic Regime' as a highly deregulatory concept capable of defining the entrepreneurial corporate vehicle required for the future.

The references to the Companies Act 1985 (as amended by the Companies Act 1999) used in the thesis have been taken from this publication. References from this consolidating publication may not accord to those contained in the original statute published by The Stationery Office limited as ISBN 0-10-540645-6 (C.A. 1985) and ISBN 0-10-544033-1 (C.A. 1999).

For the convenience of the reader the author provides in both text and notes abbreviations where he feels appropriate. A full list of abbreviations, including those contained in this bibliography, is also provided.

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¹ The references to the Companies Act 1985 (as amended by the Companies Act 1989) used in the thesis have been taken from this publication. References from this consolidating publication may not accord to those contained in the original statutes published by The Stationery Office Limited as ISBN 0-10-540685-6 (C.A. 1985) and ISBN 0-10-544089-2 (C.A. 1989).

² For the assistance of the reader the author provides in both text and notes abbreviations where he feels appropriate. A full list of abbreviations, including those contained in this bibliography, is also provided.

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Electronic Communications Act 2000

Insolvency Act 1986

Joint Stock Companies Act 1844

Limited Liability Act 1855

Partnership Act 1890

³ The detailed Regulatory Impact Assessments referred to in the RIA can also be located at <<http://www.dti.gov.uk/companiesbill/ria.htm>>.

ABBREVIATIONS

Abbreviations connected with the Company Law Review process:

Terms

CLR	The Company Law Review Steering Group
DTI	The Department of Trade and Industry
MCL	Modern Company Law For a Competitive Economy
SSTI	The Secretary of State for Trade and Industry
White Paper	The Draft I and Draft II publications together

Publications (in chronological order of date published)

Modern98	CLR, March 1998. <i>MCL</i> .
Framework99	CLR, February 1999. <i>MCL: The Strategic Framework</i> . URN 99/654
Meetings99	CLR, October 1999. <i>MCL: Company General Meetings and Shareholder Communication</i> . URN 99/1144
Formation99	CLR, October 1999. <i>MCL: Company Formation and Capital Maintenance</i> . URN 99/1145
Developing00	CLR, March 2000. <i>MCL: Developing the Framework</i> . URN 00/656
Structure00	CLR, November 2000. <i>MCL: Completing the Structure</i> . URN 00/1335
Final I	CLR, July 2001. <i>MCL: Final Report Volume I</i> . URN 01/942
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Small I	DTI, July 2001. <i>MCL: Small Business Summary</i> . URN 01/996
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Draft II	SSTI, July 2002. <i>Modernising Company Law – Draft Clauses</i> . Cm 5553-II
RIA	DTI, July 2002, Draft Overarching Regulatory Impact Assessment

Abbreviations of a general nature:

ADR	Alternative Dispute Resolution
AGM	Annual General Meeting
APB	Auditing Practices Board
ASB	Accounting Standards Board
C.A. (date)	The Companies Act or Joint Stock Companies Act of the date given (e.g. C.A. 1985)
CPR	The Civil Procedure Rules
CR 2003	DTI, July 2003. <i>Companies in 2002-2003</i> . London: The Stationery Office.
EGM	Extraordinary General Meeting
EU	European Union
FIA 2000	The Freedom of Information Act 2000
FRIA	Final Regulatory Impact Assessment on Audit Exemption Thresholds
FRSSE	The financial reporting standard for smaller entities
GB	Great Britain
HMI	Her Majesty's Inspector of Taxes
I.C.A.E.W.	The Institute of Chartered Accountants in England and Wales. The largest professional accountancy body in Europe, with over 125,000 members and arguably also the most influential. < http://www.icaew.co.uk/ > [Accessed 29 th April 2004]
IPR	The Independent Professional Review (a proposed review of accounting information of small companies each year, in substitute for an audit)
.pdf	A computerised file often available over the internet and downloadable onto a user's computer. The .pdf (portable document file) needs to be viewed using an <u>Adobe® Reader®</u> available from < http://www.adobe.com/products/acrobat/readermain.html > [Accessed 29th April 2004]
plc.	Public limited company
RIA	Regulatory Impact Assessment
SBS	Small Business Service
UK	United Kingdom

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