



The Great Transformation? *Salomon*, Economic Space and Corporate Rationality

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Introduction



- ▶ This paper seeks to examine why the corporate entity might be perceived to be especially problematic in relation to new morally significant technology
- ▶ It advances the proposition that the corporate form generated a distinctive space for economic action but that the rationality governing that space is not pre-determined but potentially amenable to regulation
- ▶ It does NOT address the vital prior question as to whether direct substantive regulation is a first best solution / or whether it is justifiable to treat such new morally significant technology as property

Are companies a distinctive problem ?



What is a company?

- ▶ Kraakman et al (2009) five key features:
 - Separate legal personality
 - Limited liability
 - Transferable shares
 - Delegated management under a board structure
 - Investor ownership

- NB: listed companies are not likely to be the only type of company relevant to new moral technologies as start ups will often be small private companies

Significance of the corporate entity

- ▶ ‘the modern corporation may be regarded not simply as one form of social organization but potentially (if not yet actually) as the dominant institution in the modern world’ (Berle and Means, 1932)
- ▶ ‘The company, incorporated under the successive Companies Acts, is a dominant institution in our society’ (Gower, Principles of Company Law, 10th ed., 2016)
- ▶ ‘The most important organization in the world is the company: the basis for the prosperity of the West and the best hope of the future for the rest of the world’ (Micklethwait and Wooldridge, 2003)

Critical responses to the corporate entity


- ▶ The perfect externalizing machine (Mitchell, 2001)
- ▶ Mandated to the pathological pursuit of profit and power (Bakan, 2004)
- ▶ Ethical loopholes and moral deflection devices (Dine, 2005)
- ▶ John Browne (former CEO of BP) notes a major disconnection between business and wider society, which traditional corporate social responsibility is unable to bridge as it is itself divorced from the core business rationality
- ▶ *Connect: how companies succeed by engaging radically with society* (2015).

The suppression of the social

- ▶ ‘On the whole, views of the economy as an autonomous, distinctive sphere of human activity organized around rationality and efficiency have impeded the serious consideration of morality’s place in economic life.’ (Zelizer, 2011)
- ▶ ‘It is impossible to deny that this question [Limited Liability] is one almost purely economic ... Yet it is equally undeniable that it cannot be probed to the bottom without taking into account a thousand facts and considerations which concern metaphysics, jurisprudence, politics, morals, and even religion.’ (Duke of Argyll, *The Unseen Foundations of Society* 1893, 357 – quoted in Boyd Hilton, 1986)

Key areas of concern

- ▶ Rationality
- ▶ Accountability
- ▶ Purpose



Economic space
and
corporate rationality
The significance of *Salomon*

The trajectory of the C19th business organisational form

- ▶ 'In 1820, corporate enterprise was the exception not the rule' (Lobban, 2010)
- ▶ The arc of business regulation is traditionally presented as a movement from the predominance of the traditional partnership model to the emergence of the readily available registered company (e.g. Hunt, 1936; Ireland, 1983)
- ▶ Adam Smith's classical political economy determines much of the discourse. Large corporations are a necessary evil where large capital required otherwise more efficient for business to be worked by owner. Equally the 'invisible hand' is framed by wider moral framework. This moral economy is gradually removed by the separation of the investment function.

Note parallel movement in understanding of economics with the ascension of neoclassicism (Milonakis & Fine, 2009; Atiyah, 1979)

Broderip v Salomon (1894)

- ▶ Vaughan Williams J recognises the company as a private company and that there was no intention to issue shares to the public. As such, although he considered the price the company paid for the business exorbitant, there was no fraud on the company as all the shareholders had full knowledge of the transaction.
- ▶ However, as principal Salomon was bound to indemnify the company, his agent, against the claims of the creditors. Furthermore, the company had a lien over the assets to override the priority conferred by the debentures.
- ▶ It would appear that the creditors could have sued Mr Salomon directly as the “creditors of the company were his creditors”.

Broderip v Salomon (1895)

A case of very great importance

Lindley LJ - “Mr Aron Solomon’s scheme is a device to defraud creditors” – such schemes, “bring into disrepute one of the most useful statutes of modern times, by perverting its legitimate use, and by making an it an instrument for cheating honest creditors”

Lopes LJ - “It would be lamentable if a scheme like this could not be defeated. If we were to permit it to succeed, we should be authorizing a perversion of the Joint Stock Companies Acts. We should be giving vitality to that which is a myth and a fiction ... To legalize such a transaction would be a scandal.”

Kay LJ – “the statutes were intended to allow seven or more persons bona fide associated for the purpose of trade to limit their liability”

Broderip v Salomon (1895)

- ▶ What was the intention of the legislature?

Lowe, inter alia, when introducing the Partnership Amendment Bill and Joint Stock Companies Bill in 1856 was quite clear that limited liability was not to extend to one person:

“it appears to me that there is something incompatible and inconsistent between the character of a man acting as a principal in trade, and that of a person being a corporator, and whose liability as such shall be limited. There would be constant ambiguity whether such a person was trading as a principal or as a private individual ... many of his acts would bear a double construction, and there would always be a struggle on the part of creditors to fix him with individual liability“

The Davey Committee (1895)

- ▶ ‘No stronger Committee or more competent to the work could have been chosen. It was a picked body of legal and commercial experts representing the combined wisdom of the most eminent and experienced judges , barristers, solicitors, accountants, and men of business’ (Manson 1895)
- ▶ Remit: to inquire what amendments are necessary in the Acts relating to Joint Stock Companies incorporated with limited liability, especially with a view to the better prevention of fraud in relation to the formation and management of companies.

The Davey Committee (2)

“It is a trite observation that legislation cannot protect people from the consequences of their own imprudence, recklessness, or want of experience. The legislature cannot supply people with prudence, judgment, or business habits. It must be remembered that the majority of Companies are honestly formed for carrying on a legitimate though it may be speculative business, and the business is conducted with honesty and reasonable ability and judgment ... Restrictive provisions, which may have the effect of either curtailing the facilities for the formation of companies which bring so much business to England or of embarrassing the administration of companies ... are not lightly to be entertained.”

Two main areas: the prospectus and “Companies without a real membership of seven”

The Davey Committee (3)

Companies without a real membership (paras 12-20)

Acknowledged that the growing practice of converting the business of an individual or of a firm into a joint stock company may be for legitimate purpose (e.g. retirement of partner or provision for family – extended in Harris’s reading of *Salomon* (2013)) but also fertile ground for fraud, especially in connection with use of debentures constituting floating charges.

Salomon decisions affirmed in strong terms and if correct “unnecessary to suggest any amendment to existing law”

However, although no magic in the number seven, no requirement that they be substantial shareholders.

Davey Committee: Appendix of evidence (1)

- ▶ Samuel Ogden JP – “unrestricted limited liability by registration is in some respects a serious danger to the whole trading community, from its tendency to alter the character and objects of commercial transactions generally. The social and personal consequences of bankruptcy, which result from unlimited liability, impose prudence on private traders [but are non-existent for limited companies] ... The spirit of speculation and recklessness which is thus fostered by limited liability ceases to be confined to such companies and inevitably spreads to the trading community, which trades in competition with them. The resulting demoralisation of the trade affected, and the discouragement of honest enterprise, is in some respects of more serious importance than the actual loss to the shareholders and creditors of the companies themselves.”

Davey Committee: Appendix of evidence (2)

- ▶ A fortiori limited liability no application to individual traders and ordinary partnerships – “it would upset all the conditions on which business is transacted, and change the relations of business from relation to persons having personal credit and position at stake to relations merely to disclosed capital with no personal credit at stake.”

Salomon v A. Salomon & Co Ltd (November 1896)

House of Lords unanimously vindicates Mr Salomon.

Lord Halsbury LC - “The appellant, in my opinion, is not shewn to have done or intended to do anything dishonest or untrustworthy , but to have suffered a great misfortune without any fault of his own.”

Salomon v A. Salomon & Co Ltd

HOL (2)

- ▶ “It was a critical moment in the history and fortunes of the private company when the Court of Appeal decided *Broderip v Salomon*. The private company narrowly escaped outlawry and extinction, but happily it did escape. It was saved on appeal by the House of Lords, who discussed no questions of policy but founded themselves simply on the language of the Act.” (Manson, 1910)

Report of Select Committee of the HOL on Companies Bill (July 1897)

Chaired by Lord Halsbury LC (other members include Lord Davey and Lord MacNaghten)

As witnesses Lindley LJ and Romer J both of their own motion raise the anomalous state of the law re the one man company. Both look to the legislative intent and the requirement for seven persons to associate.

Lord Halsbury presses on the public evil raised by the one man company. Lindley LJ is unable to articulate a substantive response.

The Significance of Salomon



Technical significance: allows for one person company to take full advantage of limited liability (Ireland, 1996)

‘the legislative limitation of liability replaced the familiar knowledge of personal character with public knowledge of abstract principles as the central element of moral calculation. In doing so, it reinforced the distinction between the public and the private while at the same time presenting the corporation as an ideal undivided subject.’ (Miller, 1994)

The significance of Salomon (2)

▶ Johnson (2010)

“This shift in legal position occurred not in response to significant pressure from economic interests, but instead because of jurisprudential arguments in which moral presumptions derived from the working law of partnership were at first attached to, and then delinked from, the law of incorporation”

“In historical terms, this can be thought of as the final removal of the vestiges of a ‘moral economy’ in which property owners were expected to take some responsibility for the welfare consequences of their actions”

“The final and complete separation of the entity of the corporation from the individuals who populated that entity created a terrain of moral ambiguity in which corporate activity took place”

Max Weber: Economy & Society

- ▶ Characterises the separation of business from household as giving rise to a distinctive calculative economic rationality
- ▶ ‘With that separation (better named ... “secession”) business ventured into a genuine frontier , a virtual no-man’s- land , free of all moral concerns and legal constraints and ready to be subordinated to the business’s own code of behavior’ (Bauman, 2008) resulting in
- ▶ ‘... the emancipation of business interests from all extant socio-cultural institutions of ethically inspired supervision and control ... and consequently the immunization of business pursuits against all values other than the maximization of profit’
- ▶ BUT capable of being regulated by nation state

Distinctive space but not distinctive rationality

- ▶ e.g. R Edward Freeman, *The new story of business towards a more responsible capitalism* (2017)

Key claims of dominant narrative:

- ▶ business is about money, profit for shareholders economic transactions
- ▶ Shareholders are the only relevant constituency
- ▶ People are self interested, competitive and greedy

Key claims of the new story

- ▶ Business is about creating value for stakeholders, profit is not a purpose in itself, people are motivated by meaning and purpose

Some Regulatory Options

Big Innovation Centre, *Purposeful Company Report* (2017) - utilise section 172(2) Companies Act 2006 to generate different purpose to s 172(1) and utilise specific forms of company e.g. Public Benefit Model or Stakeholder Participation Model.

Adopt a permeable company model as per Parker's open corporation (2002). This would involve significant engagement with stakeholders (thick proceduralism – Black, 2000 and 2001) and a meta regulatory strategy by which corporate self-regulation is subject to regulation.

The impact of globalisation

- ▶ Secession Mark Two - globalisation-
- ▶ ‘Once more , business has escaped the household’s confinement, though this time the household left behind is the modern imagined household, circumscribed and protected by the nation-states’ economic, military, and cultural powers topped with political sovereignty. Once more, business has acquired an “extraterritorial territory,” a space of its own where it can roam freely, sweeping aside minor hurdles erected by weak local powers and steering clear of obstacles built by the strong ones. It can pursue its own ends and ignore or bypass all others as economically irrelevant and therefore illegitimate’. (Bauman 2008)