Company Law

The excesses of legislation

by John Franks

A recent paper by the Law Society's Company Law Committee starts with the proposition that no government can escape responsibility for the quality of its legislation. It goes on to assert boldly that company law is not of a high enough standard.

PROBLEMS WITH LEGISLATION

The argument is made that recent legislation such as the *Companies Act* 1989 provides a case study of what is wrong with the methods of legislating and text preparation. As a committee made up primarily of practitioners and representatives of the organisations that operate the system the approach is, as is to be expected, pragmatic.

In the view of the Committee, legislation fails to achieve its objectives. Regulation is unduly complex and obscure; the manner in which the legislation is brought into force leads to confusion as to the state of the law. There is unacceptable delay.

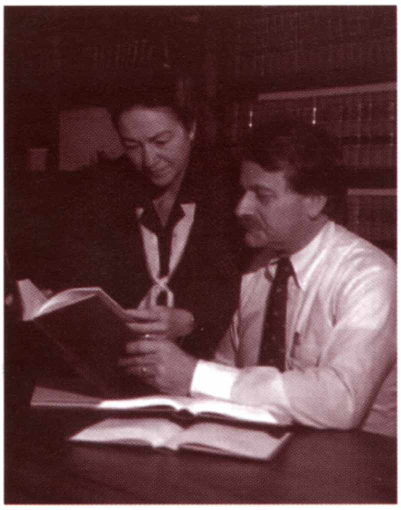
It should be noted that the House of Commons had tabled 180 pages of amendments to the Companies Bill, many not discussed because the report stage was guillotined in the House of Lords. Lord Williams is quoted as saying:

'We on these Benches are tired of the House being used as a sort of legislative sausage machine ...' (*Hansard*, 7 November 1989)

Food for thought, perhaps, for those now studying the proper role of the House of Lords in constitutional terms.

Various solutions are put forward by the Law Society, including a Royal Commission, the Law Commission, an advisory committee or a separate Company Law Commission, with preference, on balance, given to the last suggestion. The fact that one of the first Commissioners of the Law Commission was no less than Professor Gower, unfortunately did nothing to make that body the leading light in company law. However, that may have something to do with stifling attitudes on the part of the Lord Chancellors, who effectively determine what the Law Commission can and cannot do.

In theory the position could and should have been different.



THE FOUNDATION OF COMPANY LAW

The underpinning of the development of company law in this half of the twentieth century was a thorough-going review under an eminent judge, establishing the principles that were then followed through by an Act which revised and consolidated company law. Thus the Cohen Committee (appointed in 1943) first reported in 1945 (Cmd. 6659), with an amending Act following in 1947 (revising the 1929 Act) and the consolidating Act of 1948 coming into effect on 1 July 1948. All the problems of stop and start which plague practitioners today were avoided.

Twenty-four years later, Lord Jenkins was to review the 1948 Act and the *Prevention of Fraud (Investments) Act* 1958. This Committee reported on 30 May 1962 (CMD 1749). It also had to consider the registration of *Business Names Act* 1916. The Act to implement this was only passed in 1967.

However, by 1963, it was decided by that committee of the City great and good, the City Working Party, that *Notes on Amalgamations of British Businesses*, produced in 1958 at the suggestion of the Governor of the Bank of England, should be redefined. That resulted in the new *Revised Notes on Company Amalgamation and Merger* (October 1963).

The Committee was reconvened in 1967 because of:

'Public criticism of the conduct of certain takeover transactions'.

On 20 September 1967, the panel was established, with Sir Humphrey Minors as first chairman. The Code was completely rewritten and published on 27 March 1968. It was not a legal code, and the principle was that:

'The spirit as well as the precise wording of these principles and of the ensuing rules should be observed.'

Notwithstanding the legal rights of a majority, anything done to oppress a minority (in the general and not only the legal sense of the words), was wholly unacceptable.

UNACCEPTABLE DELAY

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FURTHER HINDRANCES

Another source of uncertainty concerns the principles of European harmonisation. Not only are there directives in being and in draft, but principles of European law are flowing up the Thames into the City, creating uncertainty as to the effect of the law.

The view of the Jenkins Committee and its predecessors was that it is undesirable to impose restrictions on the honest man in order to defeat an occasional wrongdoer. It is important not to place unreasonable fetters upon business which was conducted in an efficient and honest manner. Controls and regulations carried to excess can defeat their own object.

Thus, as the Law Society Committee points out, Butterworths' *Company Law Handbook* (first edition) – before the *Companies Act* 1980, contained 462 pages,

See Susan Scott-Hunt's article on insider trading at p. 21

but the latest edition is 3,544 pages – and that does not include huge volumes of subsidiary legislation.

The problems seem to stem, in part, from the media, which has a touching faith in rules and regulations. Whenever some event occurs, there is a plethora of comment as to how the particular mischief occurred and the extent to which new rules are required.

CORPORATE GOVERNANCE

The basic assumption of company law is shareholder democracy. This is underwritten by the voting rights of the shareholders who, in particular, can remove directors and appoint auditors.

In all companies where the directors (or some of them) hold a majority of the shares this democracy just does not work. Instead, for such companies there are principles of fair play, especially where the company is a public company with quoted shares. In practice, the audit system on which this so often depends has been seriously undermined by three factors:

- the board chooses the auditors and can propose their removal;

INSIDER DEALING

The market would be much improved by greater transparency. It would also benefit from the abolition of all the absurd rules about so-called 'insider dealing' which primarily benefit the professional dealers who have several hours' start over everyone else. Inside information can allow amateurs to get ahead of the professionals.

- since the introduction of competition for professional appointments, auditors take part in 'beauty contests' to get nominated and, in many cases, tender to get the job; and
- auditor firms often get other more remunerative work from the company if they enjoy good relations with management

If these practices were prohibited, much more could be left to simple statements of principles, and there could be reversion to the 1948-type legislature, instead of detailed control by more ingenious devices to get round ever increasing fine mesh text.

Accordingly, on this view:

- auditors should be selected and removed on recommendation to the shareholders by a company committee of say, seven, on which the board has only one representative; there is one representative of the staff (who is not a director) and one representative from the pension fund, if possible;
- it should be unprofessional conduct for auditors to compete for work by fee tendering; and
- auditors should not be allowed to be retained for any other work than the audit and the verification of tax returns. It should be unprofessional conduct for other work (including advice on tax planning) to be undertaken by the auditors or an associated company or firm.

It might also assist if the internal auditor were required to report to such a committee when needed.

Another controversial proposal is the suggestion that employees should have representatives on the board. This is advocated by larger companies in Europe but is not likely in itself to be seen to be a solution by English public companies.

DIRECTORS

There is also the problem that directorship has become an executive function. The idea of management working for and reporting to, a board made up of the great and the good has long since gone, the exception perhaps being league football companies. What is more, executive directors used to protect themselves by long-term contracts. This at least meant companies could ensure their key people were really committed. But because of fundamental resentment fostered by the media, long contracts are out. Result? Huge sums are required in terms of fees, incentives and benefits for joining and/or leaving a company, because there is no tenure.

The cost of changing and keeping directors has become a very real problem. The cure seems to be worse than the disease. Shareholders may require directors to invest in the company and expect their rewards to be directly linked to the results achieved for the shareholders; unlike the employed executives who manage the company.

GREATER TRANSPARENCY

The great mischief caused to all companies by the Inland Revenue practice of valuing work in progress and unsold products to compute profits for taxation is long overdue for review. Most investors do not realise how often their companies are brought to breaking point because of this practice of assessing unrealised, and perhaps unrealisable, profits. There is also a matching set of mischiefs produced by accounting standards which are slanted against the inclusion of goodwill and trademarks as assets, whilst assets and liabilities are constantly being restated to reflect so-called current values.

Most ordinary investors would find it useful to have the historic costs shown in

MEDIA ROLE

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notes against the current values. Another helpful provision would be the inclusion of figures, reflecting the active value of property, to contrast with the written down value required by accounting principles.

The market would be much improved by greater transparency. It would also benefit from the abolition of all the absurd rules about so-called 'insider dealing' which primarily benefit the professional dealers who have several hours' start over everyone else. Inside information can allow amateurs to get ahead of the professionals.

Indeed, the professionals are the chief proponents of penalties against those acting with inside information. What is needed is a new Cohen Committee and a five-year stand-still on all new primary and subordinate legislature, in order to introduce comprehensive change using simplified language, consolidated into a single Act which comes wholly into effect in one fell swoop.

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