The Company and its Constituents

Law Working Paper N° 701/2023
April 2023

Susan Watson
University of Auckland and ECGI

ECGI Working Paper Series in Law

The Company and its Constituents

Working Paper N° 701/2023
April 2023

Susan Watson

Abstract

This paper considers two models of the modern company and the possible impact of those models, first, on the legal relationship of corporate constituents to the company, and, secondly, on the liability of corporate constituents. The chapter traces the historical origins of the contractual model and the entity model. It is argued that the contractual model has its origins in early unincorporated forms and is based on the collectivity of the shareholders. The entity model has its origins in early incorporated forms with corporateness bestowed by the State and with the company an artificial legal person separate from shareholders. The chapter sets out how the two forms have existed either in parallel or have been conflated throughout the history of the modern company. It is argued that the entity model is normatively superior as it distinguishes the different legal relationships corporate constituents have with the company.

Keywords: Corporate law, corporate governance, legal history, legal theory

JEL Classifications: K22, N23

Susan Watson
Dean of University of Auckland Business School and Professor of Law
University of Auckland
Sir Owen G Glenn Building - Bldg 260
12 Grafton Rd
Auckland Central, Auckland 1001, New Zaland
e-mail: s.watson@auckland.ac.nz

THE COMPANY AND ITS CONSTITUENTS

Susan Watson

Abstract

This paper considers two models of the modern company and the possible impact of those models, first, on the legal relationship of corporate constituents to the company, and, secondly, on the liability of corporate constituents. The chapter traces the historical origins of the contractual model and the entity model. It is argued that the contractual model has its origins in early unincorporated forms and is based on the collectivity of the shareholders. The entity model has its origins in early incorporated forms with corporateness bestowed by the State and with the company an artificial legal person separate from shareholders. The chapter sets out how the two forms have existed either in parallel or have been conflated throughout the history of the modern company. It is argued that the entity model is normatively superior as it distinguishes the different legal relationships corporate constituents have with the company.

Key words
Corporate law, corporate governance, legal history, legal theory.

1. Introduction

The ‘corporateness’ of modern companies has two possible sources. Companies may derive their corporateness primarily from the people who comprise them. Alternatively the company may derive its corporate status from the state in some way. After incorporation therefore the company is either based on the shareholders collectively or exists separately from its shareholders. The fundamental basis of the company in turn determines the legal and economic relationship of the company to its constituents. Those constituents include the company’s shareholders and its directors, with some arguing that constituents extend to stakeholder groups like employees, consumers, the Government and even the environment. Contested areas of corporate law, which include issues concerning the appropriate liability of corporate constituents, relate to these contested models of the company.

Former Delaware Chancellor William T. Allen described the two long-standing conceptions that dominate contemporary thinking about what a modern corporation or company is as the property conception and the social entity conception.[1] In this paper they are referred to as the contractual model and the entity model.

In the contractual model, the company is the private property of shareholders. This model is favoured by many law and economics scholars. 'The corporation's purpose is to advance the purposes of these owners (predominantly to increase their wealth), and the function of directors, as agents of the owners, is faithfully to advance the financial interests of the owners.'[2] The company itself is no more than a nexus of contracts between constituents.

Writing in 1992 Allen noted that this model was at the time the dominant academic paradigm of the corporation. 'In its most radical form, the corporation tends to disappear, transformed from a substantial institution into just a relatively stable corner of the market in which autonomous property owners freely contract,'[3] with shareholders the residual owners of the firm.

With the increasing attention on ESG (Environmental, Social, Governance) externalities and the impact of the company on the world, the entity model may be gaining favour. In the entity model, the modern company is not the private property of shareholders. The company is a social institution that is not wholly private as it also has a public purpose. Its existence depends on government concurrence through the act of incorporation. The attributes of a corporation, juridical or legal personality, limited liability and perpetual life are derived from the state rather than privately acquired through contract. This conception provides ballast to arguments that a company depends on a social licence to operate and is under a duty in some sense to all those interested in or affected by the corporation.

In the entity model, the corporation is capable of bearing legal and moral obligations:

---

[1] WT Allen, 'Our Schizophrenic Conception of the Business Corporation' (1992) 14 *Cardozo Law Review* 261, 264.

[2] ibid 265.

[3] ibid (footnotes omitted).

> The corporation comes into being and continues as a legal entity only with governmental concurrence. The legal institutions of government grant a corporation its juridical personality, its characteristic limited liability, and its perpetual life. This conception sees this public facilitation as justified by the state's interest in promoting the general welfare. Thus, corporate purpose can be seen as including the advancement of the general welfare. The board of directors' duties extend beyond assuring investors a fair return, to include a duty of loyalty, in some sense, to all those interested in or affected by the corporation.[4]

As Allen concludes, 'To law and economics scholars, who have been so influential in academic corporate law, this model is barely coherent and dangerously wrong.'[5]

The two dominant models of the company have both historical and theoretical underpinnings. Herbert Hovenkamp explains how, historically, the jurisprudential concept of the modern corporation developed along the lines of three broad perspectives: an 'associational' perspective, a 'fictional' view that developed during the nineteenth century, and a 'personal' or 'entity' view that became important at the end of that century.[6]

The personal or entity perspectives relate to the incorporated form, with the general incorporation statutes of the nineteenth century preceded by incorporation through the Crown and later Parliament by charters, letters patent or discrete statutes. The associational perspective relates to unincorporated forms based on shareholders that were significant in the period before the enactment of the general incorporation statutes. The association of shareholders was permitted to transact as if it were a recognised legal person; the legal fiction referred to by Hovenkamp.

These three perspectives and how they relate to the two models of the company that prevailed at certain points in the development of the modern company are expanded on in the following section. The paper then sets out how the entity model ultimately prevailing at the end of the nineteenth century was short lived, with a discussion of the revival of the contractual model

---

[4] ibid.

[5] ibid.

[6] H Hovenkamp, *Enterprise and American Law, 1836–1937* (Harvard University Press, 1991) 14. Despite a divergence in the history of the development of the United States corporation from the English company after American independence, and despite the more rapid re-emergence of the modern form in the US, conceptions of the modern company shifted in similar ways in both jurisdictions.

in the twentieth century. Section 4 considers the consequences of the models on the relationship of the company with its corporate constituents and section 5 considers the impact of the two models on the liability of corporate constituents. Section 6 concludes.

2. The Origins of Associational, Legal Fiction, and Entity Perspectives

2.1 The Origin of the Associational Perspective

Societas, or simple partnerships based on the partners who comprised them, operated in parallel with the *universitas* or corporations of the Middle Ages that are discussed in section 2.2 below as the source of the entity model. Partnerships that used double-entry bookkeeping to separate for accounting purposes the partnership fund, known as Joint Stock, from the partners, emerged in England in Elizabethan times.

In terms of capital lock in, the utilisation of Joint Stock was an intermediate step between simple partnerships and modern companies. Shareholders gave up the right to withdraw their capital, but only for a limited period. Although legally a form of partnership, these private partnerships were called Joint Stock Companies. They were not incorporated. To distinguish them from chartered corporations, the form is described in this paper as the contractual Joint Stock Company.

A variation of the contractual Joint Stock Company form, where Joint Stock was separated by settling corporate assets in a trust, became significant in the eighteenth century during the period when the Bubble Act 1720 restricted access to incorporation.[7] Chancery was more efficient than the common law courts in dealing with the concept of funds, with the equitable rights of the members as beneficiaries firmly established.[8]

Though legally a partnership, this form was designed to mirror incorporated business corporations as much as possible. [9] This was done, as the legal historian F.W. Maitland put it,

[7] A Televantos, *Capitalism Before Corporations: The Morality of Business Associations and the Roots of Commercial Equity and Law* (Oxford University Press, 2021) 35–36.

[8] ibid.

[9] See AB DuBois, *The English Business Company after the Bubble Act, 1720–1800* (The Commonwealth Fund, 1938) 216–18; WW Bratton Jr, 'The New Economic Theory of the Firm: Critical Perspectives from History' (1989) 41 *Stanford Law Review* 1471; 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) 216.

‘without troubling King or Parliament, though perhaps we said we were doing nothing of the kind’.[10] This variation of the contractual Joint Stock Company form was known as the deed of settlement company.

2.2 The Origin of the Entity Perspective

Corporations were mechanisms by which the Crown granted powers to cities, churches, and universities as legal persons. Only legal persons were capable of bearing rights and duties[11] but legal persons did not need to be natural persons or (eventually) even be comprised of natural persons. By the Sixteenth Century corporations could be *persona ficta* or artificial legal persons. Maitland was careful to term *persona ficta* ‘the Italian Theory of the Corporation’. He recognised that, despite earlier glimmerings in the English Year Books, the *persona ficta* concept was not transplanted into English common law until 1612[12] by Coke CJ, in *The Case of Sutton's Hospital.*[13] Coke CJ said that the corporation was ‘invisible, immortal and rest[ing] only in intendment and consideration of the law.’[14]

Business corporations chartered by the Crown and later Parliament emerged in the same period. Business corporations were initially a hybrid form. Members of business corporations like the English East India Company could choose to subscribe to a series of terminating Joint Stocks linked to single voyages, or series of voyages. Permanent capital replaced discrete Joint Stocks in the English East India Company by 1657. The business corporation, as an artificial legal person created by the State, was a separate legal entity from its shareholders that had permanent capital. A consequence of separate legal entity status was that commentators mostly concur that shareholders of business corporations with permanent capital had limited liability to the corporation.[15] Payments by shareholders beyond instalments as part of subscriptions could not

[10] FW Maitland, ‘Trust and Corporation’ in HAL Fisher (ed), *The Collected Papers of Frederic William Maitland* (Cambridge University Press, 1911) vol 3 283.

[11] PW Duff, *Personality in Roman Private Law* (AM Kelley, 1971) 1.

[12] O Gierke and FW Maitland (trans), *Political Theories of the Middle Age* (Cambridge University Press, 1913) xiv.

[13] *The Case of Sutton’s Hospital* (1612) 10 Co Rep 23a, 77 ER 960

[14] ibid 973.

[15]. Goebel Jr, *Cases and Materials* (1946) 428 *cf* CA Cooke, *Corporation, Trust and Company: An Essay in Legal History* (Harvard University Press, 1951) 76–79. Cooke bases much of his argument on *Salmon v The Hamborough Company* (1671) 1 Chan Cas 206.

be required,[16] nor could governing bodies of corporations be forced by creditors to make calls on shareholders for debts owing by the corporations.[17]

2.3 The Origin of the Fictional Perspective

2.3.1 Prior to the general incorporation statutes

In the eighteenth century all forms of company were understood by commentators like Kyd and Blackstone to be associations of shareholders that were legal fictions. It did not matter whether the company was unincorporated and therefore contractually formed (the deed of settlement and contractual joint stock companies discussed in 2.1 above), or incorporated by Parliament as a business corporation (discussed in 2.2 above). For example, in Kyd's 1793 treatise, corporations were considered to be 'a collection of many individuals … with the capacity of acting, in several respects, as an *individual*'.[18] Similarly, in 1803 in *Blackstone's Commentaries*, corporations were characterised as individuals consolidated and united into a corporation, with those individuals and their successors considered one person at law.[19]

As a legal fiction, the company is considered to be comprised of its shareholders. It is treated *as if it were* a single person by the law, meaning that the association of shareholders could transact in the same way as an individual natural person. The fiction of legal personhood is therefore a type of collective noun for the constituent shareholders. The legal fiction concept differs from the *persona ficta* concept where the law creates an artificial legal person that need not be comprised of natural persons. The *persona ficta* concept was not favoured by commentators in the 18th Century. Kyd opined that the parts of the corporate body were bulky and visible and seen by all but the blind, and '[w]hen, therefore, a corporation is said to be invisible, that expression must be understood, of the *right* in many persons, collectively, to act as a corporation, and then it is as visible in the eye of the law, as any other right whatever'.[20] Apparently referring to *The Case of Sutton's Hospital*,[21] Kyd concluded:

---

[16] DuBois (n 9) 99–104.

[17] *The Case of the York-Buildings Company* (1740) 2 Atk 57, 26 ER 432 (Ch).

[18] S Kyd, *A Treatise on The Law of Corporations*, vol 1 (J Butterworth, 1793) 13.

[19] W Blackstone, *Commentaries on the Laws of England, in Four Books*, vol 1, 14th edn (A Strahan, 1803) 468.

[20] Kyd (n 18) 16.

[21] *The Case of Sutton's Hospital* (1612) 10 Co Rep 23a, 77 ER 960.

> [O]n this principle we may account, in a satisfactory manner, for many of the incapacities attributed to a corporation aggregate, without having recourse to the quaint observations frequent in the old books, '*that it exists merely in idea, and that it has neither soul nor body*'.[22]

Business corporations and eighteenth-century deed of settlement companies were different legal forms. Deed of settlement companies as a type of contractual Joint Stock Company were legally partnerships. Business corporations were incorporated and therefore a type of corporation. The conflation of forms may have come about because the documentation establishing the deed of settlement company was drafted to make the form as close as possible to the business corporation. Also the two forms were functionally and economically similar.[23]

Language may have exacerbated this conflation of legal forms. The terminology used for both the business corporation and the deed of settlement company implied that each was based on its shareholders. David Ciepley posits that the English East India Company copied the form of the Dutch East India Company's structure while retaining the language of contractual Joint Stock Companies and merchant guilds, resulting in an ongoing theoretical misclassification of common law incorporated companies as being based on shareholders. Although shareholders were described at that time as 'proprietors', rather than the investors or shareholders they had become, Ciepley suggests the terminology remained in place in part because the change was gradual.[24] That terminology, therefore, masked the actual critical characteristics of the business corporation.

Crucially however that distinction remained clear to the courts during the eighteenth century. To the courts, the incorporated form, the business corporation, was a form of corporation on one hand; and the unincorporated form, the deed of settlement company, was a partnership on the other. The Chancery Court presided over by Lord Eldon consistently treated deed of settlement companies legally as partnerships.[25] The courts tolerated the desire of

---

[22] Kyd (n 18) 71 (footnotes omitted) (emphasis added).

[23] P Ireland, 'Capitalism Without the Capitalist: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality' (1996) 17 *Journal of Legal History* 41, and 44–46.

[24] D Ciepley, 'Corporate Directors as Purpose Fiduciaries: Reclaiming the Corporate Law We Need' (2019) 41 *Social Science Research Network* at papers.ssrn.com/sol3/papers.cfm?abstract_id=3426747.

[25] Televantos (n 7) 43, 'courts of the Regency era, especially Lord Eldon's Chancery, refused to treat deed of settlement companies as anything other than partnerships: the trust played only a minor role in their constitution, and did not oust most of the partnership law rules'.

entrepreneurs to trade using deed of settlement companies as if they were single legal persons (the fiction) without departing from a fundamental position that these enterprises were partnerships at law, not corporations.[26]

Most significantly, deed of settlement companies were not separate legal entities so their shareholders were not protected from liability to third parties. As Televantos puts it:

> What is perhaps most remarkable about the law of the time is how it balanced these different political, economic, and ethical considerations. The courts gave effect to traders' presumed expectation that partnerships and trusts had an existence separate from the partners and trustees, by shielding the partnership or trust assets from the private wealth and creditors of the partners or trustees. At the same time, the law made clear that partners and trustees took personal responsibility for debts they contracted in their own name – whether as partner, trustee, or personally.[27]

2.3.2 After the general incorporation statutes

That distinction between incorporated form and the contractual form did not survive the general incorporation statutes. The modern company was initially considered to be an association of shareholders in the same way as a deed of settlement company was based on an association of shareholders with modern companies initially often referred to in the plural as 'they.' With the recognition of the impact of incorporation giving the company the status of a legal person, over time the company was understood to be a legal fiction based on those shareholders and an 'it'. Initially therefore modern companies incorporated through the process set out in the general incorporation statutes were not viewed as separate legal entities from their shareholders. This is evidenced by the legislature considering that limited liability for shareholders required a statutory intervention. If the modern incorporated company was considered to be a separate legal entity from its shareholders like a business corporation with permanent capital, limited liability would have been considered one of the incidents of incorporation.

The transition of the English company following the general incorporation statutes from being based on a collective, its shareholders, to being legally separate from its shareholders can be traced through the nineteenth century treatises of writer and jurist Nathanial Lindley, later Lindley LJ of the English Court of Appeal (and Lord of Appeal in Ordinary). Lindley's

---

[26] ibid 173.

[27] ibid .

treatise on company law started life as an 1863 supplement to his treatise on partnership law,[28] with Lindley seeing company law as a branch of partnership law subject to its principles.[29] In the text he described companies as partnerships incorporated by registration and companies as a form of partnership.[30] In the introduction to the text 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'.[31] Like corporations, modern companies could transact as legal persons. Their status as legal persons was understood to be a legal fiction with the underlying reality that they were based on shareholding collectivity.

From 1855 the liability of shareholders of incorporated companies could be limited,[32] and from 1856, limited liability was the default position.[33] Statutory limited liability meant shareholders and their successors were liable only to the amount of capital they initially agreed to contribute when subscribing for shares. Unlike shareholders in deed of settlement companies, shareholders of incorporated companies could not be compelled to contribute more capital by either the company or the creditors of the company.

Limited liability is significant in its effects on both shareholders and the company's capital. By separating the company's fortunes from the fortunes of its shareholders, limited liability to the company bounded the financial risk for shareholders. Also, shares became easily transferrable. Fully paid-up shares could be transferred free of the risk of future liability. If shares were partly paid up, transferees knew the extent of any future liability. The liability of a shareholder in a modern limited liability company was and is no greater or less than the amount of capital the shareholder promises to contribute. That amount of capital contribution is fixed. Once shares are fully paid up, the shareholder or any subsequent holder of the shares cannot be asked to contribute any more money to the company.[34]

---

[28] N Lindley, *Supplement to a Treatise on the Law of Partnership Including its Application to Joint-Stock and Other Companies*, 5th edn (W Maxwell, 1863).

[29] N Lindley, *A Treatise on the Law of Companies Considered as a Branch of the Law of Partnership*, 5th edn (Sweet & Maxwell, 1889).

[30] ibid 8.

[31] ibid 1.

[32] See Limited Liability Act 1855 (18 & 19 Vict c 133).

[33] See Joint Stock Companies Act 1856 (19 & 20 Vict c 47).

[34] As the nineteenth century progressed, the practice shifted from issuing shares with high par values that were not fully paid up to issuing shares for low par values (one pound) fully paid up. Speculatively that may be one of the reasons why the business corporation form did not really flourish and grow until the 1880s.

Statutory limited liability 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.[35] The law surrounding the company evolved to protect the permanent capital in the company from shareholders and their creditors.

Indeed, the birth (or rebirth) of the modern company has been linked to the transformation of bookkeeping into modern accounting, and the emergence of the accounting profession.[36] Accounts distinguished capital from costs and income. The requirement to keep proper and publicly available accounts that identified capital potentially available to creditors 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.[37] The requirement was to ensure that dividends were paid from profit and not capital – a rule set out judicially by Lord Jessel MR in *Flitcroft's case* in 1882.[38]

As CA 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 terms of finance that the 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.[39]

---

[35] Gleeson-White (n 9) 144. The twentieth century's biggest accounting firms were established in London during this period – William Deloitte (1845), Samuel Price and Edwin Waterhouse (1849), and William Cooper (1854).

[36] BS Yamey, 'The historical significance of double-entry bookkeeping: Some non-Sombartian claims' (2005) 15 *Accounting, Business & Financial History* 77, 77–78.

[37] Gleeson-White (n 9) 143.

[38] *In re Exchange Banking Company* or *Flitcroft's case* (1882) LR 21 Ch D 519.

[39] Cooke (n 15) 185.

In the second half of the nineteenth century, the consequences of incorporation and statutory limited liability saw a gradual recognition that the modern companies, like earlier business corporations, were separate legal entities from their shareholders.

By 1873, Lindley acknowledged the implications of the incorporation of a modern company; that it was a separate legal entity from its shareholders: '[A] company which is incorporated, whether by charter, special act of Parliament, or registration, is in a legal point of view distinct from the persons composing it'.[40]

How the general incorporation statute was now to be interpreted was clear from the first words in the speech of Lord Halsbury LC in *Salomon v Salomon & Co Ltd*:

> My Lords, the important question in this case, I am not certain it is not the only question, is whether the respondent company was a company at all – whether in truth *that artificial creation of the Legislature* had been validly constituted in this instance; and in order to determine that question it is necessary to look at what the statute itself has determined in that respect. I have no right to add to the requirements of the statute, nor to take from the requirements thus enacted. The sole guide must be the statute itself.[41]

The use of the words 'artificial creation of the legislature' echoes the words in *The Case of Sutton's Hospital* and the *persona ficta* concept. To Lord Halsbury it seemed 'impossible to dispute that once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself.'[42]

3. Revival of the Contractual Model

Salomon v Salomon & Co Ltd is a watershed case but the entity model did not prevail. The contractual model gained traction in the twentieth century when used by US corporate law

---

[40] N Lindley and Samuel Dickinson, *A Treatise on the Law of Partnership Including its Application to Companies*, vol 1, 3rd edn (W Maxwell, 1873) 227.

[41] *Salomon v Salomon & Co Ltd* [1897] 2 AC 22 (emphasis added),

[42] ibid 30.

scholars laying the groundwork for agency theory and for modern law and economics contractual conceptions of the company.

F. W. Maitland refers to attempts "to dispel the Fiction or rather to open the Bracket and find therein nothing but contract-bound men'.[43] (Maitland here is referring to the *persona ficta* not the legal fiction.) Maitland cited Victor Morawetz's highly influential 1882 treatise *The Law of Private Corporations*.[44] Morawetz argued that a number of individuals should be able to form a corporation of their own free will just as they can form partnerships and enter into contracts.[45] A corporation existing independently of its shareholders was a fiction, with rights and duties "in reality the rights and duties of the persons who compose it, and not of an imaginary being."[46] In common with Kyd a century earlier, Morawetz was clear in his understanding that the corporation and its members were really the same thing.[47]

The courts of the 18th century apprehended the distinction between a business corporation on one hand as an incorporated entity and a deed of settlement company on the other hand as a form of partnership. How sound was the authority Morawetz relied on? Describing Morawetz's early struggles to establish himself as a legal practitioner in a history of the Cravath firm, his biographer Swaine says:[48]

> For the lack of anything else to do he occupied himself in writing a book on the law relating to corporations, persuading his father to finance him in the year and a half it took him to complete it. Morawetz' *The Law of Private Corporations*, published in 1882 when Morawetz was but 23 years old was immediately and generally recognised as the first important book in that field. As the field was new and authorities scarce, he was able to express dogmatically his own theories on controversial points and he deliberately omitted such authorities as were against him.

---

[43] Gierke (n 12) xxiv.

[44] V Morawetz, *A Treatise on the Law of Private Corporations Other Than Charitable* (Little Brown & Co 1882).

[45] ibid, 24.

[46] Morawetz, (n 44) 2.

[47] ibid 565.

[48] Robert T Swaine, *The Cravath Firm and its Predecessors 1819-1947*, vol 1 (The Law Book Exchange Ltd 2006) 382.

P.W. Duff's statement that Bracket Theory (contractual theory) was 'held unconsciously by those who knew no theories' may be true![49] Rather than relying on legal sources, Morawetz and other US corporate treatise authors of the period such as Charles Fisk Beach and Henry O. Taylor[50] drew primarily on classical economic notions that conceived of the economy as a system of transactions between individuals.[51] These ideas were derived in part from contractual conceptions of the firm from British lawyers of the 18th century who asserted that 'only natural persons occupied the legal world'.[52]

The contractual model of the modern corporation set out by Chancellor Allen lies behind prevailing law and economics theories that conceive of the company as a nexus of contracts. As David Millon puts it, 'the private aggregation idea assumed the garb of neoclassical economics under the corporation as a "nexus-of-contracts" rubric. Advocates of this theory have used the freedom-of-contract metaphor to support their shareholder primacy, anti-regulatory policy objectives.'[53]

The revival of the contractual model was brought about by the neoclassical economic movement. Jensen and Meckling, drawing on the theories of agency, finance and property rights, set out agency theory in their seminal 1976 article.[54] In agency theory, shareholders are viewed as the economic principal and management are viewed as the economic agents. The company is thus viewed from the perspective of contracting shareholders and seen as a black box represented by a production function.[55] These scholars take an atomistic approach to the corporation. For example, Oliver Williamson argues that the relation between each constituency and the firm should be evaluated in contractual terms and that corporate

[49] Duff (n 11) 218.

[50] William Bratton, 'The New Economic Theory of the Firm: Critical Perspectives from History' (1989) 41 Stan L Rev 1471, 1489.

[51] ibid 1484.

[52] ibid 1484. See the discussion in A Jacobson, 'The Private Use of Public Authority: Sovereignty and Associations in the Common Law' (1980) 29 Buffalo L Rev 599.

[53] David Millon, 'Theories of the Corporation' (1990) Duke L J 201, 203.

[54] MC Jensen and WH Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305.

[55] ibid 306.

governance structures such as boards arise as a response to 'the needs of an exchange relation for contractual integrity.'[56]

Until recently variants of contractual theory dominated corporate law in the common law world. Although the modern neoclassical version originated in the US, its taxonomy of management as agents of shareholders resonates with corporate law scholars and jurists outside the US as it mirrors the perceived legal position for deed of settlement companies in the late 18th and early 19th Century when much corporate law doctrine developed. Notwithstanding the apparently clear rejection of a contractual basis for the modern company in the *Salomon* case, this model never died away. This may be because both the contractual model and the modern neoclassical theories of the firm share common origins in the classical economic tradition: Jensen and Meckling's acknowledgement of Adam Smith is overt.[57]

4. Consequences of the Models on the Relationship of the Company with its Corporate Constituents

Governing bodies for corporations predate general meetings for investing shareholders. In corporations the guardianship role of the governing body was key:

> Canon law described the corporate person as a persona ficta. Its corporators stood in law as guardians of property which belonged in fact to no-one, and guardianship, rather than agency, became the mark of legally competent association.[58]

Regular general meetings for shareholders were an important innovation first seen in the English East India Company, right from its incorporation in 1600. The rights of the small investing shareholders in the Company as the collectivity against the elite merchants who controlled the governing body were debated in those meetings. The conflict between the collectivity and the managerial elite led to the modernisation of the Company, culminating in 1657 when the Company acquired permanent capital and the new age of corporate capitalism really began.

[56] Oliver Williamson, 'Boards of Directors' (1984) 93 Yale Law Journal 1197, 1198.

[57] Jensen and Meckling (n 54) quote Adam Smith at the beginning of their paper on the agency problem.

[58] R Scruton and J Finnis, 'Corporate Persons' (1989) 63 *Proceedings of the Aristotelian Society, Supplementary Volumes* 239, 242.

The small shareholders were not empowered by increased control over the management of the Company. Instead, shareholder influence and rights through the general court (meeting) led to increased obligations on the governing body. Practices that favoured elite merchants, such as dividends paid in the form of commodities, and the elite merchants purchasing commodities at favourable rates, ended. The elite accepted that they did not have a permanent right to control the Company. They also accepted that the role of the governing body, supported by sworn oaths, was to act in the interests of all of the shareholders.

The governing body was transformed into the modern managers that the Company's shareholding collectivity had long demanded. This change involved a transition. The transition was away from personal accountability for property and consumable surplus to individual investors. The transition was towards economic accountability for a return on capital. For that purpose, the company began to recognise the need to distinguish capital from revenue. '[T]he greatest of accounting's responsibilities is to hold management accountable for the rate of return on capital employed'.[59] That approach also underpins the governance of a modern company when the entity model is adopted.

5. The Impact of Two Models on Liability of Corporate Constituents

Stephen Bottomley argues that the focus on economic analysis in the contractual model has led to a one-dimensional picture of corporate governance where 'there can be no privileged or ultimate analytical framework for studying the complexity of corporate organisations'.[60] He identifies four limitations to the application of the solely contractual paradigm to corporate governance. First, complex relationships between many people tend to be reduced to bilateral agreements between legal or economic actors.[61] The organisation is ignored.[62] Second, the economic analysis of corporate governance issues excludes other perspectives.[63] Third, the contractual frameworks are orientated towards end results rather than their impact on the rights

[59] RA Bryer 'The History of Accounting and the Transition to Capitalism in England: Part 2 Evidence' (2000) 25 *Accounting, Organizations and Society* 327, 368.

[60] S Bottomley, *The Constitutional Corporation: Rethinking Corporate Governance* (Ashgate Publishing, 2007) 47.

[61] ibid 30.

[62] ibid 31.

[63] ibid 31.

or interests of the persons involved.[64] Finally, 'corporations and the things they do are treated as essentially private phenomena', meaning external regulation of corporate activity, or public-law like concepts, must be justified.[65]

In the entity model, at incorporation the company is an artificial legal person based on permanent capital contributed by shareholders. The company as an inanimate artificial person requires decision-making bodies to operate in the world. One decision-making body is the board comprised of individual directors who collectively make decisions. The other decision making body is the shareholders collectively through the general meeting. Powers are allocated constitutionally to the two decision making bodies. Each company is therefore itself a body politic with its own internal system of governance.

Descriptions of general meetings as 'little Parliaments' (in the seventeenth century)[66] may therefore be apt if the modern company is seen as a body politic. Considering the internal governance of the company from a constitutional perspective better reflects the origins of corporate governance in the Courts (meetings) of the seventeenth centuries discussed in section 4 above.

In cases like *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame*,[67] the courts enforced the constitutional division of powers in the company by not permitting shareholders to override management decisions allocated to the board. The English Court of Appeal said that once the power had been delegated to the directors, the shareholders could not take it back again (other than presumably prospectively and constitutionally though the articles of association).

Is the source of the power of boards the shareholders collectively? Or do boards derive their authority from the incorporation statute? The former source might indicate the modern company is based on its shareholders collectively in accordance with the contractual model; the latter the that the entity model has ultimately prevailed. Unlike almost all US states and most other jurisdictions, directors are not granted the power to direct the company through

[64] ibid 32.

[65] ibid 33.

[66] AB Levy, *Private Corporations and their Control* (Routledge, 1950) 40.

[67] *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34 (CA).

the statute in the United Kingdom. Instead that power is given through the articles of association. Much significance is attached to this difference by UK company law scholars. The leading text Gower and Davies' *Principles of Modern Company Law*[68] states that:

> It is … a point of some theoretical (even ideological) importance: the directors' authority is derived from the shareholders through a process of delegation via the articles and not from a separate and free-standing grant of authority from the State. This helps to underline the shareholder-centred nature of British company law.

Consequently, perhaps, the orthodox view in the UK is that directors, either individually or collectively as part of the board, are in a relationship akin to agency with the shareholders as a whole who comprise the company as their principal. It is an application of the contractual model.

The main reason for the difference is the legacy of the contractual model on the general incorporation statutes in the UK. As discussed in section 2.3.2 above, an understanding that the modern company was an association of shareholders initially underpinned the general incorporation statutes. Directors were therefore the agents of the shareholders as a whole. The modern company however evolved differently through the nineteenth century so that by the end of the century it was considered to be an entity legally separate from its shareholders.

The treatment by the courts of the indoor management rule highlights the conceptual difficulties created when directors are considered always to be agents. The common law indoor management rule means that third parties dealing with the company are not bound to ensure that all internal regulations of the company relating to exercise and delegation of authority have been complied with. Two prevailing versions of the common law rule exist. Those versions draw on two different 19th century cases and, it is suggested, the two different models of the modern company.

---

[68] P L Davies, *Gower and Davies' Principles of Modern Company Law* (London, Sweet & Maxwell, 8th Ed, 2008) at p 366. See also R R Pennington, *Pennington's Company Law* (Butterworths, 8th Ed, 2001) at p 696 ("[u]nlike American law and the laws of most European countries, English law does not regard certain functions and powers as managerial or executive and therefore as inherently exercisable by the board and inalienable by it") and B R Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press, 2008) at p 30 ("UK company law, in contrast, has never dictated who will have managerial authority in a company or the method by which managers are selected. This has instead been left to the internal governance rules of companies, most typically the articles of association, the contents of which the shareholders determine").

In *Royal British Bank v Turquand*[69] ("*Turquand*"), a bond issued without a required internal resolution was deemed valid. It was established that third parties were not expected to take their inquiries beyond the public documents at the Companies Registry. They could assume internal company requirements had been complied with. The case could be viewed as setting out a rule about the apparent authority of agents. Indeed, many commentators view the indoor management rule as an aspect of the law relating to apparent authority – it was explained in that way by Diplock LJ in *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd*.[70] However, although the indoor management rule is sometimes called the rule in *Turquand*"s case, the rule was expanded and conceptualised differently by the House of Lords in *Mahony v East Holyford Mining Co*[71] ("*Mahony*")

In *Mahony*, Lord Hatherley considered that people who deal with the company externally 'are not to be affected by any irregularities which may take place in the internal management of the company'.[72] Despite the facts being essentially the same, the reasoning used in *Mahony* was quite different from the reasoning used in *Turquand*. *Turquand* was one of the raft of cases brought about by the failure of the Royal British Bank in 1856. The deed of settlement company had been registered under the Joint Stock Banking Act 1844. Under that Act, shareholders had unlimited liability and the deed of settlement was described as a deed of partnership. Directors would have been considered to be the agents of the shareholders.

By contrast, the East Holyford Mining Co Ltd was incorporated under a general incorporation statute, the Companies Act 1862. The difference in conceptualisation by judges of the role of directors in a company incorporated under the 1862 Act is demonstrated in the speeches in *Mahony*. Unlike the judge in *Turquand*, most of the members of the House of Lords did not describe the directors as the agents of the shareholders. The issue in *Mahony* was not considered to be whether the shareholders had collectively given the putative directors apparent or ostensible authority. Instead, to the House of Lords the issue was whether a form authorising the signatories

---

[69] *Royal British Bank v Turquand* (1856) 6 E & B 327, 119 ER 886.

[70] *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 (CA).

[71] *Mahony v East Holyford Mining Co* (1874–1875) 7 HL 869 (HL). *Mahony v East Holyford Mining Co* is generally remembered as the case that affirmed the rule in *Turquand*'s case. Lord Hatherley coined the term "indoor management rule" in *Mahony*. See, *eg*, E Ferran, *Company Law and Corporate Finance* (Oxford: Oxford University Press, 1999) at 468. See also J Birds, A J Boyle, I MacNeil, G McCormack, C Twigg-Flesner & C Villiers, *Boyle and Birds' Company Law* (Bristol: Jordan Publishing, 7th Ed, 2009) at 180.

[72] ibid at 894.

to the cheques of the company was invalid because the authorising signatory directors had not been duly appointed.

Lord Hatherley considered that people dealing with a company are 'entitled to presume that that of which only they can have knowledge, namely, the external acts, are rightly done, when those external acts purport to be performed in the mode in which they ought to be performed'.[73] Lord Hatherley allowed the bank dealing with the company to rely on the cheque authorisations. The reason his Lordship allowed this reliance was not because the shareholders had given the *de facto* directors apparent authority to sign the cheque authorisations, but because he determined that those dealing with the company should not to be affected by internal irregularities.

Mahony was discussed by Diplock LJ in *Freeman & Lockyer*. He described the board as having actual authority but considered that allowing an individual to act in the management or conduct of the company's business to be a form of representation creating an apparent authority. Diplock LJ went to some length to differentiate *Mahony* from other cases involving directors acting as corporate agents on the basis that in *Mahony* it was not the conduct of the board of directors that was relied on to create the apparent authority of the corporate agents. Instead, it was:[74]

> ... the conduct of those who, under the constitution of the company, were entitled to appoint them which was relied upon as a representation that certain persons were directors and secretary. Since the appointers had "actual" authority to appoint these officers, they had "actual" authority to make representations as to who the officers were.

In Diplock LJ's reading of *Mahony*, a form of apparent authority was created for the directors and therefore reliance by the third party became important. But in *Mahony* itself, although approaches differed, representations, either express or by conduct, made to any third party by the shareholders as the group entitled to appoint the directors, were not discussed. Instead the discussion centred on how the shareholders consented, assented or acquiesced to the *de facto* directors occupying the position or office of director. Crucially, the liability-creating fact for the company in *Mahony* was not representations made by the shareholders as appointers, but rather

[73] *Mahony*, ibid, 894.

[74] R R Pennington, *Pennington's Company Law* (London: Butterworths, 8th Ed, 2001) at p 507. Furthermore, "[i]n *Mahony*"s case, if the persons in question were not persons who would normally be supposed to have such authority by someone who did not in fact know the constitution of the company, it may well be that the contractor would not succeed in proving condition (3), namely, that he relied upon the representations made by those persons, unless he proved that he did in fact know the constitution of the company".

occupation of office by the *de facto* directors. Notwithstanding Diplock LJ's analysis, in *Mahony* the bank never inquired whether the directors had been appointed and did not rely on the appearance that they had been.

In summary, therefore, two common law indoor management rules exist. The narrower agency-based form preferred by Diplock LJ in *Freeman & Lockyer* is the same as the principle of apparent authority in agency law. If a company holds out an individual as a director, then the company is estopped from denying the validity of the acts of that individual. That estoppel applies to decisions made by the director as part of the board and acts carried out by the individual director as an agent of the company. The narrower indoor management rule does not treat as special the decisions of directors as part of the board. It is underpinned, it is suggested, by the contractual model of the company.

The broader indoor management rule outlined by Lord Hatherley in *Mahony* holds that all the internal decisions of directors as part of the board will bind the company whether or not representations of authority are made to third parties and whether or not third parties rely on that authority. This form of the indoor management rule extends only to acts of the board and acts of directors when acting as part of the board. The broader indoor management rule supports the entity approach as it fits a conceptualisation of the company where individual directors are not always corporate agents and are not corporate agents when they act collectively as part of the board carrying out their decision-making role. The broader indoor management rule does not require individuals to be held out as directors for their acts as part of the board to bind the company in legal relationships with third parties.[75]

Which approach is normatively preferrable? The narrower apparent authority-based indoor management rule is problematic because it does not distinguish between collective board decisions, and acts of individual directors. Particularly problematic are situations where a third party dealing with the company knows of an irregularity, but does not acquire that knowledge as a third party dealing with the company. This knowledge might arise because the third party also occupies a position in the company.[76] The third party may even be

[75] For a discussion of the competing policy considerations underpinning the indoor management rule, see the discussion of Mason CJ in *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146.

[76] *Smith v Henniker-Major* [2003] 1 WLR 1386 (HL); *Howard v Patent Ivory Manufacturing Co* (1888) 38 Ch D 156.

responsible for the irregularity.[77] If it is considered, for example, that a person who has not been duly appointed as a director but who has been held out as a director has apparent authority, then it is difficult for the company to deny that apparent authority, even to third parties who know otherwise through knowledge acquired acting in a different capacity in the company.[78] The courts have consistently held that the presumption of regularity cannot be relied on by those who have notice of the irregularity or who have been put on inquiry.[79] But even those who accept the apparent authority-based view of the indoor management rule acknowledge that such a holding would be difficult "if the Rule in *Turquand*'s case were an absolute or unqualified rule of law, applicable in all circumstances".[80]

The broader indoor management rule works better. It does not give authority to individual directors; no qualification of its application is therefore needed. If a third party has any sort of knowledge of an irregularity acquired in any capacity, the indoor management rule cannot be relied upon to validate a transaction.

The broader indoor management rule and the entity model may also align better with principles of attribution. In *Meridian Global Funds Management Asia Ltd v Securities Commission*, Lord Hoffmann set out the rules of attribution which help determine when actions can be attributed to the company for the purposes of determining the liability of the company. Lord Hoffmann observed that the company's primary rules of attribution are generally found in the company's constitution and deal with rules relating to the internal management of the company. Those rules "are obviously not enough to enable a company to go out into the world and do business".[81] It is the general rules of attribution, which include

---

[77] *Morris v Kanssen* [1946] AC 459 (HL).

[78] This is what happened in *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549 (CA). See also *Cromwell Corp Ltd v Sofrana Immobilier (NZ) Ltd* (1992) 6 NZCLC 67,997 (CA).

[79] *B Liggett (Liverpool) Ltd v Barclays Bank Ltd* [1928] 1 KB 48; *cf Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549 (CA). In *Broadlands Finance Ltd v Gisbourne Aero Club Inc* [1975] 2 NZLR 496 (relating to an incorporated society with respect to which the doctrine of constructive notice did not apply), the Court of Appeal held that a person dealing with a corporation is put on inquiry if a document is executed in a manner which is not consonant with the normal method prescribed in the public documents.

[80] *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246 (CA). The irreconciliability of the cases where the indoor management rule has been applied has been commented on by a number of judges. See, *eg*, Dawson J in *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146 at 192: "[t]he rule in *Royal British Bank v Turquand* has been applied in a number of cases, not all of which are entirely reconcilable"; and Wright J in *B Liggett (Liverpool) Ltd v Barclays Bank Ltd* [1928] 1 KB 48 at 56: "I am relieved from any examination of the exact definition of this very respectable but perhaps somewhat ambiguous rule of law…"

[81] *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500 at 506 (PC).

the rules of agency and vicarious liability and which are equally available to natural persons, that are essential if the individuals, including directors, are to engage in business with the outside world on behalf of the company.

The key point is that the primary rules of attribution are concerned with decision making by the governing bodies of the company. These are often decisions that will affect the other internal decision making body of the company; the shareholders. Examples are decisions of the board to authorise a dividend or liquidate the company. The primary rules of attribution will rarely involve acts. It is once decisions of the board are acted on by the agents of the company, that the general rules of attribution, including the principles of agency, come into play.

It could be argued that the primary rules of attribution are examples of the board acting as agents of the company. That would be a similar argument to the arguments Diplock LJ in *Freeman & Lockyer*[82] and therefore an application of the contractual model. But if the primary rules of attribution were just examples of directors acting as agents of the company, Lord Hoffmann's classification would have no meaning. The first two categories of the rules of attribution would be examples of general rules of attribution arising out of agency or as a result of vicarious liability. Also, it could be equally asserted that shareholders who take part in decision-making as part of the general meeting are agents of the company; clearly a nonsense. It is suggested that acceptance of the principles set out in *Meridian* necessarily requires acceptance of two principles. The first is that directors are not always agents and the second is that directors are not agents when they act collectively as part of the board.

In summary, therefore, the argument is that the rules of attribution can be explained using a conception of the company that resembles the entity model. Acts and knowledge of the board and the shareholders acting collectively are attributed to the company using the primary rules of attribution that are not based on agency. The general rules of attribution are concerned with the acts and knowledge of agents and employees of the company (including directors when they act externally as corporate agents). The acts and knowledge are attributed to the company using agency principles such as the imputation of knowledge (in agency) and

[82] *Freeman* (n 71).

vicarious liability (for acts of agents and employees). The general rules of attribution relate to secondary forms of liability.

The rules of attribution as applied necessarily mean that the directors collectively as the board and the shareholders collectively as the general meeting are the governing bodies of the company. When directors are acting collectively as part of the board, they are not the agents of the company. Their knowledge as part of the board is attributed to the company by the primary rules of attribution. Absent statutory provisions that override company law principles, or breach of directors' duties, the board of directors collectively should therefore be immune from liability when they act in that role. But when accepting that the members of a board that acts collectively are, as a general principle, immune from liability, it is crucial to accept also that rather than always being agents individuals who are directors are likely to have many different legal relationships with a company that in a temporal sense occur concurrently or sequentially. For example in *Standard Chartered Bank v Pakistan National Shipping Corp (No 2)*,[83] a director of a one-man company incurred liability for deceit when the House of Lords determined that when he committed the wrong he acted as an agent of the company. It was a reversal of the Court of Appeal where, counter intuitively, it was decided that the deceitful director was identified as the mind of the company and could not therefore be made personally liable.[84]

6. Conclusion

The argument set out in this paper is that two models underpin our understanding of the modern company. The contractual and entity models of the modern company draw on the law and principle surrounding earlier corporate forms: they were not built on new principles but on ancient foundations.[85] Despite the recent dominance of the contractual model, it is argued that the entity model has stronger foundations and mediates better the relationships between corporate constituents.

[83] *Standard Chartered Bank v Pakistan National Shipping Corp (No 2)* [2003] 1 AC 959 (HL).

[84] *Standard Chartered Bank v Pakistan National Shipping Corp (No 2)* [2001] QB 167.

[85] CA Cooke (n 15) 138–39.

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (https://ecgi.global/content/working-papers) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html