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**Susan Watson. How the Company Became an Entity: A New Understanding of Corporate Law// Journal of Business Law 120, 2015.*

Introduction

Corporate law regulation and scholarship is focused on solving perceived agency problems between shareholders as owners and management as agents caused by a separation of ownership (in shareholders) from control (in management.) This focus ignores the effect of the modern limited liability company form on the ownership rights of shareholders, and also the effect of the agglomeration of capital in the modern corporate entity. The central arguments in this article are, first, that the focus on shareholder\manager agency problems when regulating companies is misguided and that instead the focus should be on control alone. Secondly it is argued that the modern company is an entity created by statute comprising a capital fund normatively controlled at the times it meets by the board of directors. The focus on shareholders and indeed shareholder primacy ideas are based on an outmoded conception of the company. Shareholders ownership rights are so attenuated in the modern company that shareholders are significant only because collectively, or individually with a block of shares, they can exercise indirect control.

The aim of the article is to argue for an entity-based understanding of the anatomy of the modern company. The article will show that the modern company became an entity when capital was severed from the holders of shares with the advent of the general incorporation statutes in the mid-nineteenth century. The division was instrumental in the success of the modern company and an implicit recognition of it underpins the speeches and the outcome in *Salomon v Salomon & Co Ltd* – it is one of the reasons why *Salomon* is the seminal corporate law case in many jurisdictions.[1]

Modern companies are descendants of, and share characteristics with, two earlier forms that existed prior to the general incorporation statutes of the mid-nineteenth century: the classic corporation and the old joint stock company. The combination of joint stock with the corporation, together with the statutory enablement of limited liability and the resulting requirement that corporate accounts be kept that distinguished capital, led to the severance between shareholders outside the company and capital inside the entity. Although the modern company and statutory limited liability existed from the middle of the nineteenth century, the consequences of and advantages of the modern corporate form were not fully recognized and exploited until the latter part of the nineteenth century leading to the inevitable concentration of economic power in the company. This agglomeration of capital was identified and correctly predicted to intensify by Berle and Means in 1932. However, attributing its cause to a separation of ownership from control has led to regulatory solutions being built around shareholder empowerment. In this article it is argued that instead the regulatory focus should be on control of the corporate fund.[2]

[1] *Salomon v Salomon & Co Ltd* [1897] 22.

[2] Adolf Berle conceived of shareholders as owners; it was his central argument in the academic debate he engaged in with Merrick Dodds in the 1930s. See AA Berle, “Corporate Powers as

Adam Smith, in *The Wealth of Nations*, argued that the joint stock company was a business vehicle of limited utility that would succeed only for a certain class of enterprise. The first section of the article shows how Adam Smith was initially correct in his predictions but ultimately wrong. The paper suggests this was because the corporate form itself changed with the general incorporation statutes of the mid nineteenth century. Limited liability and the separation of capital from shareholders meant that the modern company incorporated by registration was fundamentally different to the old joint stock company.

The second section of the paper is divided into four parts. The first part traces the pre-history of the modern company in more detail, contrasting the classic corporation with the old joint stock company. The second part sets out how the understanding of the development of the modern company incorporated by registration changed through the nineteenth century. Originally conceived of as an association of persons, a partnership incorporated by registration, understanding gradually shifted to the idea of a company as an artificial legal person that existed for some purposes, a type of quasi-corporation. By the late nineteenth century in *Salomon*, the company was viewed as a real entity separate from its shareholders. The section shows how statutorily mandated company accounts that required the identification and maintenance of capital because of limited liability and which used double entry book keeping that separated shareholders from the capital they contributed, made this legal separation seem possible.

The third part argues that the importance of *Salomon* rests in the recognition of the modern company as a real entity rather than a legal fiction that existed for some purposes, and that *Salomon* marked an extension, albeit an inevitable one, of the understanding of the modern company. It is argued that the significant difference between the resulting modern company and a classic corporation is that a classic corporation is a collective of people that is a legal person for some purposes, whereas a modern company is an entity that contains a fund. The final part of the section looks briefly at the development of the understanding of the company after *Salomon*.

The next section sets out a new model of the company placing it as a type of organisation. In terms of form, it is argued that in the modern company capital contributed by shareholders is severed from those shareholders in the corporate entity. Shareholders hold shares that have rights attached to them but shareholders do not "own" the company in any meaningful sense. The modern company contains joint stock; a fund broadly defined to include intangibles such as brand and goodwill. That fund is under the control, at least in a normative sense, of the board of directors at the times when it meets. The final section sketches out some possible consequences of a new understanding of the corporate form.

Powers in Trust" (1931) 41 Harvard Law Review 1049 and EM Dodd, "For Whom Are Corporate Managers Trustees" (1932) 45 Harvard Law Review 1145.

II Adam Smith Was (Ultimately) Wrong

A: Smith and Jensen and Meckling

The focus of modern corporate law is on solving perceived agency problems. In *The Anatomy of Corporate Law,* the authors argue that corporate law is organized across jurisdictions to reduce agency problems brought about by: conflicts between managers and shareholders, conflicts between shareholders, and conflicts between shareholders and the companies' other constituencies. [3] These perceived agency problems were set out in a seminal 1976 article by Jensen and Meckling The article was based on the theory of the firm drawing on the theories of agency, finance and property rights.[4] The authors argued that corporate governance mechanisms that monitor those in control and protect the interests of shareholders as principals needed to be put in place. Other concerns, described as agency costs, were the imbalance of information between management as controllers and the shareholders as owners.[5]

Since its publication, the Jensen and Meckling article has provided the foundation for much law and economics, and finance scholarship and has also influenced thinking about corporate law.[6] But the identification of a perceived agency problem was not new. In *The Wealth of Nations*, the father of modern economics Adam Smith said of companies:

"The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers. They have, accordingly, very seldom succeeded without an exclusive privilege, and frequently have not succeeded with one. Without an exclusive privilege they have commonly mismanaged the trade. With an exclusive privilege they have both mismanaged and confined it."

So close is the link between Smith and Jensen and Meckling that the first part of the excerpt set out above is quoted by Jensen and Meckling at the beginning of their article - it is clear that their identification of an agency problem is influenced by and premised on an understanding of the corporate form shared with Smith. The father of modern economics might therefore have been an agency theorist! But a central argument in this article is that the corporate form changed fundamentally with the advent of the general incorporation statutes in the nineteenth century. Adam Smith was writing about a different sort of company.

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[3] Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry B. Hansmann, Gérard Hertig, Klaus J. Hopt, Hideki Kanda, and Edward B. Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press, Oxford, 2009) 2nd ed.

[4] M. C. Jensen and W.H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure" (1976) Journal of Financial Economics 305.

[5] Agency theory does not differentiate between directors and executive management.

[6] SSRN shows that the article has been cited 4,379 times with Jensen's work having been cited 14,302 times: http://papers.ssrn.com/sol3/cf_dev/AbsByAuth. cfm?per_ id=9 last accessed on 18 September 2014.

In the second part of the excerpt Adam Smith argued that the corporate form had limited efficacy and that companies without exclusive privileges were likely to fail. Another central argument in this article is that the changes in the structure of the modern company, brought about by limited liability and the use of accounting to segregate the corporate fund from the shareholders, directly led to its success.

B: Adam Smith's Prediction

In *The Wealth of Nations* Adam Smith argued that the corporate form is most suited for only a limited number of enterprises such as banking, insurance, canals and water supply that required high capital input, a public benefit or utility and those enterprises where "all the operations are capable of being reduced to what is called a Routine, or to such a uniformity of method as admits of little or no variation."[7] Joint stock companies without these characteristics were unlikely to be able to compete successfully with other enterprises. The success of the modern company as the vehicle of choice for most business enterprises is evidence that Smith was not ultimately correct in his predictions about the limitations of the corporate form. But for quite some time Adam Smith seemed to be right. In an analysis of a selection of 290 companies incorporated by charter or special statute in the U.K. in the period 1720 to 1844 (when the first general incorporation statute was passed into law), only five companies were established for manufacturing purposes, with railways becoming increasingly common in the latter part of the period but with the vast majority of incorporations being for water, gas, harbours, bridges and canals. All these are undertakings either identified by Smith or undertakings that can be seen to fit the Smith formula.[8]

This distribution of incorporations might be attributed to the Bubble Act of 1720. The Bubble Act was enacted to limit speculation in rash and sometimes fraudulent ventures and meant that incorporation became almost impossible in the century it was in force.[9] By limiting the granting of corporate charters, it had a chilling effect on incorporation for wider business purposes. However an analysis of 224 quasi-companies formed by contract during the period to avoid the strictures of the Bubble Act shows a similar but not identical distribution of business types. There were 29 manufacturing companies, 57 insurance companies, 63 banking companies; all enterprises where it would be more difficult to demonstrate public utility but all, except manufacturing, fitting the Smith formula.[10] In the U.S, when the Bubble Act no longer applied in the post-colonial period, only 335 charters were granted with a

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[7] Adam Smith, ***An Inquiry into the Nature and Causes of the Wealth of Nations*** (1776) 447 Google books.

[8] Of 291 incorporated companies, the majority were for infrastructure projects with 39 water, 1 banking, 34 bridges, 59 canals, 6 colonial, 27 gas, 26 harbours, 6 manufacturing, 21 property, 59 raliways and 5 shipping. These figures are derived from an analysis carried out by the author of information extracted from a database. Robin Pearson, Mark Freeman and James Taylor) *Constructing the Company: Governance and Procedures in British and Irish Joint-Stock Companies 1720-1844* - (Ms Excess and Access versions, 49, 152 cells of data) deposited with the AHDS, January 2007, plus *Summary of variable codes* booklet (27 page introduction to the database). AHDS study no. 5622 at **http://www.data-archive.ac.uk/search/searchStart.asp** last visited on 28 March 2014.

[9] The Bubble Act was repealed in 1825 (6 Geo. 4, c.91) as "unintelligible and impossibly severe." Attorney General, Hansard, XIV (1826), 416 cited and discussed in B C Hunt, *The Development of the Business Corporation in England 1800-1867* (Harvard University Press, Cambridge, Massachussets, 1936) 41.

[10] Ibid.

"mere handful" established for manufacturing purposes.[11] As in the U.K, many corporations were formed to fund the types of enterprises identified by Smith and were granted charters only for a limited period.[12]

The authors of the Report that led to the development of the first piece of legislation permitting general incorporation by registration in 1844 included that Victorian multi-tasker William Gladstone. [13] Those Report authors echoed Smith's views; also considering that only a limited number of enterprises, such as banking, insurance, canals and water supply that required large amounts of capital, high risk and long amoritization periods, were suited to the corporate form.

The subsequent 1844 Act was an attempt by the State to rein in and control the use of the corporate form. Hurdles such as minimum capitalisation requirements, a two-stage registration process, publicity requirements and enforcement difficulties, however, meant the 76 percent of companies were abandoned before completing registration in the period between 1844 and 1856.[14] By contrast the Joint Stock Companies Act 1856 and the subsequent Companies Act 1862, which remained in force with amendments until the end of the nineteenth century, were facilitative rather than restrictive. Robert Lowe, the driving force behind the legislation, believed incorporation should be made more freely available as he considered the benefits of investing in companies should be made available to the middle classes.[15] Limited liability, first sanctioned by the legislature in 1855, became the default position for shareholders and companies were required to keep accounts.

Business responded to the availability of the new form. As a writer in *The Shareholders' Guardian* commented in 1864: "when it was perceived that limited liability would be accepted even in the circles of the banking community, scarcely any bounds were placed to the animation which followed, and limited liability soon became patronized not only by banks but by every other conceivable kind of undertaking, financial and industrial."[16] It was also commented in relation to the new companies that their numbers but also the nature of their business "would have staggered Adam Smith." [17] The growth was most notable in manufacturing; an enterprise which did not fit the Smith formula. In the period 1863-1866, 876 new companies offered shares to the public. 283 of those companies were involved in

[11] Lawrence M.Friedman, *A History of American Law* (3rd ed, 2005) 130-132.. See also A. Berle and G. Means *The Modern Corporation and Private Property* (Transaction Publishing:1932) 11.

[12] William W. Bratton, 'The New Economic Theory of the Firm: Critical Perspectives from History' 41 Stan. L. Rev. 1471, 1475 (1988-1989) 1131.

[13] *First Report of the Select Committee on Joint Stock Companies* B.P.P. VII, 1844, v .Gladstone was bought in was brought in to head a select committee on joint stock companies that was established to identify measures to prevent fraud. See the discussion in R McQueen, *A Social History of Company Law: Great Britain and the Australian Colonies 1854 – 1920*, Ashgate Publishing Ltd, 2009, 43-44.

[14] See the discussion in R McQueen, *A Social History of Company Law: Great Britain and the Australian Colonies 1854 – 1920*, Ashgate Publishing Ltd, 2009, 43-44.

[15] For discussion see Watson, S, The Significance of the Source of the Powers of Boards in UK Company Law [2011] Journal of Business Law 597-613.

[16] The Shareholders' Guardian, March 1, 1864 cited in B.C. Hunt, *The Development of the Business Corporation in England 1800-1867* (Harvard University Press, Cambridge, Massachusetts, 1936) 148-149.

[17] Ibid, June 20, 1864 in ibid.

manufacturing and trading, with the next largest group mining enterprises.[18] Existing businesses that had previously operated as partnerships or by sole traders were sold to newly incorporated companies to gain the benefits of limited liability. Salomon & Co Ltd is the most famous of these.

With a concentration of economic power came a subsequent dispersal of share ownership.[19] In the U.S. the late nineteenth century saw the rapid rise of the management corporation, large multi-tiered entities that performed multiple tasks of production and marketing that contained hierarchies of salaried executives. [20] Investors no longer involved themselves in management, The management corporation displaced the market economy causing power to move from individuals involved in bilateral contracting to groups such as investors, suppliers and consumers.[21] These management corporations were capable of monopolistic control of industries in a manner that had not been foreseen by Adam Smith. Manufacturing processes benefitted from economies of scale with fixed costs reduced by maximizing output. [22] Costs were reduced by bringing them within the firm, leading to "merger mania" with the growth of corporations and aggregation of capital. "Loose" combinations, or trusts, such as railroad pools, were checked only by the introduction of antitrust legislation like the Sherman Act in 1890.[23] The Sherman Act did not stop moves towards full mergers and in fact may have accelerated them as an alternative to the "loose combination" cartels.[24] By 1890, three-quarters of the wealth of the United States was controlled by corporations with the Sherman Act failing to prevent corporate consolidations.[25] The lack of effectiveness of the first competition laws may be due in part to the potency of the corporate vehicle created in the mid nineteenth century but fully unleashed in the late nineteenth century.

Cheffins highlights the move of U.K. companies to the stock market in the period between 1880 and 1914, with the most rapid phase during the mid-1890s.[26] There were 70 companies listed on the London Stock Exchange in 1885; 571 in 1907 with a similar expodential increase on the provincial exchanges.[27] Prior to that period, if businesses converted to companies, they remained closely held.[28]

[18] B.C. Hunt, *The Development of the Business Corporation in England 1800-1867* (Harvard University Press, Cambridge, Massachusetts, 1936) 150.

[19] A. Berle and G. Means *The Modern Corporation and Private Property* (Transaction Publishing:1932) 11.

[20] William W. Bratton, "The New Economic Theory of the Firm: Critical Perspectives from History" 41 Stan. L. Rev. 1471, 1475 (1988-1989) 1487.

[21] William W. Bratton, "The New Economic Theory of the Firm: Critical Perspectives from History" 41 Stan. L. Rev. 1471, 1475 (1988-1989) 1488.

[22] H. Hovenkamp *Enterprise and American Law: 1836-1957* (Harvard University Press, Massachusetts, 1991) 242. (Advantages identified and exploited by Josiah Wedgwood 100 years earlier with the use of double entry book keeping).

[23] Hovenkamp, ibid, 242.

[24] Hovenkamp, ibid, 243.

[25] M. J. Horwitz, "*Santa Clara* Revisited: The Development of Corporate Theory" 88 W. Va. L. Rev. 173 (1985-86) at p.180.

[26] B.R. Cheffins *Corporate Ownership and Control: British Business Transformed* (Oxford University Press,2008).

[27] Cheffins,ibid,176.

[28] See the discussion in Cheffins, ibid, .176-180.

Compared with the U.S, amalgamations in the U.K. were relatively rare until the end of the nineteenth century when both vertical, and to a lesser extent horizontal amalgamations became common also leading to the rise of the management corporation.[29] An exception was the insurance industry where overenthusiatic amalgamations resulted in the enactment of the Life Assurance Companies Act 1870. That act made court authorization for transfers of life business compulsory.[30] The reason for the lack of relative success of U.K. and European corporations has been a subject of speculation. It may simply have been that the access to resources in the U.S. was much greater than the U.K, which depended to a larger extent on trade, that the growth in the U.S. facilitated by the freedom of the corporate form, was inevitable. By 1900 the U.S. had become the world's largest economy. Gleeson-White attributes the growth in the U.S. to a number of factors: the entrepreneurial culture based on incorporation, continual measurement and the use of managerial accounting, as well as the vast resources available.[31] It is important to remember also that the difference was relative; although the rate and extent of growth was not as great in the U.K as in the U.S, there was still an enormous amount of growth in a short period.

By 1911 Nobel Prize winner and President of Columbia University Nicholas Murray Butler was able to assert that the "limited liability corporation is the greatest single discovery of modern times… even steam and electricity would be reduced to comparative impotence without it."[32] Professor Gower in the leading U.K. work on company law similarly commented: "Unquestionably the limited liability company has been a major instrument in making possible the industrial and commercial development which have occurred throughout the world."[33]
How did the company move from a form of limited utility to the preferred structure for enterprise and the foundation business vehicle of the modern economy? In particular what changed so that Smith was initially correct but ultimately wrong? In terms of scale of operation and complexity no one would argue that the modern company bears much resemblance to the 18th century joint stock companies Smith was writing about. But agency theorists would argue that the form and the resulting problems brought about by a separation of ownership from control are essentially the same for a modern company as they were for a joint stock company of the 18th century. A central argument in this article is that the forms are fundamentally different. They became structurally different as the status of shareholders changed with the advent of statutory limited liability. The key difference between the joint stock companies that existed prior to the general incorporation statutes that Adam Smith wrote about, and our modern companies is that a modern company is recognized as a separate legal entity from its shareholders. The change in status of shareholders, confirmed in *Salomon*, was brought about by the statutory legitimization of limited liability and the statutory requirement that modern companies keep accounts where capital was identified and separated from costs and from income. The enclosure of capital within the company, like the enclosures of land

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29 Cheffins, ibid, 188.
30 R.M. Merkin and R. Colinvaux, *Colinvaux and Merkin's Insurance Contract Law* (10th ed) (Thomson Reuters, 2015) para 13-003.
31 J. Gleeson-White, Double Entry: How the merchants of Venice shaped the modern world – and how their invention could make or break the planet (Allen & Unwin, 2011) 156.
32 William M Fletcher, Cyclopedia of the Law of Corporations 21 (1917).
33 L.C.B Gower, *Principles of Modern Company Law* (5th ed. 1992) p 70.

that had taken place centuries earlier, created economic advantages for the modern companies that made their growth in scale and their utility for a wide range of business inevitable. Adam Smith was ultimately wrong because he was not writing about the limited liability modern company, which has enormous structural advantages which did not exist for the joint stock companies in his time.

Smith argued that joint stock companies could not succeed without an exclusive privilege; he was writing about privileges such as exclusive territories for foreign trade such as the privilege enjoyed by the East India Company. The privilege and competitive advantage enjoyed by the modern company is the privilege of limited liability and the subsequent enclosure of capital in the company segregated from shareholders.

Smith also wrote about directors as managers of other people's money leading to Jensen and Meckling identifying the primary problem for corporate law being an agency problem between shareholders as owners and management as agents. The solution to the "agency problem" is seen to be aligning the interests of shareholders and management (for example, by the use of incentive pay), or empowering shareholders (for example, by the introduction in many jurisdictions of "say on pay." In this article, it is argued that Jensen and Meckling's arguments are based on the form of joint stock company that existed at the time of Adam Smith. The modern company is a different form and the problems of management control call for different solutions suited to the different form.

The next section will look at how the modern company developed.

III The Development of the Modern Company

In the second half of the nineteenth century jurists and business people sought to understand the new legal form; a company incorporated by registration. The modern company had antecedents in both early forms of the corporation and early forms of the partnership and the joint stock company and was a confluence of key characteristics of these earlier forms. The first part of this section briefly sets out the development and key characteristics of the two major antecedent forms; the corporation and the joint stock company.

A: Pre-History of the Modern Company

Before the mid century general incorporation statutes enabling incorporation by registration, corporations and companies were different forms of legal organisation. At the time of Coke in the early seventeenth century, methods of incorporation were by Parliament, by grants from the Crown, or by prescription.[34] Corporations were invariably viewed as political institutions that had a public purpose.[35] Coke in *The Case of Sutton's Hospital* in 1612 set out the English theory of corporations that remained in place for hundreds of years and resonates with us today. Coke described corporations as: "a collection of many individuals, united into one body under a special denomination, having perpetual succession under an artificial form, and vested, by the policy of the law, with the capacity of acting in several respects as an

[34] C.A. Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Manchester University Press, Manchester, 1950) 67.
[35] Ibid, 66.

individual."[36] (In the rest of this article, this legal form is described as the classic corporation.)

Joint stock companies formed prior to the legislation that permitted incorporation by registration are the second form discussed in this article. Independently of the classic corporation, the joint stock company began to emerge during the Tudor period in England. In Europe a form of business association (*commenda)* had already been developed where capital was contributed by partners who did not take an active part in the venture.[37] A more sophisticated form of *commenda* where investors provided capital to operating partners and more not liable beyond the amount contributed evolved during this period. Francis Drake, the privateer, operated an early form of joint stock enterprise which involved raiding Spanish ships returning from the Americas. It is rumoured that Queen Elizabeth as his secret backer contributed capital.

Most English business associations of the period were *societas* rather than *commenda* though. Initially each member of the joint stock company traded with his or her own stock and liability remained with the venturer. The stock could be goods or a ship but the idea of the contribution of a fund for enterprise with proceeds shared in proportion with the amount contributed was gradually developed during this period. The "combination of the pursuit of a common associative purpose with the exploitation of a common privilege was expressed in terms of joint stock."[38] The reason for the slower emergence of the *commenda* form in England may be because Luca Pacioli's double entry book keeping *Suma de Arithmetica* published in Italian in 1494, was not translated and published in England until 1543.[39] Double entry book keeping was necessary for a separation of the accounts of the firm from the capitalist accounts of the capital partners.[40] In Pacoli's double-entry book keeping, capital is creditor and cash is debtor.[41] Over time in England, joint stock companies became separate accounting entities because the books of the firm were not the accounts of the partners as individuals.[42] Eventually the joint stock became a permanent fund managed by a group drawn from the members.[43] Crucially, the later legal separation of the joint stock fund from the investors was "supported (or perhaps led) by the notion of the business as a separate accounting entity." [44]

Legal personality, brought about as a result of joint stock companies being granted charters and thus being a type of classic corporation, was a secondary consideration for members of joint stock companies; what mattered to them was the grant of a right

[36] C.A. Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Manchester University Press, Manchester, 1950) 66.
[37] Ibid, 45-46.
[38] Ibid, 56.
[39] Ibid, 46.
[40] Ibid.
[41] J. Gleeson-White, Double Entry: How the merchants of Venice shaped the modern world – and how their invention could make or break the planet (Allen & Unwin, 2011) 156.
[42] C.A. Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Manchester University Press, Manchester, 1950) 66.
[43] Ibid, 50
[44] Ibid, 48

or franchise that came with the corporate charter and the common interest in the joint stock. As C.A. Cooke explained: “Joint stock companies were in another class, distinguished from corporations in that the joint stock fund subscribed for by the members was the very essence of their association.”[45] The corporate form and joint stock were used together in the field of foreign trade in the 16th and 17th century in ventures such as the East India Company. What venturers sought from the grant of a corporate charter was the advantage of a franchise over a certain region. Joint stock companies were granted corporate charters by the sovereign because they undertook public responsibilities, but the stockholders gained private benefits. These grants could include governmental and administrative responsibilities over a region as the English were initially unable to govern the territories they gained by colonisation. The East India Company is an early and famous example. By the early 18th century the balance had shifted so that the public responsibilities of joint stock companies given corporate charters could be small and the private privileges could dominate.[46]

Also at that time the money-making opportunities possible in the trading of the shares of members in the joint stock became apparent. Perhaps inevitably speculation led to stock price bubbles and financial loss. The enactment of the Bubble Act of 1720 made corporate charters almost impossible to obtain. Unwilling to give up the advantages of the corporate form, business and the ingenuity of lawyers responded by developing a form of joint stock company created by contracts and trust devices with the joint stock held in trust for the benefit of shareholders as beneficiaries. These trust devices were recognised as a form of company by the Chancery Courts but were regarded as partnerships at common law. (In this article, this form is described as the unincorporated company.)

Before the general incorporation statutes, therefore, the dominant legal forms for business that were created by individuals were partnerships for smaller enterprises, and unincorporated companies (with joint stock held in trust created by deeds of settlement.) There were also joint stock companies. In terms of legal classification these joint stock companies were a form of classic corporation. Classic corporations were created by the Crown or by statutory instrument. These were incorporated by Royal Charter, by statute or by letters patent. These corporations could have joint stock or they may have been created for other purposes; an example being municipal corporations. Joint stock was not one of the necessary privileges of corporate bodies.[47] All classic corporations were the same legal form and were created by the State for a special purpose that at least ostensibly had a public benefit. The very act of incorporation presumed state involvement. [48] The English theory of classic corporations set out by Coke in *Sutton’s Hospital* in 1612 was applied to them. By contrast the word “company“ denoted nothing of incorporation, it indicated a body of persons associated together in a common purpose, usually in connection with trade.”[49] It did not necessarily mean that the company had joint stock, although many trading

[45] Ibid.
[46] Ibid, 49.
[47] Ibid, 141.
[48] H. Hovenkamp *Enterprise and American Law: 1836-1957* (Harvard University Press, Massachusetts, 1991) 12.
[49] C.A. Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Manchester University Press, Manchester, 1950) 141.

companies were joint stock ventures and those that had charters or were created by statute or letters patent were classic corporations .

After 1844, incorporation was by registration rather than by charter or statute. After the enactment of the general incorporation statutes, modern companies continued to be described as joint stock companies for a period. It is a central argument in this article that companies incorporated by registration were a different legal form from the earlier joint stock companies created by charter or statute. The joint stock company was an association of individuals that was a classic corporation and therefore a legal person for some purposes. It, or they, held joint stock. The modern company is an entity that contains a joint stock fund. It is for that reason, in this article the older form is described as the joint stock company and companies incorporated by registration are described as modern companies.

B: General Incorporation Statutes

The development in understanding of the modern company did not take place in a vacuum, but evolved through the second half of the nineteenth century. The political and social environment of the modern company affected not only how it operated but also how it was conceived of. Hovenkamp in *Enterprise and American Law 1837-1937* sets out the development in understanding of the modern business corporation. Despite a divergence in the history of the development of the corporation after American independence, the conception of the modern company developed along parallel lines in most jurisdictions, including the U.S. and the U.K.

Hovenkamp explains how the jurisprudential concept of the modern corporation passed through three broad categories: an "associational" view, a "fictional" view that ascended during the nineteenth century, and a "personal" or "entity" view that became important at the end of the century.[50] The associative, fictional and entity views of the modern company were all drawn from the law and principle surrounding early forms of the joint stock company and classic corporation. They were not built on new principles but ancient foundations. [51] Associational ideas came from the law surrounding joint stock companies and unincorporated companies where companies were seen as associations akin to partnerships. The legal fiction idea was drawn from classic corporations' law outlined by Coke in the *Case of Sutton's Hospital*. Entity ideas came from German jurists such as von Gierke, Dernberg and Mestre. The chief proponent of real entity theory was the German academic Otto von Gierke who posited that the real and social existence of a group makes it a legal person. As such, the corporation was not created by the law, but was pre-legal or extra-legal.[52] Even though the law did not create the corporation, von Gierke argued that it was bound to recognise its existence. [53] What is important to note though is that the modern company was a new form that had no single direct historical antecedent.

[50] H. Hovenkamp *Enterprise and American Law: 1836-1957* (Harvard University Press, Massachusetts, 1991) 14.

[51] C.A. Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Manchester University Press, Manchester, 1950).138-139.

[52] O. Gierke, "Political Theories of the Middle Age (Frederic William Maitland trans., 1927) (1990) 611; Harris, n 19, 1424; M. Petrin, 'Reconceptualising the Theory of the Firm- From Nature to Function' Penn State Law Review 1, 6.(2013).

In 1999 in *O'Neill v Phillips*,[54] Lord Hoffmann said that company law developed seamlessly from partnership law. Partnership law was and is based on the idea of a firm being an association of individuals. Certainly initially principles of partnership law were used to explain the modern company. Distinguished jurist Lord Lindley's highly influential treatise on company law started life as an 1863 supplement to his treatise on partnership law[55] with Lord Lindley seeing company law as a branch of partnership law subject to its principles.[56] In the introduction to the text Lord Lindley defined a company as an "association of many persons who contribute money or money's worth to a common stock and employ it in some trade or business…"[57] Later in the text he describes companies as partnerships incorporated by registration and companies as a form of partnership.[58]

An associative view of the modern company where it was seen as a direct descendant of the joint stock company supported the use of partnership principles to explain it. As we have seen, although many joint stock companies were, by virtue of a charter or statute, corporations, the motivating driver for their existence was the sharing in the joint stock. Partnership principles had also been used to explain the unincorporated companies that sprang up to avoid the strictures of the Bubble Act 1720 and which were, at common law, if not equity, treated by the courts as partnerships. As the late nineteenth century progressed, it was increasingly recognised that the modern company was a different legal form from the joint stock company and the unincorporated company. In areas such as the adoption of the doctrine of ultra vires into company law, courts increasingly drew on the a body of law that applied to corporations moving to seeing modern companies as a type of classic corporation and therefore as a legal fiction, just a Coke regarded a corporation as a legal fiction. For example, in 1867 in *Oakes v Turquand and Harding*, Lord Cranworth explained:[59] "The course of legislation was to rear up the company into a separate persona, with certain powers and privileges, but without conferring on it in an unqualified manner all the attributes of a perfect corporation. "

But modern companies were not the same as Coke's classic corporations. Modern companies had joint stock; capital. From 1855 the liability of shareholders of modern companies could be limited and from 1856 limited liability was the default position. Limited liability meant shareholders and their successors were liable only to the amount of capital they initially agreed to contribute when subscribing for shares. This meant that capital needed to be identified and separated from shareholders. The Companies Act 1862 was described as the accountants' friend because it required the keeping of accounts at every point of a public company's life. [60] Indeed, the birth of

[54] *O'Neill v Phillips* [1999] 1 WLR 1092 at 1099A.
[55] N. Lindley, *Supplement to a Treatise on the Law of Partnership Including its Application to Joint-Stock and Other Companies,* 5th ed, (London, 1863).
[56] N. Lindley, *A Treatise on the Law of Companies Considered as a Branch of the Law of Partnership (5th ed) (Sweet & Maxwell Ltd, London 1889*).
[57] Ibid, 1
[58] Ibid, 8.
[59] *Oakes v Turquand and Harding* (1867) LR 2 HL 325, 374.
[60] Gleeson-White *Double Entry: How the merchants of Venice shaped the modern world – and how their invention could make or break the planet* (Allen & Unwin, 2011) 144. The twentieth

the modern company has been linked with the transformation of book keeping into accounting and the emergence of the accounting profession.[61] Accounts distinguished capital from costs and from income. The requirement to keep proper and publically available accounts that identified capital was also driven by the actions of the Railway Kings like George Hudson who "fiddled the books", showing costs as capital investments rather than expenses.[62] The requirement was to ensure that dividends were paid from profit and not capital – a rule set out judicially by Lord Jessel M. R. in *Flitcroft's* case in 1882. [63]

The legislative requirement of separation for accounting purposes of the shareholders from the capital they contributed led to questions about the nature of the modern company.[64] Prior to the introduction of the general incorporation statutes if a person had been asked to describe a joint stock company, they would have said it was the collective of individuals that by means of a statute or charter had been given corporate status and which held a joint stock fund. The corporate collective was a legal person that held the stock. Joint stock had been seen as separate from the holders of the shares for bookkeeping purposes but not legal purposes since the end of the sixteenth century. Until limited liability the separation was of minimal significance as the holders of shares could be called upon to contribute more capital if the company got into financial difficulty.

The requirement that the joint stock fund be separated from the shareholders in modern companies was not derived from corporations' law and was inconsistent with it; in corporations' law, the classic corporation was a combination of individuals that became, for certain purposes, an artificial legal person. Coke in *The Case of Sutton's Hospital* in 1612 did not discuss joint stock because the concept did not exist at that time. As we have seen the legal principles that governed joint stock companies developed independently from corporations' law with the two forms combining in the modern company. Legal precedent existed for the separation of shareholders from stock held in the company. In unincorporated joint stock companies, the joint stock was held in a trust that was separate from the partnership that settled the stock in the trust and the shareholders who were beneficiaries of the trust. For the jurists of the Victorian period, who were familiar with the earlier unincorporated form, it would not have been such an intuitive leap to substitute the company for the trust when conceptualising the modern company. The significance of the substitution may not have been understood; a classic corporation as described by Coke was a combination of individuals but a modern company separated from its shareholders was an entity with a capital fund. The shareholders of a modern company were outside it; they did

century's biggest accounting firms were established in London during this period – William Deloitte (1845), Samuel Price and Edwin Waterhouse (1849); William Cooper (1854).

[61] B. S. Yamey, "The Historical Significance of Double-Entry Book Keeping: Some Non-Sombartian Claims," Accounting, Business and Financial History, vol 15, issue 1, March 2005, pp.77-85 discussed in J. Gleeson-White, *Double Entry: How the merchants of Venice shaped the modern world – and how their invention could make or break the planet* (Allen & Unwin, 2011) 156.77-78.
[62] Ibid, 143.
[63] ***In re Exchange Banking Company*** or ***Flitcroft's case*** (1882) LR 21 Ch D 519
[64] See the discussions in P. Ireland, "The Rise of the Limited Liability Company" (1984) 12 Journal of the Sociology of Law 239; T L Alborn, *Conceiving Companies: Joint Stock Politics in Victorian Britain* (Routledge, Oxford and New York: 1998).

not comprise the company unlike a classic corporation, which was comprised of individuals.

This separation of shareholders from the legal entity called the company and from the capital they contributed was facilitated by the use of double entry book keeping and the requirement that companies keep accounts, a fact perhaps under recognized. As C.A. Cooke, writing in 1951 pointed out the “importance of the double entry system of keeping books lies not in its arithmetic, but in its metaphysics. To create a capital fund which can be shown as in debit or in credit towards its owners was to do the same thing in finance that lawyers did in terms of law. The lawyers created, for essentially practical purposes, the legal entity of the corporation, a legal person separate and distinct from its members, linked with them by rights and duties. The business men created the financial entity of the business, a fund separate and distinct from its subscribers, linked with them by debits and credits. The most common corporate form of the twentieth century, the [modern] company, is descended from these two inventions.”[65]

C: *Salomon*

Salomon v Salomon & Co Ltd is correctly identified as the seminal company law case in many common law jurisdictions because it judicially established that the company is an entity that is separate from its shareholders.[66] In terms of Hovenkamp’s outline of the jurisprudential development in thinking about the modern company, with *Salomon* the conception of the modern company moved from the fictional view to the entity view. C A Cooke says that: “If the application of incorporation to the joint stock fund be thought of for a moment as a chemical reaction, the decision of the House of Lords in *Salomon v Salomon* marks the end point of that reaction.”[67] *Salomon* thus determined the anatomy of the modern company incorporated by the process of registration. Its significance cannot be overstated and the House of Lords were aware of its significance at the time they decided it. The recognition of a company as a separate legal entity rather than an artificial legal person for some purposes was key. It was a distinction that mattered because of limited liability but a distinction that was possible because of the use of double entry book keeping had already separated capital from shareholders.

Salomon worked its way up through the English judicial system in the 1890s at *Jarndyce v Jarndyce* speed. Commentary and other company law experts of the period anticipated a different outcome in the House of Lords predicting the modern company would be treated as a legal fiction in the same way as a classic corporation was treated as a legal fiction, rather than an entity. The first major review of the Companies Act 1862 was underway. The Davey Report, which was written before *Salomon* reached the House of Lords, was wide ranging - perhaps the first work of comparative corporate governance contrasting English company law with corporate law in European jurisdictions and with the U.S.[68] The Report dealt with contemporary

[65] **C.A. Cooke,** ***Corporation, Trust and Company: An Essay in Legal History*** **(Manchester University Press, Manchester, 1950)** 185.
[66] *Salomon v Salomon & Co Ltd* [1897] 22.
[67] Ibid,178.
[68] Vaughan Williams J was a member of the Committee, as was the QC who acted for Salomon in the Court of Appeal.

problems that still trouble us today such as when to impose civil or criminal liability on directors and the extent to which creditors might expect protection when dealing with companies. The Committee noted the high number of companies in the U.K; 18,361 at the time of the Report,[69] and also the ease of incorporation, which the Committee considered gave the U.K. a competitive advantage over Continental jurisdictions. The Committee commented on the trend to convert the businesses of individuals or firms into companies.[70] The rise of the small "private" company which was incorporated with the motivation of an existing business obtaining the benefits of limited liability rather than as an associative joint enterprise seeking to raise funds from the public was discussed at length by the Davey Committee[71] but it was ultimately determined that no change to the companies' law was necessary.[72] It was considered that if the primary motivation of incorporation was to avoid liability to creditors, the corporate form would be set aside by the courts. Part of the sanguinity of the Davey Committee may have been brought about by a belief that the Court of Appeal judgments in *Salomon*, would not be overturned by the House of Lords. Indeed the Committee appended the judgments of the Court of Appeal to the Report.

The Davey Committee therefore clearly endorsed Lord Lindley's view in the Court of Appeal in *Salomon* that incorporation would be upheld unless a company was established for an illegitimate purpose. Despite finding against Salomon, and consistent with the most recent edition of his treatise Lord Lindley in his judgment accepted that the incorporation of the company could not be disputed, citing s 18 of the Companies Act 1862 [73] and that the fact that the company did have seven members as required by s 48 of that Act. The basis of Lord Lindley's finding against *Salomon* in the Court of Appeal was that he considered Salomon & Co Ltd was created for an illegitimate purpose;[74] to defeat the claims of creditors. Lord Lindley thus appeared to consider that a company was a form of legal fiction that existed for some purposes but if those purposes were illegitimate, its existence could be disregarded. Such a conception was consistent with commentary of the period. The Crown or State could revoke corporate charters of a classic corporation, so the revocation of the concession of incorporation would have seemed consistent with the treatment of the company as a type of classic corporation. It was also consistent with Coke's depiction of the corporation as an artificial legal person for some purposes.
Classic corporations did not have joint stock or stockholders, so the Court needed to apply principles drawn from elsewhere to explain the relationship between Mr Salomon and the company. Lord Lindley regarded Salomon & Co Ltd as a trustee for Mr Salomon. The idea of a company as a trust probably arose from the use of the unincorporated form prior to the general incorporation statutes. Because shareholders were considered to have no legal ownership in the unincorporated company's property at common law, they were regarded as its beneficiaries holding equitable

[69] *Report of the Departmental Committee appointed by the Board of Trade, to inquire into what amendments are necessary in the Acts relating to Joint Stock Companies with limited liability under the Companies Act* (1895), clause 4.
[70] Ibid, clause 12.
[71] Ibid, clause13.
[72] Ibid, clause 16. There was however a recommendation that grounds for winding up be extended to include, amongst other things, where a certificate of incorporation had been obtained to defraud, defeat or delay creditors.
[73] *Broderip v Salomon* [1895] 2 Ch. 323, 337.
[74] Ibid.

interests.[75] It is tempting to think that Lord Lindley drew on this law about the earlier unincorporated company form. Also, ideas of corporations as forms of trust existed in the late nineteenth century U.S. - Lord Lindley may also have drawn on those ideas.[76]

Whilst Lord Lindley considered that the Salomon & Co Ltd was a trustee for Mr Salomon, Vaughan Williams J in the lower court had held that the company was an agent for Mr Salomon. Vaughan Williams J drew on the earlier associative conceptualisations of the company, considering it essential that all shareholders actually be actively involved in the company for the corporate form to be upheld.

Lord Macnaghten in the House of Lords did not agree with the Judges in the lower courts and did not view the company as a trustee or agent of the shareholders stating:[77]

"The company is at law a different person altogether from the subscribers to the Memorandum and, although it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them."

The concept of a legal person derived from corporations' law was applied to the modern company by Lord Macnaghten so that the joint stock fund became the person, the entity, rather than the subscribers to the memorandum, the shareholders. The individuals who would previously have been viewed as associated together and comprising the corporation were viewed as severed from the modern company and external to it. The holders of the shares were not part of the entity. The House of Lords, as a matter of statutory interpretation, considered that if all the requirements of the Companies Act 1862 were complied with, the company was a legal entity entirely separate from its shareholders. That company containing the fund existed at all times and was a real thing, not a fiction for some purposes only.

In summary, *Salomon* is primarily remembered as the case that confirmed that a company incorporated by registration is a separate legal entity from its incorporators and shareholders. This holding moved beyond the prevailing understanding by the late nineteenth century that a modern company was an artificial legal person. The legal fiction could be displaced if, for example, a company was established for illegitimate purposes such as a device for defeating creditors' claims. The conception of a legal person was not new being drawn from classic corporations' law but in corporations' law, the corporation was a collective of individuals that became a legal person. Corporations' law could not be applied to the modern company where, due to limited liability and accounting requirements, there was a statutorily mandated capital fund. After *Salomon* the modern company was recognized to be a joint stock fund severed from the shareholders by limited liability and double entry book keeping; the modern company was an entity.

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[75] **C.A. Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Manchester University Press, Manchester, 1950)** 69.
[76] H. Hovenkamp *Enterprise and American Law: 1836-1957* (Harvard University Press, Massachusetts, 1991)
[77] *Salomon v Salomon & Co Ltd* [1897] 22, 51.

The recognition of the company as a separate legal entity led to a focus on the legal relationships of shareholders individually and collectively, and directors individually and collectively, with the company. Even today these legal relationships are not fully understood as we continue to rely on principles used to explain earlier forms such as the joint stock company, the unincorporated company and the classic corporation. The final part of this section contains a brief discussion of real entity theory. Its proponents sought to use it as an explanation of the internal dimension of the modern corporate entity.

D: After *Salomon*

The rise of the managerialist corporation and the centrifugal aggregation of the capital funds of companies identified by Berle and Means was an inevitable consequence of the modern company being treated by the law as a real entity entirely separate from its shareholders. Once it was accepted that a company was an entity, a real thing rather than a legal fiction, the consequential questions became what animated the company and how the entity was controlled. Lord Halsbury in *Salomon* described the company as a "real thing.[78] If Lord Halsbury was not influenced by real entity ideas of the company, which at the time *Salomon* was decided were finding their way into thinking about the company, *Salomon* was the watershed decision that laid the ground work for the importation of the theory into the way English jurists thought about the company. Real entity theory posits that the organisation of human beings is a real person, a living organism "possessed of a real will of its own, and capable of actions and responsibility for them, just as a man is."[79] The theory gathered such traction in the U.K. in the early years of the twentieth century that, in an article reproduced in the Law Quarterly Review in 1911 from a Festschrift for Professor von Gierke, Frederick Pollock argued not just that the legal fiction theory had been officially discarded by the English courts, but in fact had never been adopted.[80]

Others were less convinced. Salmond, writing in 1906 was scathing, talking about German jurists such as von Gierke, Dernberg and Mestre attempting to establish a new theory that treats corporate personality as a reality and not a fiction[81] being given "sympathetic exposition, if not express support from Prof. Maitland."[82] Salmond argues that the will of the company is in fact the wills of a majority of its directors or shareholders and that when men associate together they do not become one person "any more than two horses become one animal when they pull the same cart."[83]

A variant of real entity theory was known as organic theory. Denning LJ, in *HL Bolton (Engineering) Co Ltd v TJ Graham and Sons Ltd*, had explored the notion that, while the acts, knowledge and state of mind of servants and agents of a company are legally separate from a company, those who are the directing mind and will of the

[78] *Salomon v Salomon & Co Ltd* [1897] 22., See the discussion in R Cooke *Turning Points of the Common Law* (Sweet & Maxwell, 1997) 11.

[79] *Salomon v Salomon & Co Ltd* [1897] 22.

[80] F. Pollock, 'Has the Common Law Received the Fiction Theory of Corporations?'[1911] 27 L.Q.R. 219, 235.

[81] J.W. Salmond, *Jurisprudence: or the Theory of the Law* (Steven and Haynes, 1907) 350.

[82] Salmond, ibid,, fn 1.

[83] Salmond, ibid.

company are in fact acting *as* the company:[84]
“A company may in many ways be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre. Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.” [85]Also Lord Reid, in the leading case *Tesco Supermarkets Ltd v Nattrass*, stressed that describing the person identified with the company as its alter ego was misleading: “The person who speaks and acts as the company is not alter. He is identified with the company.”[86]

Real entity and organic conceptualisations of the company are helpful in that they recognise the company as an entity with an internal dimension. Some drawbacks with the application of real entity theory to the modern company exist though. First, real entity theory is limited as it does not take account of the legal relationships that external “stakeholders” have with the company including individual shareholders and individual directors. A director at the times that the board of directors meet is part of the collective internal “organ” that is the board. But at other times, when the director acts externally on behalf of the company, the director is an agent of the company. Real entity theory and organic theory do not address that second legal relationship. Similarly shareholders have membership rights that they exercise collectively when they meet internally at the shareholders’ meeting. These membership rights come from corporations’ law and are recognized in real entity theory. But individual shareholders in addition have rights attaching to their shares that are external to the company. These rights come from joint stock company law. Individual shareholders usually have financial rights that entitle them to a share of dividends and to share

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[84] *HL Bolton (Engineering) Co. Ltd v TJ Graham and Sons Ltd* [1957] 1 QB 159, 172.

[85] A good discussion of identification theory can be found in *Canadian Dredge and Dock Co Ltd v The Queen* (1985) 19 DLR (4th) 314. The case involved conspiracy to defraud. Estey J in the Supreme Court of Canada commented as follows:

“This rule of law was seen as a result of the removal of the officer or managerial-level employee from the general class of ‘inferior servants or agents’ for whose acts the corporate employer continued (as in the case of the human employer) to be immune from vicarious liability in criminal law. This result is generally referred to as the ‘identification’ theory. It produces the element of mens rea in the corporate entity, otherwise absent from the legal entity but present in the natural person, the directing mind. This establishes the ‘identity’ between the directing mind and the corporation which results in the corporation being found guilty for the act or the natural person, the employee. Such is the power of legal reasoning. It is the direct descendant of Blackstone’s famous theorem: ‘The husband and the wife in law are one and that one is the husband’. … In order to trigger its operation and through it corporate criminal liability for the actions of the employee (who must generally be liable himself), the actor - employee who physically committed the offence must be the ego, the ‘centre’ of the corporate personality, the ‘vital organ’ of the body corporate, the alter ego of the employer corporation or its ‘directing mind’. … Lord Reid in *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153, challenged the accuracy of the expression ‘alter ego’ and so joins Viscount Haldane in the use of the expression ‘ego’ of the corporation. It follows that the management officer is not guilty additionally of the offence of conspiring with the employer to commit the wrongful act in question because in the identification theory there is only one entity, the natural and legal person having merged into one identity, and hence the basic requirement of two persons in a conspiracy is not met …” .328-329.

[86] *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153, 171 (HL).

proportionately in the assets of the company after it ceases to exist as an entity and if it is wound up solvent. (It is these financial rights that cause shareholders to be described as owners of the company by most commentators. But shares need not be issued with these financial rights attached to them. As pointed out recently by Margaret Blair in a paper posted on the Harvard Law School Forum on Corporate Governance and Financial Regulation : “Shareholders own their shares, of course, just as employees may own their pension claims and bondholders own their bonds.” [87] But that does not mean that shareholders “own” the company any more than employees or bondholders do.)

Another drawback with organic theory is that, unlike organs in a body, the corporate decision making bodies are only active at certain times and for certain purposes. The board as the control organ is only active when it meets. The shareholders only act as an “organ” when they act collectively as members in the meeting. Whilst the board as an organ makes decisions that will directly affect the corporate fund, the shareholders as an organ are not really internal at all being one step removed making decisions about the composition of the board and the internal rules governing the corporate entity.
The final section of this paper contains a speculative discussion of the place of the modern company in organisational theory.

IV The Modern Company

In 1998 in “Frankenstein Incorporated or a Fools’ Parliament” John Farrar called for recognition of the modern company as a type of firm.[88] The contribution of twentieth century economists such as Coase was to assist in our understanding of what a firm is. Coase in 1937 in “The Nature of the Firm” identified that although production could be carried out in a decentralized way through contracting between individuals as Adam Smith had shown centuries earlier, firms will replace the market when the transaction costs connected with production means it is cheaper for firms to organize what would otherwise be market transactions.[89] The boundaries will be created by the extent to which transaction costs are internalized.
But companies are also a form of organisation. In a review of a book by Meir Dan-Cohen *Organizational Jurisprudence* Richard B Stewart agreed with Dan-Cohen’s criticism of the failure of current legal theory to take sufficient account of the organisation. “…”prevailing legal theory is ultimately based on a two-tier conception of society that comprehends only individuals and government. This model of political individualism tends either to personify organizations, investing them with the same rights and responsibilities as individuals, or to dissolve them into a mere aggregation of individuals that lacks independent jurisprudential significance. This approach, however, fails to address the distinctive and important characteristics of organizations

[87] http://blogs.law.harvard.edu/corpgov/2012/06/27/corporate-law-and-the-team-production-problem/ last accessed on 11 November 2014.
[88] J. H. Farrar. (1998) "Frankenstein Incorporated or Fools’ Parliament? Revisiting the Concept of the Corporation in Corporate Governance," (1998) 10 *Bond Law Review*: 142.
[89] R. H. Coase, “The Nature of the Firm” in R. H. Coase *The Firm, the Market and the Law* (The University of Chicago Press, Chicago, 1988) 33.

such as corporations."[90] Prescient though Adam Smith was, he and subsequent classical economists focused on individuals rather than organisations.[91] The fatal flaw in modern agency theory is that it does not take account of the fact that a modern company is an entity, a form of organization with an internal as well as an external aspect.

So a company is a form of organisation created by statute. The company contains a capital fund that is internal to the firm not because of transaction cost efficiencies but because its existence is statutorily mandated. The company is separate from the holders of its shares, although shareholders as members of the company collectively at the times they meet have the constitutional right to make decisions about the internal rules of the company. Shareholders as members can also vote to determine the composition of the board. Directors when they meet collectively as the board can make decisions about the fund. The fund comprises more than a capital sum, although the historical recognition of capital as a concept and the metaphysics of double entry book keeping facilitated the separation of the fund from the shareholders. The fund is also includes goodwill in the corporate personality in the living enterprise,[92] its intellectual property as well as its physical assets and goodwill.

The key questions for corporate law relate therefore to control of the corporate fund. Berle and Means describe control, like sovereignty, its counterpart in the political sphere, as an elusive concept "as power can rarely be sharply segregated or clearly defined."[93] In a structural and normative sense it is the board that controls the fund. Boards are a required component of companies.[94] The board has all the powers necessary for making decisions about the company. It would seem that when directors act collectively as part of the board making decisions about the company, they have a different legal relationship to the company than when an individual director acts on behalf of the company when it interacts with third parties. Lord Hoffmann's speech in *Meridian Global Funds* appears to support this taxonomy of the company by separating the primary rules of attribution such as decisions of the board from secondary rules of attribution such as agency.[95] Apart from their internal involvement in decision making as part of the board, directors are agents of the company and external to it. The board, at the time when it meets to make decisions, makes decisions as the company. Boards do not meet all of the time. At other times the

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[90] Richard B Stewart, "Book Review, Organizational Jurisprudence" 101 Harv. L.Rev. 371, 1987-1988.

[91] The application of economic theories to the modern company will be discussed in a later paper.

[92] **C.A. Cooke,** ***Corporation, Trust and Company: An Essay in Legal History*** **(Manchester University Press, Manchester, 1950)** 18.

[93] A. Berle and G. Means *The Modern Corporation and Private Property* (Transaction Publishing:1932) 66.

[94] In U.K. company law, directors derive their powers from the consitutuion of the company rather than the statute, In most jurisdictions directors derive their powers from the statute, IThis fact might be used to support arguments of shareholder primacy but I have argued elsewhere that it is an historical anomaly. (ref) In addition, if shareholders did not appoint directors, and exercised control rights directly themselves, they would be deemed de factot directors in most jurisdictions and by made subject to the obligations of directors. (See the arguments set out by the author in…) Also shareholders that exercise illegitimate influence over directors also risk being deemed shadow directors and subject to liability (See Vanderbilt paper)

[95] *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 3 NZLR 7 ; 2 AC 500, 506 (PC). See also S. Watson, "Conceptual Confusion – Organs, Agents and Identity in the English Courts" (2011) 23 Sac LJ 762.

default position is that senior management will control the corporate fund. That default control position and the informational advantages that senior management have over non-executive directors have led to senior management taking the benefits of control in many corporations
Shareholders own shares and those usually carry with them a number of rights including a right to receive notice of, attend and vote at meetings of the company. Those rights are residual membership entitlements carried over from the classic corporation. The difference between a member of a classic corporation and a shareholder of a modern company though is that voting rights are attached to shares rather than to the individual member. The norm of one share equaling one vote was a relatively late development in the history of the modern company. The decisions that shareholders make at meetings are not decisions relating to the company, conceived of as the fund, itself. Instead they are decisions about the internal rules of the company and about the composition of the group that is charged with making the decisions about the fund; the board of directors. [96] As recognized by Berle and Means, shareholders who hold or acquire blocks of shares may use their voting rights to exercise control over decision making.[97] But this exercise of control will be indirect, a form of influence, and will be as a consequence of the fact that block shareholders will control appointments to the board and the internal rules of the company not because shareholders normatively control the company. Shareholders who do exercise direct control over decision making risk, especially in corporate decisions about "the fund" risk being deemed to be shadow directors.[98] The division between covert influence and control is a graduated one; when shareholders hold large blocks of shares their influence may be very great indeed and their interests may prevail. The extent to which that influence may be a problem rather than a solution to the agency problem is a topic for further study.

V Conclusion

In 1918 Walter Rathernau wrote that: "the depersonalization of ownership, the objectification of enterprise, the detachment of property from the possessor leads to a point where the enterprise becomes transformed into an institution which resembles the state in character." The passage was quoted by Berle and Means in the final chapter of their book where they set out their new concept of the corporation arguing that control of the great corporations should operate as a purely neutral technocracy where claims of various community groups are recognized with each assigned a portion of income based on public policy rather than "private cupidity.

[96] The reason that the board will do what they consider current shareholders want is because the members of the board seek to retain their positions on the board not because, in a normative sense, the interests of shareholders *should* prevail. In other words, a consequence of the fact that corporations almost always issue shares to stockholders with voting rights attached is boards taking into account what current shareholders want. Shareholders with large blocks of shares or activist shareholders may attempt to influence the board, successfully or unsuccessfully, to consider their interests ahead of the long term interests of the corporation. These wishes are likely to be perceived by the board to be the profitability and therefore dividend yield from the corporation and also the perceived value of the shares. But these concerns are consequences of the fact that the directors on the board will be aware that the shareholders could remove them from office. When companies are listed, boards will be conscious of share price as they will be aware that a low share price may be caused at least in part by an unfavourable perception of the management of the company. A low share price may also facilitate a hostile takeover and removal of current directors from office. See the discussion in Berle and Means,

[97] Berle and Means *The Modern Corporation and Private Property* (Transaction Publishing: 1932)

[98] C Noonan and S. Watson, "The Nature of Shadow Directorship: Ad hoc Statutory Intervention or Core Company Law Principle?" [2006] Journal of Business Law 763

Interestingly these comments echo recommendations made by Gladstone's committee and by Adam Smith himself that the enterprises best suited to corporate status are those with long amorotization periods.

Berle and Means argue that "[s]hould the corporate leaders, for example, set forth a program comprising fair wages, security to employees, reasonable service to their public and stabilization of business, all of which would divert a portion of the profits from the owners of the passive property, and should the community generally accept such a scheme as a logical and human solution of industrial difficulties, the interests of passive property owners would have to give way." Much as the argument resonates, a difficulty has been arguing why the rights of shareholders as passive owners *should* yield to other stakeholders. What this article endeavours to offer is a different understanding of what a company is. At least since Jensen and Meckling's article published in 1972, the key problem for corporate law has been seen as an agency problem brought about by the separation of ownership from control. Here it is argued that the key problem is the segregation of the capital fund in the company and the key issues are around control of that fund. Since the advent of the general incorporation statutes, the key characteristic of the company, which distinguishes it from other types of firms, is the existence of joint stock; a capital fund. The firm is built around that capital fund. The modern company is a firm and an organization primarily because of the existence of that internal capital fund, rather than arising from the internalisation of transaction costs, as is the case with other firms. Whereas employees and agents of other types of firms, like partnerships, owe fiduciary obligations of honesty and loyalty to the owners of the firm (the partners) corporations are constructed so that these obligations are owed to a fund. The fact that the obligations are often expressed as being owed to the shareholders as a whole implies that decisions made by boards that favour constituents other than shareholders are beyond the mandate of boards, even though these types of decisions are often given the fig leaf of legitimacy with arguments that they are being made in the long term interests of shareholders. Once the modern company is understood, decisions of boards that favour constituents of the firm other than shareholders are legitimate and in fact required so long as the objective is to sustain and grow the capital fund.

The segregation of capital in the modern company since the mid nineteenth century, like the enclosures of land that took place in the centuries before, created huge, wealth-generating advantages for those in control. As Berle and Means identified, efficiencies mean that left ~~unchecked the aggregation of~~ capital can only increase with the size and power of corporations, and those who control them, inevitably growing. Some checks were put in place through the twentieth century most particularly competition or anti-trust laws, and securities laws. But many regulatory measures aimed at companies have been stymied by a fundamental misunderstanding of what a company is.

As is clear from the historical background traversed above, the state, on behalf of society, enacted the modern corporate structure in order to obtain a benefit for society. The corporation became a complex creature of statute. This statutory structure conferred a real advantage on the shareholders of the corporation. In particular, limited liability represented a remarkable advantage to shareholders. In essence, the corporation eventually became a vehicle for investment. The benefit society was to obtain in return, of course, was an increase in economic activity and growth that would result, and there is no doubt that the statutory structure engendered vast economic activity and growth. It can be accepted, therefore, as outlined in the historical survey set out above, that the advantages to shareholders were conferred in return for the benefit society would derive from enacting that statutory structure. In this structure, control, or ultimate control, by shareholders was seen as appropriate and explains why the focus has traditionally been on shareholder control. Once it has been accepted, however, that this focus is misguided, the question arises whether a benefit in terms of increased economic activity and growth alone is an adequate return for the advantages shareholders enjoy. This question will no doubt be pursued with more vigour than in the past. It is not within the ambit of this paper, however, to determine whether society might choose to exact a greater or different benefit than a purely economic benefit, and whether it is appropriate to look for a benefit in the direction of environmental protection, or the recognition of the workforce as stakeholders in the corporation, or as a demand for a greater contribution to the commons, or some such other societal aspiration. What this paper does establish, however, is that it is for society, through the state, and not the shareholders, to determine the extent and content of the benefit it will exact in return for the statutory structure it enacted and continues to re-enact.

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A modern company is a type of organisation that contains at its centre an internal fund. Joint stock and the corporation coalesced in the modern company. Limited liability and the identification of capital through company accounts severed capital from shareholders. Normatively the company is controlled by the board, although shareholders, especially those who hold large blocks of shares may influence corporate decision making. Companies are repositories of capital and of power. With power comes responsibility that must rest with corporate boards. Questions such as how the corporate board of a modern company might exercise that power to meet its responsibilities, the extent to which the State and legislature can and should reach that capital fund, and the place of this model in corporate doctrine and theory will be the subject of future articles.

2). Решите задачу. Дайте правовую оценку правомерности предъявления данного иска акционером (истцом). Оцените доводы акционера (истца). Сделайте общий вывод о возможности удовлетворения требований акционера (истца) арбитражным судом.

Акционерное общество уступило обществу с ограниченной ответственностью право требования на получение оплаты за первую из двух частей оборудования, которую оно должно было поставить через три месяца государственному унитарному предприятию по договору поставки, заключенному на год и предусматривающему поставку двух партий оборудования с последующей отдельной оплатой за каждую партию за вычетом 20 процентов от стоимости каждой партии оборудования с учетом уже уплаченного аванса. Оплата по данному договору должна производиться государственным унитарным предприятием за счет доходов от его деятельности.

Взамен общество с ограниченной ответственностью прощало акционерному обществу долг по оплате подрядных работ. О состоявшейся уступке прав требования государственное унитарное предприятие было уведомлено акционерным обществом.

Однако один из акционеров акционерного общества обратился в арбитражный суд с иском о признании данного договора уступки прав требований недействительным по следующим основаниям:

1) стоимость уступленного права требования составила более 25 процентов балансовой стоимости активов акционерного общества по данным его бухгалтерской (финансовой) отчетности на последнюю отчетную дату, соответственно в силу закона сделка по его уступке как крупная для данного общества подлежала согласованию с Собранием акционеров, которое в соответствие с уставом общества осуществляло и функции совета директоров;
2) размер прощенного долга составляет шестьдесят процентов от уступленного права требования, что является неравноценным эквивалентом;
3) безвозмездная уступка прав требования является дарением. Дарение в отношениях между коммерческими организациями прямо запрещено в п/п 4 п. 1 ст. 575 Гражданского кодекса РФ;
4) нельзя частично уступить право в длящемся обязательстве (договор поставки заключен на один год и предусматривает поставку двух партий оборудования);
5) первая партия оборудования на момент уступки права требования еще не была поставлена и право требования ее оплаты у акционерного общества не возникло;
6) договор поставки, по которому уступлено право требования, был заключен

государственным унитарным предприятием (заказчиком) без проведения конкурса или аукциона по определению поставщика.