Regulating close companies in Corporate Law – towards a more formal recognition?

Introduction

Globally there remains great interest in the closely-held company. Yet in many Corporate Law systems such entities stand out by reason of their lack of formal legislative recognition. In contrast, the UK and Commonwealth courts have accepted that there is a distinct category of firm known as the “close company” (often characterised as the “quasi partnership”) and have modified principles of corporate law to give effect to that perception. This paper will evaluate that judicial adaptation phenomenon in the light of possible further judicial customisation of corporate law and prospective legislative action in the field.

Close companies and quasi partnerships defined

With no formal recognition of close companies in UK Corporate Law it is difficult to offer a definition that will attract consensus. We sense what a close company is, but pinning down fundamentals is difficult. What seems clear in the paradigm situation is that a close company is a species of private company. Shares in a close company are not freely transferable; that is the same position as in a partnership as prescribed in effect by s. 24(7) of the Partnership Act 1890. There is a well-established definition (dating back to the 1920s) of close companies in the UK Income and Corporation Taxes Act 2010 ss. 439 and 450 with the maximum membership for fiscal purposes being fixed at 5. Other jurisdictions use a higher figure for corporate law purposes, with some permitting up to 30 members for a close company. One advantage in having membership capped is that there is an expectation that all members will play a managerial role. In certain jurisdictions that envisioned managerial participation develops into a scenario in which the board of directors is scrapped, with members taking the managerial helm. That represents a departure from the orthodox UK position where under Art 3 of the Model Articles for Private Companies in the Companies (Model Articles) Regulations 2008 (SI 2008/3229) the directors enjoy the managerial prerogative and shareholders can according to Art 4 only trespass into the managerial sphere in extreme circumstances by use of special resolution.

We have clearer guidance on what is required for a quasi partnership to exist. Ebrahimi v Westbourne Galleries Ltd highlights three common indicia for a company to be characterised as a quasi partnership. Firstly, it would be based upon a previous business association – i.e. a partnership. There would be an expectation that all members would participate in the management of the company, as is the case in a traditional partnership.
There would also be share transfer restrictions, as in a partnership. It is not necessary for all three indicia to be present to create a quasi partnership, but, as they are interlinked, it is common to find these three characteristics working in unison. We note that a company can become a quasi partnership (or indeed lose that descriptor) at some stage in its life after incorporation. An individual might become a quasi partner in the company at some point in the company’s evolution after incorporation and then lose that status subsequently. A quasi partner de novo might surrender that status and become a dormant participator. The permutations are endless.

From the above we might conclude that for UK Corporate Law purposes, all quasi partnerships qualify as close companies, but not all close companies are quasi partnerships.

The challenge of closely-held companies

To what extent should the established principles of Corporate Law give way to the reality of the relationships between stakeholders that exist within a close company? There are two ways of looking at this conundrum.

From a purely internal perspective there is much to be said for allowing flexible private ordering. A close company is in essence an incorporated partnership and therefore the members of that association should be allowed to define their relationship inter se with the statutory regime applying only in default. This is what happens in the traditional partnership. The partnership influence in this area of corporate law has been marked. But it would be wrong to assume that partnership principles will always operate to the exclusion of corporate norms in mapping out that relationship. So, in O’Donnell v Shanahan the Court of Appeal eschewed the opportunity to apply a liberal partnership law principle dealing with private profits obtained by a participator, and instead opted for a stricter corporate law prohibitory norm. The Court of Appeal determined that a private profit is to be accounted for in the close company context, even if it could not have been earned by the company itself.

Addressing this question from an external viewpoint different considerations come into play. Members of a close company enjoy the facility of limited liability, so it is natural that they should bear the burdens associated with the grant of that economic licence. Those burdens typically relate to disclosure of information and share capital maintenance, both deemed necessary to protect creditors’ interests. That said, for SMEs using the private company form, those restrictions have lessened since 1981 as the deregulation bandwagon has rolled forward. However, those concessions are dependent upon criteria related to the size of the company’s business and are not directed towards the composition of its underlying membership. They are also concessions granted by the legislature and not via judicial whim.

Meeting the challenge: historical evolution

Close companies have been around for many decades. In the same way that the private company was recognised in practice long before it received legislative approval in the Companies Act 1907, so the same may be said of the close company. In terms of UK Corporate Law discourse the designation of close company first surfaced in the 1950s through the work of academics such as Gower. Like many terms used in Corporate Law today, the US linguistic heritage is obvious. Close corporations have operated in many US states for some time. Discrete legislative facilities, which were first offered to them in the USA in the 1950s, have taken a variety of forms since then. A customised variant, the LLC, first surfaced in Wyoming in 1977 and there is now a Revised Uniform LLC Act (first drafted in 1995 and revised on a number of occasions since then) to provide a flexible model for other states wishing to follow suit. However, the problem we have if we focus unduly on the US position is that the close corporation in that part of the world is in fact usually equated with what would appear to be our standard private company. So, in fact English law, which formally imported the private company from the Continent at the start of the 20th century, has built up greater experience of regulating this type of firm. It has drawn upon a partnership heritage to do so.

How has English Law responded to the close company phenomenon? That adaptation has rested largely upon judicial creativity. Salomon v Salomon & Co Ltd confirms that the most fundamental attribute of a company (namely separate corporate personality) must be extended to a close company. This ruling of a full panel of the House of Lords attracted the ire of some commentators because of its potential for abuse, but its current status as the dominant Company Law precedent is unquestioned.

A move towards the discrete regulation of close companies emerged in 1945 via the proposals in para 53 of the Cohen Committee on Company Law Amendment (Cmd 6659). These sought to preserve the concessions currently available to all private companies solely for the benefit of a smaller cohort known as “exempt private companies”. This new exempt status would continue to offer relief from certain disclosure requirements and from the curbs on loans to directors. These proposals took statutory form in s. 129 of the Companies Act 1948. However, they soon attracted concern among policymakers. One problem was that something like 70% of private companies were capable of benefitting from them. The exempt category was in fact the norm! There were also difficulties in defining exactly what was to be regarded as an exempt private company, as reflected in litigation. The Jenkins Committee (1962) (Cmd 1749) para 63(a) called for this experiment to be abandoned and that recommendation was implemented by s. 2 of the Companies Act 1967.

In spite of this legislative setback, voices calling for special treatment for closely-held companies were not silenced. An authority of some perceived historical significance is Re Duomatic Ltd. Here Buckley J recognised that in the context of a small private company the mandatory statutory provisions on shareholder resolutions could be sidestepped by applying a principle of unanimous assent. In fact, any historian of Company Law would remind us that this conclusion was not novel, but it had never been so clearly expressed as it was in the following words:
“...I proceed on the basis that where it can be shown that all shareholders who have a right to attend and vote at a general meeting of the company assent to some matter which a general meeting of the company could carry into effect, that assent is as binding as a resolution in general meeting would be.”

This principle, which rests upon an estoppel, has since been refined and applied in a range of contexts. It is recognised as authoritative in common law jurisdictions, such as Australia, British Virgin Islands, Canada, Hong Kong, India, Ireland, Malaysia, New Zealand, Singapore and South Africa. It provides an example of how Company Law regulatory models can converge across the globe through the processes of common law jurisprudence. We return later to the operation of this particular precedent simply because it provides the clearest example of judicial adaptation at work. Indeed, it has inspired a legislative adjunct in the form of the written resolution, but in the UK it has steadfastly resisted suggestions that it should be incorporated wholesale into the legislative matrix. The Company Law Review in its Final Report (URN 01/942) of July 2001 favoured (at paras 7.2—7.26) statutory consolidation, but the Government in its subsequent White Paper, Modernising Company Law (Cm 5553, 2002) came out against legislative codification of the principle (see paras 2.34 and 2.35). A reasonable interpretation of s. 281(4) of the Companies Act 2006 would suggest that for the purposes of that section it is preserved by virtue of being a “rule of law”. It would also appear to be recognised more explicitly through the saving terms of the ratification provision found in s. 239(6)(a) of the 2006 Act.

Another watershed is Bushell v Faith. Here the House of Lords by a majority upheld the decision of the Court of Appeal ruling that in a close company the members could agree a system of weighted voting rights which would have the practical effect of preventing the passing of an ordinary resolution to dismiss a director under what is now s. 168 of the Companies Act 2006. This conclusion, undermining a sacred tenet of corporate governance, was controversial when it was handed down; indeed there were moves made to effect a statutory repeal, but these came to nothing in English Law. However, a weighted votes clause would only be acceptable in a close company context, a point stressed by Lord Donovan, who noted the partnership perspective:

“And there may be good reasons why Parliament should leave some companies with freedom of manoeuvre in this particular matter. There are many small companies which are conducted in practice as though they were little more than partnerships, particularly family companies running a family business; and it is, unfortunately, sometimes necessary to provide some safeguards against family quarrels having their repercussions in the boardroom.”

The House of Lords handed down its ruling in Ebrahimi v Westbourne Galleries Ltd two years later and broadened the options for a participator to realise an investment in a solvent close company via a “just and equitable” winding up. Where there was a quasi-partnership company, which would typically have some or all of three characteristics relating to prior association, participation in management and share transfer curbs, established norms of corporate law might give way to equitable considerations. This is necessary because this combination of conditions could produce a situation where a
founder member of a company was excluded from management, denied an income (because no dividends were paid) and was forced to see his capital used for the benefit of the remaining participators. Escape would not be possible due to restrictions on transfer. Lord Wilberforce explained (at 379) why this flexibility was permitted:

“a limited company is more than a mere judicial entity, with a personality in law of its own; that there is room in company law for recognition of the fact that behind it or amongst it there are individuals with rights, expectations and obligations inter se which are not necessarily submerged in the company structure.”

The House of Lords viewed the petitioner’s predicament as unfair (even though it had not resulted from technical breaches of current company law) and were prepared to order the drastic remedy of a winding up on “just and equitable” grounds to prevent its continuance. At the time, the alternative remedy of ordering a share buyout under what is now s. 996 of the Companies Act 2006 resulting from a finding of unfair prejudice was not practically possible because of the limitations of the then statutory provision.

The court is reluctant to opt for winding up on the just and equitable ground because it is a drastic solution capable of causing collateral harm to innocent stakeholders. This will only be permitted if the company is solvent and the court will always be alert for ways to sever the Gordian knot without liquidation. But that may not be possible. Witness Re Brand and Harding Ltd where Roth J felt compelled to order the winding up of a family quasi partnership business because the prospects of securing cooperation to value the interest of a party seeking an exit were slim. Compare this with Maresca v Brookfield Development and Construction Ltd where Norris J was able to resolve the exit problem without the need for ordering a winding up on the just and equitable ground.

Although the judicial role in adaptation of companies’ legislation to the needs of close companies is thus established in the above cases, we must be careful not to overstate the argument for departing from standard corporate law norms where there is a closely-held company. O’Neill v Phillips shows that equitable considerations do not always trump the need for commercial certainty as the House of Lords was at pains to circumscribe the notion of legitimate expectations so as to prevent it being used in an unfair prejudice petition in circumstances where it lacked any orthodox legal foundation. To be disappointed as a shareholder is not to be equated with being the victim of unfair prejudice. This adherence to corporate law orthodoxy in the face of the social and cultural environment upon which a small company has been constructed has been mirrored in the family company context. There seems little doubt that the House of Lords wanted to damp down the fires of unfair prejudice litigation, which at that time raged with particular ferocity in the close company context. The Law Commission in its 1997 Report, Shareholder Remedies (LC No 246, Cm 3769) had thought along similar lines and it is likely that the House of Lords were translating its thoughts into legal precedent. That desire was also evident in Lord Hoffmann’s approach towards encouraging buyout offers made to petitioners to forestall unfair prejudice litigation.
So we can see that there is a body of jurisprudence favouring adaptation in the case of close companies, but also can note that there are dissenting voices highlighting the inherent dangers in departing from prescribed regulatory regimes established by Parliament. Judicial adaptation can create uncertainty in a way that should be less obvious in legislation.

**Procedural flexibility: Duomatic refined**

Since 1969 the UK courts (and their common law counterparts) have had opportunities to revisit the *Duomatic* principle in a range of situations. The principle is capable of application in a variety of contexts where a shareholder resolution is required, but has not been passed. Invariably the companies concerned are close companies. This need to rely on the *Duomatic* concession illustrates the reality of how SMEs often fail to comply with formal corporate law procedures. This may be due to the fact that such firms frequently operate with limited professional support. Since 2008 such companies are no longer required to have a company secretary, as s. 270 of the Companies Act 2006 indicates. In truth, informal assent is often raised in an attempt to shield directors from the consequences of their failure to ensure proper corporate procedures are followed in the close company context. This may be an important safety valve because the judiciary are notoriously reluctant to offer relief to defaulting officers if they throw themselves upon the court’s mercy under s. 1157 of the Companies Act 2006.

The *Duomatic* principle is based upon the unanimous assent of voting shareholders supplanting the need for a formal resolution on their part. The principle can apply where the resolution required is from a class of shareholders, rather than shareholders in general. In order to invoke the principle of informal assent it is not necessary to show that such assent was given concurrently at a particular meeting. But any assent must be the result of a conscious decision to agree to a specified course of action. The courts are reluctant to infer assent simply because a matter has been drawn to the attention of shareholders without any real effort to discuss it. As Newey J said in *Rolfe v Rolfe* there has to be some outward manifestation of assent. A leading authority on the status of *Duomatic* is *Schofield v Schofield*. In this instance the Court of Appeal stressed the need for objective evidence of assent; mere presence at a meeting without raising any objection to a proposed course of action would not necessarily suffice. Etherton LJ was quite insistent upon this qualification in para [41] of the judgment. This need for objectivity might serve to explain the thinking of Oliver J in *Re New Cedos Engineering Co Ltd* where the idea that the private thoughts of a sole shareholder might be used to invoke the *Duomatic* principle were roundly dismissed by the court.

Particular difficulties arise where certain shareholders are only present at critical meetings through a proxy or other representative. We must also remember that shares can have both legal and beneficial owners. What seems likely from the comments of Hart J in *Deakin v Faulding* is that the beneficial owners are capable of giving the necessary assent. That said, the point did hinge very much upon the particular circumstances of that case. But if there are multiple beneficial owners of a share the better view is that the assent of all such
owners is required. In order to rely on the Duomatic principle the shareholders must have acted in good faith and honestly in assenting to a course of action.

In deciding whether to apply Duomatic or not the courts will ask themselves what the underlying purpose of the procedure that has been disregarded is. If it is there for protecting the interests of creditors (or some other third party) they will be reluctant to permit latitude, but if it is purely for the domestic consumption of shareholders a more relaxed attitude might be displayed. In Cane v Jones the principle was deployed to permit what amounted to an informal variation of the articles of association. That said, the trend in recent years has been to make the concessionary principle applicable to a wide range of matters requiring shareholder resolutions.

The Duomatic concession cannot operate to displace the right of directors to manage. But in the close company scenario that undermining of management is not a likely possibility because the shareholders and directors often are the same individuals.

A major limitation on the usage of the Duomatic principle is that it can only operate in circumstances where the company is solvent. If the company is insolvent (or doubtfully solvent) the court will not allow informality. The rationale here is that once the company has lost its financial stability the shareholders’ tangible economic interest in it disappears and it is the emerging creditor interest that should be prioritised. The message for those who operate a close company is clear – relying on judicial concessions permitting informality is a dangerous game.

Finally, Duomatic cannot be employed to undertake an activity that would not in any case be permitted by Company Law even if there was strict adherence to procedural rules. Procedural flexibility has its limits.

The Duomatic principle was revisited in Re BW Estates Ltd (No. 2), which was concerned with the validity of appointment of administrators by an inquorate board. The appointment was challenged on the grounds that it could not be shown that all of the shareholders had assented to a change in the articles reducing the quorum required for board meetings. At first instance HHJ Purle QC applied Duomatic to validate the appointment. On appeal the Court of Appeal took a different view. Duomatic could not apply because there were two registered shareholders and, as one of these was a dissolved company, there was no way in which it could have assented to the articles being changed to facilitate the appointment of the administrators.

The widespread adoption of the unanimous assent concession in common law jurisdictions must say something about the logic underpinning it. Slavish adherence to formal procedures attracts little support in any quarter. Judicial validation of procedural shortfall supports security of transaction by frustrating counterparty opportunism. Permitting informality in decision-making may also reduce administrative costs. We note here by way of analogy the wide range of decision-making options now available under Insolvency (England and Wales) Rules 2016 (SI 2016/1024) Part 15 to creditors of insolvent companies, all designed to cut red tape and costs. But, although such formal determination procedures may appear to have little value in themselves, the mere fact that they are prescribed may
mean that any decision reached on the basis of said procedures is the product of considered reflection. When we are dealing with limited companies in which a range of stakeholders (and not merely shareholders) have a legitimate interest\textsuperscript{71}, there is something to be said for encouraging deliberation\textsuperscript{72}. Duomatic at heart reflects shareholder primacy philosophy, whereas the 21\textsuperscript{st} century company has to serve wider interests. There may also be a link between lax corporate governance and corporate failure\textsuperscript{73}. Furthermore, in the modern era it is possible to communicate with shareholders electronically without requiring attendance at a meeting. That fact of technological advance might undermine a line of authority that has stood for many years and was based upon modes of communication familiar to the Victorians.

\textbf{Contractual underpinning and the “close” nexus}\textsuperscript{74}

The existence of an agreement outside the traditional constitution of the company is a common (but not inevitable) feature of most close companies, though perhaps less so for family firms. Indeed, it is the very existence of such an agreement that may justify departure from the strict requirements of Company Law\textsuperscript{75}. Where such an agreement exists the usual contractual questions about the terms of the agreement, and whether it may be varied, arise. Variation of a shareholder agreement will depend upon the terms of said agreement and will usually require unanimity. It may be that the shareholder agreement may require the assent of the company, but this is fraught with difficulty\textsuperscript{76}. A formal variation procedure may be specified, but it does appear that there is scope for the Duomatic principle to come into play, as Mummery LJ concluded in the Court of Appeal in Euro Brokers Holdings Ltd v Monecor (London) Ltd\textsuperscript{77}. Shareholder agreements will retain their importance in this particular corporate context notwithstanding the introduction by s. 22 of the Companies Act 2006 of the possibility of entrenching articles of association\textsuperscript{78}. Such agreements are more flexible and are easier to customise.

Does the close company automatically produce a fiduciary relationship between its participators? The orthodox answer to this question should be in the negative. Any fiduciary relationship found to exist will be between individual members and the company itself\textsuperscript{79}. This point, which reflects the separate status of the firm, has recently been confirmed in the LLP context\textsuperscript{80}. This exclusionary argument is reinforced by the fact that participators in a close company will often operate under a shareholder agreement and, barring the introduction of explicit fiduciary duties by said agreement, the English courts will not willingly create fiduciary obligations on the back of a contract.

A close relationship does not mean that disagreement is out of the question. There are a range of remedies available to a disgruntled shareholder in a close company. These however require recourse to the court. There is no automatic exit option to realise one’s investment. Lord Hoffmann stressed this in O’Neill v Phillips\textsuperscript{81} and the Law Commission in 1997 in Shareholder Remedies (LC 246, Cm 3769) had at para 3.66 also rejected this idea previously. This contrasts with the idea of appraisal rights in defined circumstances, as pioneered by US Corporate Law.
In recent decades it has become the norm for shareholder agreements to include a compulsory arbitration clause to address shareholder disputes, thereby avoiding damaging publicity in the courts. Can such a provision, by virtue of s. 9 of the Arbitration Act 1996, be used to block an application to the court for statutory relief? The authorities here were initially contradictory, but the Court of Appeal clarified matters in Fulham FC (1987) Ltd v Richards. The company here ran the Premier League with 20 football club members each owning one share. It was a closely-held company, but an unusual one at that. A club in dispute with the League wished to pursue a s. 994 petition. The Court of Appeal ruled that the arbitration mechanism should be respected because the arbitrator could provide the remedies sought under this unfair prejudice petition. This ruling confirms the primacy of the contractual nexus in close companies. But it has its limits; a winding up remedy cannot be awarded by an arbitrator, so a just and equitable petition would have to proceed to the court.

A related issue concerns the effect of one participator leaving the association. This is where we have to confront so-called “tag along” and “drag along” clauses. To explain, the former clause allows a minority shareholder to follow the exit of the leading shareholder by having shares purchased at fair value, whilst a drag along clause compels a minority shareholder to sell up if the primary shareholder wishes to leave the company and to sell his interest in the business to an outsider. Some consideration of these questions is to be found in Constable v Executive Connections Ltd. The case is problematical because it involves an attempt to alter established articles of association to introduce a drag along provision. This is inherently more objectionable than having such a clause in the constitution de novo. The value of this precedent is further limited by virtue of the fact that it involved an application for an interim injunction to restrain said alteration pending a full trial. Nevertheless, on the facts of the case, Christopher Nugee QC ruled that it was arguable that this attempt to introduce a drag along facility constituted an abuse of majority power and should be restrained pending trial. Notwithstanding these points, drag along clauses are now common in close company constitutions and it would seem implicit in the Court of Appeal ruling in Arbuthnott v Bonnyman that they are not inherently objectionable.

Should we move towards formal legislative recognition of close companies?

It is apparent that there is little explicit legislative recognition of the special needs of closely-held companies in English law. True, there are sections in the Companies Act 2006 that are particularly apposite, such as s. 306, which empowers the court to summon a shareholder meeting in contravention of quorum requirements so as to enable a deadlock to be broken. This was modified in 1948 to permit one member meetings and thus to be of particular value in the quasi partnership context. Section 994 is also particularly relevant to close companies, as is the just and equitable winding up provision in s. 122(1)(g) of the Insolvency Act 1986. Notwithstanding, we have a growing number of provisions that offer exemptions according to the economic size of the business operation linked to assets, turnover and number of employees. Clearly such concessions will by definition apply to SMEs, but many SMEs do not fall under the closely-held company category.
There is broad agreement that close companies require some form of statutory regulation because they employ the device of limited liability with all of the dangers for outside parties that flow from it. Close companies cannot be left entirely as creatures of contract. The question therefore is what form that regulation should take.

The arguments for a new dedicated legislative treatment are reasonably well balanced here. On the one hand, there is much to be said for a self-contained legislative code for close companies. This might provide a further boost to small enterprise by reducing transaction costs in drafting customised shareholder agreements. It would strike a chord with the “Think Small First” mantra. But, as we have seen above, one of the hallmarks of the close company is the degree of contractual flexibility. A discrete legislative framework for close companies might therefore provide little additional value, apart from providing a model to be adopted in default of explicit agreement. It might even result in additional costs if a close company then transitioned into a larger private company thereby requiring re-registration. Attempts to provide discrete regulation for smaller type companies have not met with universal success. Although the division of companies into small and medium-sized for accounts/audit purposes is well established, trying to develop discrete regulation in other areas has proved a challenge. The Law Commission grappled with this problem when reviewing shareholder remedies two decades ago. Moreover, the experiment conducted via Insolvency Act 2000 s. 1 (inserting Schedule A1 into the Insolvency Act 1986) of developing a dedicated rescue procedure by customising a variant of the company voluntary arrangement mechanism for small companies has proved to be a miserable failure.

The Company Law Review (1997-2001) revisited the question in its major study of UK corporate law. In its Final Report in July 2001 (URN 01/942) it supported the status quo as far as the classification of companies was concerned. It did not favour a special regime for close companies. It did however at paras 7.20-7.26 recommend converting the common law Duomatic principle into a statutory concession as it felt that this would be more user-friendly for entrepreneurs who exploit the small company format. But In the follow-up White Paper of July 2002, Modernising Company Law (Cm 5553) the government (at paras 2.34 and 2.35) rejected this proposal, preferring instead to leave the matter to the evolving common law. One advantage in this approach is that Duomatic will retain its preeminent status across the common law world and in turn will allow for the jurisprudence to be refreshed from a variety of sources. A common law rule that evolves in this organic way can provide the basis for a more successful legal transplant.

Moving into practical politics, the fact that English Law has not provided a fully discrete statutory framework for private companies might suggest a lack of appetite for providing a designer menu for a more restricted category of firm within the private company constituency. A similar lack of legislative action is apparent with regard to group companies, where the courts have been left to devise a regulatory solution based largely upon the separate identity of group members. Most registered companies in the UK would fall under the close classification and much of the commercial activity carried out in the corporate sector is conducted via a group structure; the failure of the legislator directly to address these realities on the ground speaks volumes. The obsession with the larger self-standing
company having a marked separation of ownership and control persists. Compare this static
approach with the legislative willingness to provide discrete structures for single member
companies\textsuperscript{92}, LLPs\textsuperscript{93} and Community Interest Companies\textsuperscript{94}. Latterly, we have seen the
introduction of a modified form of limited partnership for hedge funds via The Legislative
Reform (Private Fund Limited Partnerships) Order 2017 (SI 2017/514), a reform which
waters down some of the traditional restrictions on the participation in management by
limited partners.

What does the experience of other jurisdictions tell us about explicit treatment of close
companies? South Africa had a close corporation regime for the years from 1984-2011.
This radical regime, inspired by unconsummated UK proposals for reform\textsuperscript{95}, did away with
the notion of shares and instead provided for participators to have percentage interests in
the company\textsuperscript{96}. In spite of the plaudits it received\textsuperscript{97} it was scrapped in terms of any future
incorporations of such entities in 2011 when the South African Companies Act 2008 took
effect. But existing close corporations were not disestablished and many thousands still
operate. The reasons for this abandonment of the close corporation experiment are hard to
fathom, but it may well be that the policymakers felt that the existence of this category
over-complicated corporate law. The position today is that the close company does exist in
attenuated form but the discrete category of close corporation has been left to wither on
the vine\textsuperscript{98}.

Australia had a short flirtation with discrete regulation of close companies under the Close
Corporations Act 1989. But that legislation, which was less radical than the South African
model, along with other attempts to provide a federal corporate law regime, fell apart in the
constitutional crises of the 1990s. The Corporations Law 2001, which flowed from a
constitutional settlement, does not offer a discrete menu for close corporations. New
Zealand, which is noted for its radical Companies Act 1993, also fails to make significant
special provision for closely-held companies\textsuperscript{99}.

Ireland recently reconfigured its corporate law statutes in a major reform. The Companies
Act 2014 mirrors the UK model in terms of its magnitude, though it does pay greater heed to
the needs of small companies by working on the assumption that the legislation is geared
towards the private company user, whilst making special provision for public companies. It
does make provision for what is termed a CLS company\textsuperscript{100}, which is a deregulated form of
the private company with unlimited capacity and able to dispense with many formal
requirements as to meetings. This is a positive development. However, once again, there is
no explicit legislative recognition of close companies. The unanimous assent principle
remains the preserve of common law in Ireland.

**Conclusion**

The fundamental problem posed by the close company is that it was not on the radar when
the great step forward in Company Law took place in the mid 19\textsuperscript{th} century with the advent
of registered companies with limited liability. The law has had to play “catch up” since then.
We have had to progress from a one dimensional view of the company to a more diverse
and nuanced perspective. Both the courts and the legislature have played a part in this process of adapting a standard business model to the close company reality. This experience is not unique. Witness the evolution of the group of companies at the other end of the commercial scale. Arguably much less has been achieved in terms of adapting Company Law to the reality of groups than has been achieved for close companies.

The pattern of development outlined above reflects the incorporation of “equitable” principles into the classic Corporate Law mix. This has been achieved by inventing the quasi partnership construct and by refusing to allow rigid adherence to procedural formalism to produce an inequitable outcome. The advent through legislation of the unfair prejudice jurisdiction since 1980 has also created opportunities for the introduction of equitable perspectives into the close company arena\textsuperscript{101}. A major advance in the future would be the acceptance of the existence of directly enforceable fiduciary duties between participators in a close company. One suspects that is a step that the courts are reluctant to take for fear of opening a Pandora’s box of legal complexity and litigation. We should bear in mind that in the UK most shareholder litigation arises in the close company context and there may be public policy reasons for keeping such litigation under control. Similarly, the idea of granting automatic exit or appraisal rights for investors in close companies has been shunned in view of its potential to cause economic disruption in the SME sector where a sudden loss of capital could be a disaster. These concerns are understandable but, it is submitted, that they may be overblown because such inherent dangers may be controlled through contract and the good sense of the judiciary, who have developed a constructive set of effective rules in English Law for close companies.

UK Corporate Law has, through judicial ingenuity, done much to create a discrete regulatory regime for the close company. Parliament has had limited input in this process of blurring the lines between the paradigm corporate and partnership forms. The legislature has taken a passive role by not overturning “creative” judicial rulings and by refusing to convert common law jurisprudence into statutory rule. The instrumentality of Contract has been obvious in providing the equivalent of “fusion food” on the menu for partaking entrepreneurs. The courts have navigated a fine balance that exists between upholding a respect for fundamental principle whilst introducing the necessary adaptations to reflect the underlying relationships that exist within companies. Farrar\textsuperscript{102} characterised this as a process of “fact-based jurisprudence”. In the opinion of the present author, the courts should be left to continue this incremental process without the need for general statutory interference in the form of a discrete regulatory matrix. Indeed, some of the heat has been taken out of the debate here since 2001 with the introduction of the limited liability partnership via the Limited Liability Partnerships Act 2000 as this provides a structure for the small family business which combines many of the positive features of limited companies and partnerships. This new vehicle is available for all forms of business and is not restricted to professional groups. But it does require a minimum of two members.

If the legislature wanted to test the water in developing a less radical strategy it might wish to introduce a compulsory arbitration facility for disputes arising in the context of a closely-held company. Again, the problem of definition could complicate this initiative, but
the issue is not unsurmountable. An alternative would be to exclude the s. 994 unfair prejudice jurisdiction from close companies, unless it were specifically envisaged by shareholder agreement. A variant on this latter solution has been favoured in LLP law. Questions of definition might also frustrate this approach, which could only work if we had a clear definition of a closely-held company. LLPs are a distinct category of legal person that require separate registration. We do not have that clarity at the moment for closely-held companies, so it is best left to the participators through contract to resolve this matter for themselves, albeit at the risk of some form of judicial “review”.

Notwithstanding this, in view of the high percentage of close companies within the private company constituency, there is something to be said for revisiting the option of a separate legislative regime for private companies generally. The courts cannot take on this major task. Many other jurisdictions, particularly in Europe, have gone down this road, but the UK has declined to follow. Instead, we have a mammoth Companies Act with numerous areas of segregated provision for private companies. A further gloss is then added by the courts to modify the position for close companies. Hardly a user friendly approach! In the post-Brexit world the introduction of a customised private company regime would reassure UK business that the government has its interests at heart.

Notes

1 The July 2014 Vienna World Congress of Comparative Law devoted a session to them. This drew on national reports by experts from many jurisdictions. For a comparative overview see Ch 2 in McCahery and Vermeulen (2010).
2 Prentice (1983) memorably compared the close company to an elephant – easier to describe than to define.
3 Kershaw (2009: 803) suggests in a glossary that in atypical cases a public company with few shareholders might properly be regarded as a close company.
4 The South African close companies’ regime capped membership at 10.
5 One result of this expectation that exists within a close company is that any exclusion from management is likely to trigger an unfair prejudice petition under s. 994 of the Companies Act 2006. In Re BC & G Care Homes Ltd [2016] BCC 615 a quasi partner was excluded from management. The court held that this was unfair, particularly as the controllers had not made any offer to the excluded party to buy out his share. See also Blackmore v Richardson [2006] BCC 276. The Law Commission (Shareholder Remedies,
1997) (LC 246, Cm 3769) favoured a presumption that this would automatically be seen as unfair but this recommendation was not implemented.

6 That was the position under the South African Close Corporations Act 69 of 1984.

[1973] AC 360. Note Lord Millett’s caution in CVC/Opportunity Equity Partners Ltd v Demarco Almeida [2002] BCC 684 at [32] that these are only typical features and are not exclusive defining elements.

7 Partnership Act 1890 s. 24(5).

8 Arden LJ stressed this in Strahan v Wilcox [2006] EWCA Civ 13 at [19].

9 Exemplified by Moss v Elphick [1910] 1 KB 846.

10 The petitioner in O’Neill v Phillips [1997] 1 WLR 1092 started in the company as an employee before attaining quasi partnership status.

11 Exemplified by Aas v Benham [1891] 2 Ch 244.

12 Lord MacNaghten refers to the private company in Salomon v Salomon & Co Ltd [1897] AC 22 at 48 and 52. On how the company began to be used by former partnerships as the preferred vehicle for commerce see Ireland (2003: 471).

13 Kahn-Freund (1944: 59) objected to the idea of the private company with few shareholders and little responsibility to creditors – he called for such companies to be converted into partnerships.

14 For the development of US close companies see Cheffins (1989). The significance of close corporations in America was underlined by the controversial Supreme Court ruling in Burwell v Hobby Lobby Stores Inc [2014] 573 US 1 where the US Supreme Court (by a majority) ruled them capable of benefitting from religious protection under the law. One of the dissenters, Justice Ginsburg, argued that there were logical flaws in restricting this religious freedom to close companies because many such companies were in fact large enterprises. Again, definitional complications loom large.

15 For analysis see Cottam et al (2011).

16 See Harris (2013).

17 [1897] AC 22. For discussion of the landmark status of this precedent see Lim (2014).

18 Kahn-Freund (1944: 59) objected to the idea of the private company with few shareholders and little responsibility to creditors – he called for such companies to be converted into partnerships.


21 See Qualter Hall & Co Ltd v Board of Trade [1962] Ch 273 and Re Prenn’s Settlement [1961] 1 WLR 569. In fairness the Cohen Committee (supra) itself conceded (at para 53) that there were problems in drawing up an appropriate definition.

22 Exempt private companies have survived in some Commonwealth jurisdictions – e.g. Singapore (maximum membership is 20).

23 [1969] 2 Ch 365. For critique see Morse (1971).

24 This point is made by Sealy and Worthington (2008: 195).

25 The earliest manifestation can be found in the comments of Cotton LJ in Baroness Wenlock v River Dee Co (1887) 36 Ch D 675n at 681-682n. A perusal of the judgment of Lord Davey in Salomon v Salomon & Co Ltd [1897] AC 22 at 57 would detect traces of a familiar
approach. The ruling of Buckley J drew upon cases such as Re Express Engineering Works Ltd [1920] 1 Ch 466 and Parker and Cooper Ltd v Reading [1926] 1 Ch 795. The Irish Supreme Court had trodden a similar track a decade earlier in Buchanan Ltd v McVey [1954] IR 89. Duomatic is thus best viewed as the most notable cover version of an old recording.  

29 See for example Mercanti v Mercanti [2016] WASCA 206.  
30 Westminster Oil v International Investment House Co LLC (unreported, Eastern Caribbean Supreme Court, Court of Appeal, 30 April 2012).  
32 Re Smart Wave Ltd [2016] HKFCA 23.  
33 Though questions have been asked about its current status in view of the enactment of s. 117 of the Indian Companies Act 2013.  
34 Kerr v Conduit Enterprises Ltd [2010] IEHC 300. In Ireland it is sometimes designed the Buchanan principle (for explanation see footnote 27 above).  
36 Raffles Town Club Pte Ltd v Lim Eng Hock Peter [2012] SGCA 62 at para [29], Bounty Resources Armenia Ltd v Li Haidong [2015] SGHC 188.  
38 See Companies Act 2006 s. 288. Such resolutions, which can only be utilised by private companies, employ the same majorities as would be required for a “real” resolution but they cannot be used to remove a director or auditor. The Jenkins Committee (Cmd 1749, 1962) called for the introduction of written resolutions (see paras 460 and 468(d)) but this change was only made in 1989. Malaysia introduced written resolutions in 1992 and made them more widely available via s. 290 of their Companies Act 2016.  
39 [1970] AC 1099. The company membership here totalled three, all from the same family.  
40 For critique see Schmitthoff (1970), Collier (1970)  
41 In Hong Kong, the decision was overturned – see Companies Ordinance 2014 (Cap 622) s. 462(7).  
44 [2014] EWHC 247 (Ch).  
45 [2013] EWHC 3151 (Ch).  
46 [1999] 1 WLR 1092 – this was originally a one member company into which the petitioner, a promising employee, was introduced to membership via allotment of a 25% shareholding.  
47 See for example Lexi Holdings v Luqman [2009] EWCA Civ 117.  
48 The leading critique is provided by Grantham (1993). For other reviews see Burton (2000), Cabrelli (2001), Goddard (2004) and Ellis (2011). The burgeoning nature of this area of law is reflected by the introduction of a discrete chapter in the third edition of Kosmin and Roberts (2013).
Malaysia has refused to go down this route, preferring instead to retain the company secretary role. But Kenya followed the UK approach with s. 243 of its Companies Act 2015.


[2010] EWHC 244 (Ch) at [41].


Therefore the comments of the court in Re Bailey Hay & Co Ltd [1971] 1 WLR 1357 must be treated with some caution. The point here is that there were several opportunities over a period of time for the abstentionist shareholders to object, but as these opportunities were not taken, that was deemed sufficient to indicate agreement.


This idea of a duty of husbandry where a company is on the verge of insolvency derives from Commonwealth jurisprudence applied by the Court of Appeal in West Mercia Safetywear v Dodd [1988] BCLC 250. This was then recognised by s. 172(3) of the Companies Act 2006, but its parameters have been left to common law jurisprudence.

A fact underlined because of the potential of the avoidance provision embodied in s. 423 of the Insolvency Act 1986 to come into play. See BTI 2014 LLC v Sequana SA [2016] EWHC 1686 (Ch).
This is a point made by Grantham (1993:265).

A parallel could be drawn here with the lax approach towards appointment of administrators, an approach castigated by Sir Andrew Morritt C in Minmar 929 Ltd v Khalatschi [2011] BCC 485.

Ireland cautions against taking the contractual view beyond the scope of private companies into corporate law generally – Ireland (2003).

This issue has been debated in other jurisdictions – for the evolving attitudes in the US and Germany see Kulms (2001).

Witness Russell v Northern Bank Development Ltd [1992] 1 WLR 588 where the House of Lords was required to be at its most ingenious to uphold the spirit of the shareholder agreement whilst preserving the integrity of fundamental principles of corporate law. For a comparative perspective see Cheung (2012).

In North American a “statutory unanimous shareholder agreement” is used as an alternative to entrenchment – see Cheung (2008).

Flannigan (2014), who advocates wider fiduciary accountability of shareholders, accepts this fact.

See Sales J in F & C Alternative Investments (Holdings) Ltd v Barthelemy [2011] EWHC 1731 (Ch) at [207]-[216].


[2011] BCC 910. See also the Privy Council advice in Anzen Ltd v Hermes One Ltd [2016] UKPC 1 (a BVI appeal) where the matter turned upon the construction of the particular arbitration clause.

For useful precedents and analysis see Wolf (2014: 264-267). There may need to be a bona fide offer from an outsider for drag along to apply – McCausland v Surfing Hardware International Holdings Pty [2013] NSWC 902.


[2015] EWCA Civ 536.

The argument is weakened if small firms switched to unlimited liability options – see Freedman (2000).

Reisberg (2010:374) advocates this. For similar calls for change voiced in New Zealand see Spisto and Samujh (2001) and Farrington (2007).

Freedman (1994) favours this solution: i.e. a single piece of companies’ legislation with maximum flexibility embodied. At the same time the DTI concluded that there was little pressure from business for reform – see The Law Applicable to Private Companies (URN 94/529). See Hicks (1995).

Originally in Law Commission Consultation Paper 142 on Shareholder Remedies (1996) it was looking at special additional remedies for members in private companies with 5 or fewer shareholders. In its final report (Shareholder Remedies) (LC No. 246, 1997)(Cm 3769) it opted for alternative remedy to combat exclusion from management based upon a presumption of unfair prejudice which would come into play if the petitioner held 10% of the shares and the company operated with shareholders acting as managers.
Private companies, in spite of their predominance, are relegated to a default category – s. 4(1) of the Companies Act 2006. That said, the Model Articles do now offer a more customised treatment for private companies. Malaysia retained its uniform system when it reformed its law in the Companies Act 2016.

This was forced upon the UK by EC commitments. See Companies Act 2006 ss. 123 and 231 for examples of UK customisation for single member companies. The European Commission is working on proposals to further harmonise the law on single member companies, as these form a significant constituency in the EU SME sector. Malaysia introduced single member companies via its Companies Act 2016.

Under the Limited Liability Partnerships Act 2000. As LLPs are regarded as corporations the unsatisfactory solution adopted has been to apply the Companies Act 2006 en masse with suitable adaptation – see Limited Liability Partnerships (Application of the Companies Act 2006) Regulations 2009 (SI 2009/1804).

Introduced in 2004 and recognised by s. 6 of the Companies Act 2006 the statutory base is still contained in the Companies (Audit, Investigations and Community Enterprise) Act 2004.

A New Form of Incorporation for Small Firms (1981, Cmnd 8171), with a contribution by L.C.B. Gower.

For explanation see Henning (1999: 76).

From commentators such as Procaccia (1987) and Dine (1998).

For the demise of the close corporation in South Africa see Henning (2016).

The same is true of Kenya (Companies Act 2015) and Malaysia (Companies Act 2016).

An abbreviation of “company limited by shares”. The other type of private company is known as a “designated activity company” (or DAC for short). It retains many of the features of current private companies.

Lord Hoffmann notes this in O’Neill v Phillips [1999] 1 WLR 1092 at 1098-1099.


See Limited Liability Partnership Regulations 2001 (SI 2001/1090) and the Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009 (SI 2009/1804). Under the modified s. 994(3) of the Companies Act 2006 access to s. 994 can be excluded by a unanimous written agreement between LLP members.

References


