1 Theoretical underpinnings of companies and their governance

Corporations are a product and a part of society. Thus understanding corporations involves insights into the way in which the corporation is viewed as a social phenomenon. This may be discovered by investigating historical and theoretical foundations and forming a conception of the functioning of the corporation as a dynamic entity. The models of companies that have been adopted in various jurisdictions are shaped by the theories concerning the place of companies within society. Different theories concerning the origin and purpose of corporations influence the model of company adopted and thus shape the relationship that companies have with all the participants in their economic activity and with their regulators. Formulating a regulatory structure without such an enquiry invites incoherence. Thus Bottomley:

> The broad and basic purpose of examining corporate theory is to develop a framework within which we can assess the values and assumptions that either unite or divide the plethora of cases, reform proposals, legislative amendments, and practices that constitute modern corporation law. This law has not sprung up overnight. We need some way of disentangling the different philosophical and political perspectives from which it has been constructed.[1]

Or, more pithily, 'one cannot intelligently discuss whether a corporation is acting responsibly when it shuts down a factory without taking a position on the role of corporations in society'.[2]

It should be noted that some theories seek to provide explanations of corporations by studying their origins. Others look at the way in which corporations operate. Some theories have both aspects. Thus, corporations may be seen as the product of a contract between founding members (legal contractualism). This is a foundational theory. But when this is used to justify the pre-eminence of shareholders as 'owners' of the company it becomes an operational theory. Some of the difficult-

[1] S. Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' [1990] 19 *Federal Law Review* 203 at 204.
[2] K. Greenfield, 'From Rights to Regulation' in F. Patfield (ed.), *Perspectives on Company Law: 2* (Kluwer, London, 1997), 1.

ies encountered by contractualism in seeking to explain the operation of companies have arisen because foundational theories have been applied to the operation of companies without an understanding of the difference between a foundation contract and the dynamics involved in the operation of a company. The key point in the difference is the way in which the company's constitution operates, not merely as a contract but as an arbiter of the rights and duties of those concerned with the ongoing nature of the concern. One purely operational theory is the organic conception of companies as used in the criminal law to justify conviction of a company as the 'alter ego' of its controlling mind and will.[3] Although this arose primarily to explain how a company could form a will if it was the fictional product of a state concession of power, it could apply to any functioning company whatever its theoretical foundations are seen to be.

A key element in determining what model of company particular societies have adopted and therefore the relationship with participants and regulators is the way in which the 'corporate veil' is viewed. The strength and purpose of the corporate veil is directly derived from the theories that shape the model adopted in any jurisdiction. The status of the corporate veil contains the essence of the model of company adopted and also contains important lessons for those seeking to regulate companies. Corporate personality and the corporate veil may be seen as a shorthand expression to encompass the theoretical and sociological underpinnings of the existence of a company.

It is therefore vital to understand the derivation of companies if progress is to be made in steering them in a desired direction. Such an understanding is also essential for the proper characterisation of contentious issues which will arise. For example: is a dispute between two shareholders about an alteration of the constitution of the company to be classified as a contractual dispute or as a constitutional one that requires the imposition of public law principles? The proper classification may well depend on whether the company is seen as a creature of the state or as a contractual arrangement between a group of people.

This chapter seeks to examine the way in which disparate theories give rise to different models of companies. The analysis has the eventual purpose of determining the optimum basis for regulating companies and continuing the analysis into situations involving groups of related companies.

[3] *Tesco Supermarkets v Natrass* [1972] AC 153; *H.L. Bolton (Engineering) Co Ltd v T. J. Graham & Sons Ltd* [1957] 1 QB 159; *DPP v Kent and Sussex Contractors Ltd* [1944] KB 146.

The existence of companies: theories

Theories of company existence are all important in the understanding of the appropriate corporate governance model. Critically, they affect the degree of state interference that is deemed appropriate in the conduct of company affairs, as well as the range of interests that compose the 'interests of the company'. Although theories overlap and interweave, it is suggested that a convenient structure can be imposed by taking as a starting point three theories that have been influential in shaping models of companies. These are the contractual, the communitaire, and the concessionary theories. The contractual and communitaire theories represent two extremes since they reflect notions of the company as a product of laissez-faire individualism and as an instrument of the state, respectively. The concession theory may provide a less extreme 'middle way'.

Contractual theories

Legal contractualism

According to legal contractual theory,[4] two or more parties come together[5] to make a pact to carry on commercial activity and it is from this pact that the company is born.[6] Bottomley labels this the 'aggregate' theory,[7] explaining various versions thus:

> Contract supplies the explanatory framework for both the judicial and the political status of the corporation. Internally the corporation is regarded as an association or aggregation of individuals; it comprises contractual relations between members *inter se*, and between members and management.[8]

The logical outcome of the theoretical contractual base is to limit the social responsibility of the company and create an entity remote from regulatory interference because any denial of the right to use the free enterprise tool which is available tends to interfere with this concept of

[4] This differs from the economic nexus of contracts theory. See J. Parkinson, *Corporate Power and Responsibility* (Clarendon, Oxford, 1995), 75–76. See also discussion of economic theories below.
[5] It is unclear exactly how this theory adapts to one-person companies.
[6] Bottomley, 'Taking Corporations Seriously'.
[7] Ibid., 208. He attributes the label to J. C. Coates, 'State Takeover Statutes and Corporate Theory: the Revival of an Old Debate' (1989) 64 *New York University Law Review* 806.
[8] See D. Sullivan and D. Conlon, 'Crisis and Transition in Corporate Governance Paradigms: The Role of the Chancery Court of Delaware' (1997) *Law and Society Review* 713.

the company.[9] The theory has the effect of putting the corporation into the sphere of private law, of viewing the legitimation of the power it wields as coming from the entrepreneurial activities of the members and lessening the state's justification for regulatory interference.[10]

In the UK this doctrine is reflected in section 14 of the Companies Act 1985,[11] which 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 articles.

Although this expresses the contractual view well,[12] the difficulties that the courts have had in its interpretation also flag the limits of the doctrine.[13] For example, the 'contract' is unenforceable if the plaintiff is suing in a capacity other than shareholder,[14] and the courts have categorised those given a 'special' right by the articles as 'outsiders' in order to exclude them from the right to enforce the section 14 contract.[15] *Eley v Positive Government Life Assurance*[16] is a case that illustrates the court's dilemma well. In that case, Article 118 of the company's articles provided for Eley's indefinite employment by the company. The article provided that he could be removed only for misconduct. Eley had drafted the articles. Despite the fact that Eley was a shareholder the court refused to allow him to enforce the article.

Although the court often uses contractual language, a better explanation of these cases may be that the vision of the articles as a contract is

[9] D. Sugarman and G. Rubin (eds.), *Law, Economy and Society, 1750–1914* (Professional Books, Abingdon, 1984) note (at 12–13): 'The ideology of freedom of contract was an important element in the liberalisation of English company law in the 19th century . . . However, as in other areas of private law, the power of freedom of contract, the rise of legal formalism and perhaps, on occasions, a sympathy for these agencies of economic growth, encouraged the courts frequently to adopt the mantle of legal abstentionism rather than the watchdog.'

[10] Ibid., 209.

[11] And its equivalent, section 180(1) Corporations Law in Australia. See S. Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) *Sydney Law Review* 281.

[12] See also *Automatic Self-Cleansing Filter Syndicate Co v Cunninghame* [1906] 2 Ch 34.

[13] Bottomley, 'Contractualism'.

[14] *Eley v Positive Government Security Life Assurance Co Ltd* (1876) 1 ExD 88 (Court of Appeal).

[15] See also *Hickman v Kent or Romney Marsh Sheepbreeders Association* [1915] 1 Ch 881; *Beattie v Beattie Ltd* [1938] Ch 708. But management rights appear to have been enforced in *Quin & Axtens v Salmon* [1909] AC 442, *Pulbrook v Richmond Consolidated Mining Co* (1878) 9 ChD 610, and *Imperial Hydropathic Hotel Co, Blackpool v Hampson* (1882) 23 ChD 1.

[16] (1876) 1 ExD 88.

false and they are in fact a constitutional document which requires some public law principles to be applied for its proper interpretation.[17] These might well include preventing a solicitor from entrenching his employment position by using his privileged position as drafter of the constitution. However, as explained below, this vision would require the adoption of a concession notion of the company.

Because legal contractual notions are 'strained' in explaining the effects of this 'contract', Bottomley suggests two explanations.[18] First, he sees the historical development of unincorporated joint stock companies as emerging from an amalgam of partnership and trust concepts, and secondly 'it allows us to define the boundaries of the company by circumscribing the rights of membership'.[19] The first explanation he dismisses as conservative, requiring us to accept that time has stood still since the mid nineteenth century. Although this is a valid criticism, there is more. It can be seen that the climate for companies changed radically between the time when the state conceded both trading and political powers to trading organisations[20] and the later situation where several persons could come together and, provided that the formalities were in order, could form their own company.

It is therefore unsurprising that the emphasis changed from notions such as *ultra vires* to ideas of bargains and contracts between individuals. But the picture is not complete until we accept that the state still plays a significant role in the new companies, the essence of which is their limited liability.[21] Trading with limited liability removes our modern companies a momentous distance from unincorporated joint stock companies. There are therefore two strands to the difference: the advent of incorporation by registration in 1844,[22] and the grant of limited liability in 1855.[23] Despite the possibility that some form of limited liability could have been achieved by private law devices,[24] 'it is clear

[17] Contra, K. Wedderburn, 'Shareholder's Rights and the Rule in *Foss v Harbottle*' [1957] *Cambridge Law Journal* 194, arguing that a shareholder may enforce *any* right even if by chance they stand to gain in an 'outsider' capacity. But see G. Goldberg, 'The Enforcement of Outsider Rights under s26(i) of the Companies Act 1948' (1972) 35 *Modern Law Review* 362 and G. Prentice, 'The Enforcement of Outsider Rights' [1980] 1 *Company Lawyer* 179, arguing along constitutional lines.

[18] Bottomley, 'Contractualism', 282.

[19] Ibid., 283.

[20] See below under discussion of concession theory.

[21] For a discussion of some public law issues relating to the control of directors, see R. Nolan, 'The Proper Purpose Doctrine and Company Directors' in B. Rider (ed.), *The Realm of Company Law* (Kluwer, London, 1998).

[22] Joint Stock Companies Act 1844.

[23] Limited Liability Act 1855.

[24] F. Maitland, *Selected Essays* (ed. H. D. Hazeltine, G. Lapsley, P. Winfield) (Cambridge University Press, Cambridge, 1936).

that without the legislative intervention, limited liability could never have been achieved in a satisfactory and clear cut fashion, and it was this intervention which finally established companies as the major instrument in economic development. Of this the immediate and startling increase in promotions is sufficient proof.'[25]

The second criticism rests on the way in which the courts have sought to use the contract to designate insiders and outsiders in order to determine whether or not a right under the articles can be enforced.[26] As we have seen above, the court's treatment of this issue gives powerful force to the argument that the company has a constitution rather than a contract at the heart of its organisational structure. However, a further consequence is that the focus on the contract between *members* and the company has the inevitable effect of excluding other participants in the economic enterprise, thereby giving us a limited model serving the shareholders alone. Thus, this foundational theory has a significant tendency to limit the 'interests of the company' to the interests of those contractors.[27] It also emphasises the free enterprise rights of the contractors.[28] Stokes argues that the contractual model legitimises the power of the board of directors because they are the appointees of the owners: 'Thus, by invoking the idea of the freedom of a property owner to make any contract with respect to his property the power accorded to corporate managers appears legitimate, being the outcome of ordinary principles of freedom of contract.'[29] This in turn leads to 'ends-

[25] L. Gower, *Gower's Principles of Modern Company Law* (6th edn, ed. Paul Davies, Sweet & Maxwell, London, 1997) at 46, citing Shannon (1931–2) *Economic History*, vol II, p. 290. Figures given by Shannon indicate 956 companies registered between 1844 and 1856. In the following six years, 2,479 were registered. In 1864 their paid-up capital was £31 million.

[26] *Quin & Axtens Ltd v Salmon* [1909] 1 Ch 311, [1909] AC 442; *Eley v Positive Government Security Life Assurance Co Ltd* (1876) 1 ExD 88 (Court of Appeal).

[27] Bottomley 'Contractualism', at 287: '[Economic] contractualism promises a framework that either eschews or plays down consideration of the company as an analytical construct, focusing instead on the roles of managers and shareholders.'

[28] And the ownership of the founders. It is criticised by M. Wolff, 'On the Nature of Legal Persons' (1938) *Law Quarterly Review* 494 at 497, citing the transference of the property of five promoters to a company. 'If we are to assume . . . that the five members still remain owners of the estate, we are obliged to add the proviso: "But they are treated in every respect as if they were no longer owners and as if a new, a sixth, person had become the owner."' He accepts that it has some justification where 'economic' ownership is the issue rather than 'juristic' ownership but feels that even here it is 'not completely sound; not all the members of a corporation are (from the economic standpoint) masters of the undertaking and owners of the corporation's property. If one member has 95 per cent of all the shares, he alone determines the fate of the enterprise.'

[29] M. Stokes, 'Company Law and Legal Theory' in W. Twining (ed.), *Legal Theory and Common Law* (Blackwell, Oxford, 1986), 155, 162.

orientated'[30] behaviour whereby: 'Provided that corporate actions and decisions comply with the terms of the contract they can be judged primarily in terms of whether they achieve some desired goal, rather than by reference to their impact on the rights or interests of the persons involved.'[31]

As explained above, a key reason for the strain experienced in applying the notion of legal contractualism to the operation of companies is the different considerations that apply to the balancing of rights and duties of the participants when the company is up and running. The foundational theory becomes less convincing at this point.

A reflection of the contractual theory can also be seen in rules such as the UK rule in *Foss v Harbottle*, which accepts that in most cases the majority decision of the contractors, taken according to the constitutional (contractual) rights of the shareholders, represents the will of the corporation. Thus, according to Friedman,[32] a corporation is owned by its shareholders, who should be able to rely on their agents (the directors) to make as much money for them as possible. Taking account of other social concerns would amount to imposing a tax on shareholders to which they had not consented.

This approach has roots in realist[33] theory 'according to which groups have natural moral and legal personality'.[34] The theory sees companies as made up of natural persons, the majority of members representing the will of the corporation. The corporation is thus entitled to autonomy from the state as being the natural expression of the desires of the corporators.

Consequently, corporations obtained their political and thus legal status independently from the state.[35] As Greenfield persuasively argues, the debate about the purpose of corporations becomes bogged down in 'rights' based notions relying on the legal metaphors of ownership and contract.[36]

[30] Bottomley, 'Contractualism', at 289.
[31] Ibid.
[32] Milton Friedman, 'The Social Responsibility of Business Is to Increase Its Profits', *New York Times Magazine*, 13 September 1970.
[33] See in particular P. Ewick, 'In the Belly of the Beast: Rethinking Rights, Persons and Organisations' (1988) 13 *Law and Social Inquiry* 175 at 179: 'Individuals can no more be separated or detached from their organisational affiliations than the organisation can be abstracted from its membership.' See also Bottomley, 'Contractualism', 288. For a study of the way in which association means sacrificing selfish 'ends', see S. Leader, *Freedom of Association* (Yale University Press, New Haven, CT, 1992), especially ch. 7; and see below on methods of regulation for a fuller treatment of these issues.
[34] Leader, *Freedom of Association*, 41.
[35] G. Mark, 'The Personification of the Business Corporation in American Law' (1987) 45 *University of Chicago Law Review* 1441 at 1470.
[36] Greenfield, 'From Rights to Regulation', 15.

Legal contractualism differs substantially from economic contractualism because it has a greater flexibility, allowing notions of reasonableness and equity to be considered as integral in a contract. However, both are arguing from a similar foundation in that the essence of the company is seen as residing in the contractual relationships between the actors.

Economic contractualism

The economic analysis starts from the perspective that 'the company has traditionally been thought of more as a voluntary association between shareholders than as a creation of the state'.[37] Cheffins argues that 'companies legislation has had in and of itself only a modest impact on the bargaining dynamics which account for the nature and form of business enterprises. Thus, analytically an incorporated company is, like other types of firms, fundamentally, a nexus of contracts.' For the purposes of economic analysis individuals rather than the state are the legitimation for the operation of the commercial venture. Denial of a separate personality to the entity formed by the human group of actors[38] is a necessary foundation[39] for the application of market theories, since the underlying assumption is the creation of maximum efficiency by individual market players bargaining with full information.[40] Taking the view that free markets are the most effective wealth creation system,[41] neo-classical economists including Coase have analysed companies[42] as a method of reducing the costs of a complex market consisting of a series of bargains among parties.[43] Transaction costs are reduced by the organisational design of the company.[44] 'Corporate law establishes a set of off-the-rack legal rules that mimic what investors and their agents would typically contract to do. Most shareholders, it is assumed, would

[37] B. Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon, Oxford, 1997), 41. Gower, *Principles of Company Law*, disagrees (see above).

[38] S. J. Stoljar, *Groups and Entities: An Enquiry into Corporate Theory* (ANU Press, Canberra, 1973), 40; and G. Teubner, 'Enterprise Corporatism: New Industrial Policy and the "Essence of the Legal Person"' (1988) 36 *American Journal of Comparative Law* 130.

[39] But Bottomley, 'Taking Corporations Seriously', at 211, sees it as a way to 'submerge the tension that exists in making choices between individual and group values'.

[40] Cheffins, *Company Law*, 6.

[41] After A. Smith, *The Wealth of Nations* (J. M. Dent & Sons, London, 1910).

[42] And firms that are not always companies.

[43] Alice Belcher, 'The Boundaries of the Firm: the Theories of Coase, Knight and Weitzman' (1997) 17 *Legal Studies* 22.

[44] O. E. Williamson, 'Contract Analysis: The Transaction Cost Approach' in P. Burrows and C. G. Velanovski (eds.), *The Economic Approach to Law* (Butterworth, London, 1981); Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' 21 *Journal of Law and Society* 168.

contract with the business managers to ensure that the managers seek to maximise profit.'[45]

The theories rest on notions of rationality, efficiency and information. The economists posit that a person acting rationally will enter into a bargain which will be to his or her benefit. In a sale transaction, both parties acting rationally will benefit both themselves and therefore society.[46] However, notions of the measurement of efficiency vary. Pareto efficiency requires that someone gains and no one loses. In contrast, the Kaldor–Hicks test accepts as efficient 'a policy which results in sufficient benefits for those who gain such that *potentially* they can compensate fully all the losers and still remain better off'.[47]

The explanation of what is 'rational' also varies widely, from simple wealth maximisation to complex motives including altruism, leading to the somewhat exasperated criticism that '[f]rom the point of view of understanding motivation in terms of rational self-interest . . . if we expand backward with self-interest as an explanation until it absorbs everything, including altruism, then it signifies nothing – it lacks explanatory specificity or power.'[48]

The third pillar for the economic analysis is information flows. The rational actor is seen as making rational choices with full and perfect information at his or her command.

Rational actors utilising perfect information will produce maximum allocative efficiency by making choices that exploit competition in the market. However, allocative efficiency will not occur unless all the costs incurred in the transaction are internalised. Thus, if a company pollutes a river, causing damage to other river users but incurring no penalty, the goods produced by that company will be underpriced. That this type of behaviour causes real problems for those who would impose minimal regulation and rely instead on market behaviour and private law instruments is evident.

Applying market economics to company law involves seeing the company not as a free standing institution but as a network of bargains

[45] Greenfield, 'From Rights to Regulation', 10.

[46] Ogus gives the following example: 'Bill agrees to sell a car to Ben for £5,000. In normal circumstances it is appropriate to infer that Bill values the car at less than £5,000 (say £4,500) and Ben values it at more than £5,000 (say £5,500). If the contract is performed, both parties will gain £500 and therefore there is a gain to society – the car has moved to a more valuable use in the hands of Ben . . . this is said to be an allocatively "efficient" consequence.' A. Ogus, *Regulation*: *Legal Form and Economic Theory* (Clarendon Press, Oxford, 1994).

[47] Explanation given by Ogus, *Regulation*, 24, who immediately points out that there is no requirement for the gainers to compensate the losers. See below in criticism section.

[48] I. Ayres and J. Braithwaite, *Responsive Regulation* (Oxford University Press, Oxford, 1992), 23.

between all involved, all acting rationally with perfect information. The utility of company law is to prevent the high costs of reaching individual bargains with every involved person. Company law thus reduces transaction costs.

This approach has a number of consequences. State interventions, such as the decisions of the courts on constitutional issues, are seen as imposing implied terms in the contract between shareholders, and the duties of directors are imposed because their interests and that of the shareholders are imperfectly aligned. Posner[49] explains that because the interests of management and shareholders are not perfectly aligned the potential of management to divert resources to their own use would lead shareholders in a free bargaining position to insist on 'protective features' in the corporate charter. In this respect the corporate governance aspects of company law reduce transaction costs by 'implying in every corporation charter the normal rights that shareholders could be expected to insist upon,[50] of which the most important right is the right to cast votes. This is a variation of the implied terms approach but it comes close to recognising the constitutional nature of the venture.'[51] As noted above, company law itself is seen as an off-the-shelf set of implied terms that can be adopted to reduce the expense of inventing individual bargains. Regulation is required only as a means of redressing imperfections in the market. Starting from the premise that free, perfect, markets produce optimum wealth implies that only where there is 'market failure' should the state intervene to attempt to redress the failure and permit the market to function again.[52]

One interesting facet of many of the neo-classical economic models is the lowly place occupied by the doctrine of limited liability. It is seen as an incentive to investment[53] but the role of the state in providing this

[49] R. Posner, *Economic Analysis of Law* (4th edn, Little Brown, Boston, 1992).

[50] F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, MA, 1991) have provided a recent restatement of the contractual theory in the context of public companies raising money from the public. Governance structures are seen as necessary to ensure that promises made on the raising of capital are kept and to prevent the exploitation by managers and others.

[51] Posner, *Economic Analysis*, 411.

[52] It should be noted that this wealth maximisation approach is not without critics. See C. E. Baker, 'The Ideology of the Economic Analysis of Law' (1975) 5 *Philosophy and Public Affairs* 3; R. M. Dworkin, 'Is Wealth a Value?' (1980) 9 *Journal of Legal Studies* 191; D. Campbell, 'Ayres *versus* Coase: An Attempt to Recover the Issue of Equality in Law and Economics' (1994) 21 *Journal of Law and Society* 434, arguing that underlying social relations in transactions have been overlooked; D. Campbell and S. Picciotto, 'Exploring the Interaction between Law and Economics: the Limits of Formalism' (1998) 18 *Legal Studies* 249; and R. Cooter, 'Law and Unified Social Theory' (1995) 22 *Journal of Law and Society* 50.

[53] Posner, *Economic Analysis*, 392.