A Thorogood Special Briefing

Chapter 1
The evolution of Company Articles and the Company Constitution

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Chapter 1
The evolution of Company Articles and the Company Constitution

Introduction

This chapter contains an outline review of the development of company law from Tudor times to the present day, with emphasis on articles and the constitution. It should be interesting, not to say entertaining in parts and the easiest read in the whole Report. There is though a point to it all, because it puts the subject in context and should help in its understanding.

Companies prior to 1844

The earliest companies date back to the sixteenth century and were incorporated by charters granted by the Crown. Such incorporations were few and far between, but they included some well-known names such as the Hudson's Bay Company, the East India Company and the South Seas Company. The East India Company was enormous and a remarkable creation with remarkable powers. It had its own army and Charles II gave it the authority to declare war, something that does not fit comfortably with the now accepted principles of corporate governance. The South Seas Company gave its name to the South Seas bubble, and was a fraud and an unmitigated disaster.

An alternative to a Royal Charter was incorporation by an Act of Parliament. Many companies were formed in this way and it must have taken up a lot of parliamentary time (165 canal acts were submitted to parliament in the 45 years from 1758). Later, the rapid development of the railways led to numerous railway companies created in this way – there were 29 in 1836 and 272 Railway Acts in 1846.

Following the South Seas Company debacle, Parliament passed the so-called Bubble Act of 1720. This Act, whilst commendably aiming to protect the public, severely hampered and deterred the formation of joint stock companies.

Despite this Act the number of unincorporated joint stock companies grew, and their number significantly increased after its repeal in 1825. These companies fulfilled a purpose and had shareholders and transferable shares, but were in a largely unregulated and unsatisfactory position. The situation was ripe for reform. Two Acts of Parliament went some way to help but they had severe limitations. They were the Trading Companies Act 1834 and the Chartered Company Act 1837. These Acts gave some of the features of incorporation, including the right to sue and be sued.

Despite these unincorporated companies most Victorian gentlemen carried on their businesses as sole traders or in partnerships. The great literature of the period gives many unintended illustrations of this. In Charles Dickens' *Christmas Carol*, which was published in 1839, Ebenezer Scrooge is visited by the ghost of his late partner Jacob Marley. He is not visited by the ghost of his late director and fellow shareholder.

Company registration and the Joint Stock Companies Acts of 1844 and 1856

Incorporation by Act of Parliament was prohibitively expensive and not feasible in most cases, and unfortunately unincorporated companies were associated with many fraudulent promotions and other scandals. Parliament responded by setting up a committee to study the problems and make recommendations. This committee was chaired by the youthful President of the Board of Trade, William Gladstone. This resulted in the Joint Stock Companies Act 1844 – often referred to as Gladstone's Act.

This enabled companies to be incorporated by a process of registration, and it established Companies House and the office of Registrar of Companies. Britain was the first country in the world to have company registration. The Act, which did not permit limited liability, applied to all joint stock companies with more than 25 members or which permitted the transfer of shares without the consent of all members. Registered companies had to file basic information and this was available to the public.

In 1855 the first Limited Liability Act was passed, and in 1856 the 1844 and 1855 Acts were amended and consolidated into the Joint Stock Companies Act 1856. Existing companies, except for banking and insurance companies, were required to re-register under this Act. The 1856 Act required all registered companies to file an annual return and is often referred to as the first modern Companies Act.

Limited liability

We often take the limited liability of company members for granted, but in the early days of registered companies it was enormously controversial. There were many scandals and of course they are not unknown in modern times. Limited liability means that shareholders are not liable for company debts beyond the uncalled amount of their shares, and in the case of a company limited by guarantee, the members are not liable beyond the amount of their guarantee. The amount of the liability is often very modest and today 85 per cent of companies limited by shares have a share capital of £100 or less. George Bernard Shaw, the acerbic writer, was once asked what the word 'Limited' at the end of a company's name meant. He replied that a group of gentlemen were advertising the fact that they did not intend to pay their debts.

The 1844 Act only permitted the registration of unlimited companies but this was changed by the Limited Liability Act 1855, introduced by Lord Palmerston's government at the height of the Crimean War. Limited liability was hedged with a number of safeguards, including:

- The company had to have auditors approved by the Board of Trade.
- The word 'Limited' or the abbreviation 'Ltd' had to be displayed at the end of the company name.
- The company had to have at least 25 members.
- There were specified minimum amounts for both issued and paid up capital.
- There were tight rules about dividends and loans to directors.

The Limited Liability Act 1855 was consolidated into the Joint Stock Companies Act 1856 and rather surprisingly many of these safeguards were then removed. Most of them have subsequently been reintroduced, some in a different form. Limited liability was a factor in the expansion of trade and the growth of prosperity (by the standards of the time) but sceptics foresaw trouble and the sceptics were proved right. There were a good few frauds and scandals, and 30 per cent of companies formed between 1856 and 1883 became insolvent. The most damaging insolvency was the bank Overend, Gurney which failed in 1866. It had been a long-standing partnership and was floated as a limited liability company when it was experiencing financial difficulties. The collapse of Overend, Gurney led to a general run on the banks and forced the Bank of England to raise interest rates to 10 per cent. The run on Overend, Gurney was the last run on a British bank until the run on Northern Rock in 2007.

There were contemporary doubts about just how far the principle of limited liability was applicable, but many of them were settled by the House of Lords judgment in one of the most famous cases in company law, *Salomon v Salomon and Co Ltd 1897*. Mr Salomon was a leather merchant and by some accounts a less than reputable person. He had transferred his assets into a limited liability company but the House of Lords found no evidence of fraud or deliberate abuse. Mr Salomon owned most of the company's shares and the others were held for his benefit. Mr Salomon won and the principle of limited liability was upheld.

Since the Salomon case there have been many attempts to what is colloquially known as "lift the veil of incorporation". The cases are decided on the basis of the individual facts. However, it can be said that the courts will not allow limited liability to be abused as a fraud or as a way of evading contractual or other legal obligations.

It is interesting to note that out of nearly two and a half million companies registered on the active list at Companies House, only around 5,000 are unlimited. In all the others the members have the privilege of limited liability.

Evolution from 1856 to 1985

The pattern of company law development since 1856 has been for a series of reforming acts followed by consolidating legislation. The first consolidating Act was not long coming. A series of further acts in the late 1850s were consolidated into the Companies Act 1862, which was the first Act to be given the title 'Companies Act'. As well as consolidation there were new provisions, including permitting the registration of companies limited by guarantee.

Not all law affecting companies comes in Companies Acts and the plethora of legislation regularly made company law harder to use and left us demanding consolidating legislation. A major Companies Act places big demands on the Parliamentary timetable and, despite its importance, is not something that voters clamour for. The last four main Companies Acts were in 1929, 1948, 1985 and 2006.

Of course a very considerable body of case law has developed. A rather startling illustration of this is that more than 1,800 cases are listed in the Table of Cases at the front of Boyle and Birds' *Company Law* published by Jordans. Some of the cases are of great importance and well-known, such as *Salomon v Salomon and Co Ltd 1897*. Others are of much more limited application. An example of one of these is *Ernest v Loma Gold Mines 1897*, which established that the company secretary has no authority to insert the date of the meeting in proxy forms unless authorised by the member to do so. The body of case law continues to develop.

There has been a trend towards more public disclosure, and companies have been required to keep certain information in statutory registers which may be inspected by the public. It became a requirement that accounts be put into the public domain. This started with just an annual balance sheet and then a profit and loss account was added. Subsequently consolidated accounts (if applicable) were required and so was more and more information in the directors' report and elsewhere.

An enormously significant development was the concept of a private company introduced by the Companies Act 1908. Prior to then there was only one sort of company – broadly what we would recognise as a public company. Private companies became (by number) the overwhelming majority. In 1907 there were just 70,000 companies registered at Companies House. There are now almost two and a half million, of which 99.7 per cent are private companies. The burden of disclosure was lessened for private companies, and company law in some respects treated private companies differently. An example is the requirement that public companies must have at least £50,000 share capital, of which at least a quarter and all of any share premium must be paid up before it can start trading or borrow money. There are no minimum share capital requirements for private companies, most of which are grossly undercapitalised.

The Companies Act 1948 created 'exempt private companies' which were distinct from other private companies. These did not have to file public accounts and were given certain other privileges. Their status did not last long and the concept of exempt private companies was abolished by the Companies Act 1967. They were then subject to the increased accounting and auditing requirements imposed on all private companies by that Act. The Companies Act 1981 created new categories of private companies, namely 'small' and 'medium' companies. There were reduced accounting and other disclosure requirements for them. These and numerous other changes were in need of consolidation and this was duly done in the Companies Act 1985. Of course the Act itself made significant changes to company law.

The Companies Act 2006

This is the latest main Companies Act and it is huge. It contains 305,397 words and is the longest piece of legislation ever enacted in the United Kingdom. It was a long time gestating. The DTI set up the company Law Review Steering Group in 1998 with instructions to study the whole of company law and make recommendations. Very extensive consultation took place and the Company Law Reform Bill was introduced into Parliament in the autumn of 2005. Incredibly this was an amending Bill, but it was subsequently withdrawn and reintroduced as consolidating legislation. The Companies Act 2006 received Royal Assent in November 2006.

The Act was implemented in stages on different dates, with the final batch of measures coming into force on 1st October 2009. The Act's provisions relating to the company constitution, including the new model articles, were among the provisions taking effect on this final date.

The number and types of companies

Even a casual glance at the figures must reveal the explosive growth in the number of registered companies, entirely accounted for by the growth in the number of private companies. In 1907, just before the option of private companies became available, there were 70,000 companies registered at Companies House. The million milestone was passed as recently as 1995. The number of companies on the active register in the United Kingdom at 30th January 2011 was:

Public companies	8,156	0.3%
Other companies	2,418,858	99.7%
	2,427,014	100.00%

The approximate breakdown of 'Other Companies' was:

Private companies limited by shares	2,343,614	96.3%
Private companies limited by guarantee	78,000	3.2%
Unlimited companies	5,400	0.2%
	2,427,014	99.7%

The number of companies on the total register in the United Kingdom at 30th January 2011 was 2,657,073.

Development of the constitution and articles

The constitution of companies registered under the Joint Stock Companies Act 1844 was expressed in a 'deed of settlement', which was in many ways similar to the constitutional document of an unincorporated joint stock company. This encompassed the function of the articles of association. Shortly afterwards the Company Clauses Consolidation Act 1845 provided standard provisions of the type included in private statutes of incorporation. These were available, if wanted, to be incorporated by reference.

The Joint Stock Companies Act 1856 abandoned the concept of a deed of settlement and substituted the memorandum and articles of association as the twin constitutional documents. The memorandum provided evidence that the subscribers wished to form a company and take a specified number of shares. It also established the name of the company and dealt with certain specified other matters. Companies are still required to have a memorandum, although under CA2006 from 1st October 2009 it is no longer part of the constitution and its functions are greatly curtailed. There is more about this in Chapter 2.

Model articles were provided in a schedule to the Joint Stock Companies Act 1856 and labelled Table B. Subsequently model articles were issued as part of, or by regulations under, the Companies Acts of 1862, 1906, 1908, 1929, 1948, 1985 and 2006. From 1862 to 1985 the model articles for companies limited by shares were called Table A. There were different Tables for other types of company. The tables were amended from time to time before their replacement.

None of the model articles have been compulsory for any company. Companies have been free to exclude them, adopt them in their entirety or adopt them with modifications. For most companies they have been the 'default provision' which is explained in Chapter 4.

The 1856 and 2006 model articles compared

It is fascinating to put the two documents side by side and see how they compare. Some elements are very similar. For example the 1856 Reg. 46 reads as follows:

> *'The business of the company shall be managed by the directors, who may exercise all such powers of the company as are not by this Act or by the articles of association, if any, declared to be exercisable by the company in general meeting, subject nevertheless to any regulations of the articles of association, to the provisions of this Act, and to such regulations, being not inconsistent with the aforesaid regulations or provisions, as may be prescribed by the company in general meeting shall invalidate any prior act of the directors which would have been valid if such regulation had not been made.'*

This single sentence contains 113 words, illustrating that legislative verbosity is not an exclusively modern phenomenon. The same rule is made by the 2006 model articles (number 3 in all of them) as follows:

> *'Subject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company.'*

Some of the 1856 provisions contravene the present law. For example, Reg. 43 includes '*No person shall be a proxy who is not a shareholder*'. CA2006 gives each member the right to appoint a proxy of their choosing. Some are surprising, such as Reg. 38 which states:

> *'Every shareholder shall have one vote for every share up to ten; he shall have an additional vote for every five shares beyond the first ten shares up to one hundred, and an additional vote for every ten shares held by him beyond the first hundred shares.'*

Perhaps the Victorian pioneers could have taught us a few things. Reg. 70 states:

> *'Once at the least in every year the directors shall lay before the company in general meeting a statement of the income and expenditure for the past year, made up to a date not more than 3 months before such meeting.'*

Furthermore an audit was required, though directors did not have to worry about accounting standards. CA2006 gives the directors of a public company six months to lay the accounts and if, which is not compulsory, the accounts of a private company are laid, the directors are now allowed nine months.

This review is concluded by spotlighting something that is inconceivable today and may come as a surprise to many readers. Reg. 11 of the 1856 Table B states:

> *'Any person becoming entitled to a share in consequence of the death, bankruptcy, or insolvency of any shareholder, or in consequence of the marriage of any female shareholder, or in any way other than by transfer, may be registered as a shareholder upon such evidence being produced as may from time to time be required by the company.'*

This is a reminder that in accordance with the law at the time a woman's property vested in her husband on marriage. I recently came across an example of how this could work in practice. At around this time a well known woman novelist visited her London publisher and collected a payment for her royalties. On the return journey she carelessly left the money on the train but it was handed in by a fellow passenger. She subsequently returned to London to collect it from the Lost Property Office, but it was necessary for her husband to go with her and sign for it. This was because he was the legal owner.