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The Era of Regulated Capitalism

In the Western countries of market economy the economic system of capitalism is in a transitional stage. Capitalism at the end of the twentieth century is very different from capitalism at the end of the nineteenth century. The idea of *laisser-aller* has now been widely discarded, although some still think that all is best if the economic world is left to its own laws and the survival of the fittest is the accepted rule. At the end of the twentieth century it has been realized that, although the system of economic liberalism as a form of the capitalist system provided great wealth and prosperity down to the upper strata of the middle classes, it also created great social injustice and poverty so oppressive as to keep those near the starvation line from rising above the station of life into which they were born.

When it is realized that the nineteenth century system of economic liberalism which continued to the end of the First World War is gone and we are now in a transitional period, the question arises as to where that transition will lead. Some economists and sociologists think that capitalism is in its last stage and, as predicted by Karl Marx, after dying a slow and painful death, will give place to the millenium of socialism. Other modern thinkers take a different view. They point to the fact that economic and social life in the countries that adopted the system of socialism after the First World War have not done too well under it. In terms of human happiness, personal freedom and even economic progress, those countries have not, to an impartial and unbiased observer, created the conditions of advance that are commensurate with the progress in the countries of market economy, even if one

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takes into account the social and economic backwardness of some of these countries that existed when they embarked on the new economic system. The socialists made grievous and costly mistakes in the central planning of the economy, although many planners have learned by their mistakes. Freedom of thought and movement of persons across frontiers into Western economies is still strictly regimented in many of these countries, obviously because a comparison with the situation prevailing in the market economy countries is not welcome. Therefore, that Western countries will move from liberal capitalism into an era of socialism is not a well-founded conclusion.

What then is the era into which the relinquished system of liberal capitalism is now moving in the Western world? It is, as far as the development in the Western countries of Europe indicates, a system of regulated capitalism or, in other words, a period of social responsibility. It is a function of the state to see that social justice is done, that the weaker groups of the population are given the protection of the state, and that the state machinery is used to prevent their exploitation by unscrupulous excesses of unbridled capitalism. The weaker groups of the population which require protection include the consumers, who have been found to be helpless when faced with powerful, concentrated, trans-national or national enterprises, the employees, who might become defenseless pawns in the economic and political power game when exposed to redundancy and social insecurity, the investors, whose savings are endangered by unscrupulous speculators who, for instance, did not prevent the Great Crash in the United States in 1929, and the population at large, which is deprived of the ecological enjoyment of their environment when encountering the ravages of a science, which thinks only in terms of technological progress. That the state functions to protect these weaker groups of the population is now generally recognized. This recognition has given rise to new branches of law. A law of consumer protection has become an integral part of our legal order. The law of employee protection has been developed not only by allowing trade unions an enhanced status but by devising legal protection against unfair dismissal, length of notice of termination of the contract of employment, and compensation for loss of work. Investors are protected by regulations administered by such institutions as the Securities and Exchange Commission in the United States, the Panel on Takeovers and Mergers in the United Kingdom, the *Commission des Opérations de Bourse* in France and a general strengthening of the protection provisions of company and securities law. The environment is protected by planning and zoning legislation. Looked at from a wider perspective, we have entered into a new era of capitalism, namely that of regulated capitalism.

As far as Europe is concerned, this is no longer a matter of party political differences. This view is indeed accepted by all parties in the Western countries. It allows, however, a wider inference. The period of liberal capitalism appears to be followed by a period of regulated capitalism or, if one wants to express it differently, of social responsibility. This economic system has great advantages when compared with the socialist system adopted by the countries of state-planned economy, except perhaps the Yugoslav system which appears to combine a socialist form with principles of regulated capitalism. The economy of regulated capitalism admits the personal liberties cherished in the Western tradition, freedom of thought and personal freedom and prevents, at the same time, the worst excesses of unbridled capitalism. In many European countries it finds expression in the adoption of the mixed economy in which a public and private sector of the economy work side by side. This system is founded on the regulation of the private sector by the state. Here, of course, differences between economists and politicians arise. Some are in favour of little interference by the state with the private sector; some consider it necessary for the state to exercise a stricter control. We are not concerned here with these differences. Suffice it to say that there is general agreement that in the era of regulated capitalism it is a function of the state to exercise some degree of control over the.private sector.

The Interests Involved in the Company

The development of regulated capitalism has greatly affected company law philosophy. The company is the typical form of private enterprise in all Western countries. However, in the era of regulated capitalism the company is no longer regarded as an instrument of profit maximization in the sole interest of the shareholders. The general view is that the interests of the employees and the public at large have likewise to be taken into account. The shareholders are the providers of the capital that the company requires for the successful carrying on of its business. It is uncontested that the company should work profitably; the importance of the profit motive has been in no way impaired. Even the best schemes of employee participation or profit sharing will not work when the company operates at a loss. But the interest of the shareholders, as we shall see, is no longer the sole determinant in the management of the company. The employees who often give their lifetime for their work in the company have an interest that equals that of the shareholders. The public at large is likewise interested in the conduct of the company. Not only has the company to think of its public image, but essentially the company is just one unit in the national body politic. Company law has thus changed its character. It has developed from company law (*droit des sociétés*) to a law of enterprises (*droit des entreprises*).

This transition means that the function of the management in the modern company has changed. The aim of the management is no longer to obtain the maximum profit for the shareholders of the company, distributable by way of dividends, by its operations, irrespective of the interests of the employees and society at large. The function of the management is nowadays that of balancing all relevant interests, namely those of the shareholders who rightly demand an adequate return on their investments, of the employees who rightly demand just wages and job security, and of the public at large which requires that the affairs of the company are conducted in the wider context of the national interest.

That balancing function of modern management is essentially a function of social engineering. It is comparable to the function of modern government which aims at finding a compromise between the conflicting interests of pressure groups in the community. Consciously or unconsciously, most managements of large companies are aware of this position and fulfill this function well.

One of the curious aspects of the present situation is that although modern company-law philosophy is widely accepted in the system of regulated capitalism, the company laws of most Western countries do not give expression to it but are still framed in terms of economic liberalism. The Western European countries have, however, found it necessary to graft rules expressing modern company-law philosophy on the body of the liberalistic concept of the company. Some of these measures of European regulation will be examined in the following, but it may already be observed here that, as far as the Member States of the European Economic Community are concerned, ideas emanating from that organization have been very influential. These developments will be examined separately for the directors, the shareholders, the employees, and the public interest. But before this examination can be carried out, it is necessary to consider the classification of companies as such.

A New Classification of Companies

The traditional classification of companies in Europe is into public and private companies. The private company originated in Germany as the *Gesellschaft mit beschränkter Haftung* (GmbH), where it is still regulated by the Law of April 20, 1892. This Law is at present under revision. Professor H. Würdinger writes in his *German Company Law*: "The private company . . . is an invention of the legislature, and was created by the Law of 20th April, 1892 (GmbHG) without any historical precedent in German or European law."[1] The idea of the private company was to make the form of the limited-liability company available to small business. This idea spread from Germany to France and the other European countries. The private company was introduced into French law by the Law of March 7, 1925 which admitted the creation of the *société à responsabilité limitée* (SARL). In Belgium this form is known as the *société des personnes à responsabilité limitée* (SPRL). In the United Kingdom the private company was introduced by the Company Law Reform of 1907 and 1908.[2]

The traditional distinction between public and private companies is no longer in accordance with economic reality. The private company is used for two different purposes, as the small family company and as a subsidiary of large enterprises, particularly of the public-company type. The United Kingdom Companies Act 1948 sought to distinguish between these two types of the private company. The Act attempted to grant the privilege of balance-sheet secrecy to small private companies owned by individuals, called exempt private companies, but it withheld the principle of balance-sheet secrecy from subsidiary private companies, the shares of which were owned by other companies. This arrangement proved to be too complicated, and, since the Companies Act 1967, all private companies in the United Kingdom, large or small, have had to publish their balance sheets. However, it is now widely recognized in the United Kingdom that that measure went too far and that small family companies require special regulation. In the leading case of *In re Westbourne Galleries Limited*[3] the House of Lords recognized that the so-called partnership company[4] enjoyed a special status and that the shareholders in such a company were under an equitable obligation not to exercise their legal rights in a manner contravening the expectations of the other members.

The modern classification of companies that is closer to economic

1. H. WÜRDINGER, GERMAN COMPANY LAW 183 (1975).
2. 1 PALMER, COMPANY LAW, ¶ 2-09 (2d ed. 1976).
3. [1973] A.C. 360; *see* Bushell v. Faith, [1970] A.C. 1099; Schmitthoff, *How the English Discovered the Private Company*, in QUO VADIS IUS SOCIETATUM? 183 (1972).
4. *See generally* Morse & Tedd, *Partnership Companies*, 1971 J. BUS. L. 261.

reality is that between large public companies listed at the Stock Exchange and family companies which use the corporate form only for purposes of convenience, such as to avail themselves of the benefit of limited liability or for tax reasons. Between these two poles of large listed public companies and small family companies is a spectrum of large private companies and unlisted public companies. The concept of the large company[5] is recognized in many European countries, although no unanimity exists on what constitutes a large company. Thus, in Germany, where the GmbH in principle enjoys balance-sheet secrecy, following the United Kingdom Companies Act 1967, the so-called *Publizitätsgesetz* of 1969 was introduced which lays down three criteria for the GmbH:

(a) the total balance of the annual balance sheet exceeds DM 125,000,000;
(b) the turnover in the last twelve months exceeds DM 250,000,000;
(c) the enterprise has employed more than 5,000 employees during the last twelve months.

If two of these criteria are satisfied, the GmbH must publish its balance sheet, like the public company (*Aktiengesellschaft*, A.G.). Sometimes different criteria are employed for the large company with respect to balance-sheet secrecy and the requirement of employee participation. Thus in Germany a GmbH must have a supervisory board and employee participation if it has more than 500 employees. In the Netherlands every company, whether public or private, must publish its balance sheet if it satisfies the following three cumulative criteria:

(a) according to its balance sheet the issued capital and the reserves amount to at least D.Fl. 10,000,000;
(b) the company or any other company in which it holds at least half of the issued shares for its own benefit is compelled by law to establish a works council; and
(c) the company or any such other company usually employs at least 100 employees in the Netherlands.

In Denmark, according to an Act of June 13, 1973, a company must have a supervisory board with employee participation if it has more than fifty employees and the employees so desire. According to the Fifth Draft Directive of the EEC, which deals with company structure and applies only to public companies, all these companies must have a supervisory board but employee participation is on principle only provided for companies having 500 or more employees.

It would be desirable if in the course of time a uniform concept of the large company could be established in the EEC for the purposes of

5. *See generally* Schmitthoff, *New Concepts in Company Law*, 1973 J. BUS. L. 312.

publicity and employee participation, but at present there is no indication for a development in that direction.

In the United Kingdom an interesting change in attitude is noticeable which is necessary in order to comply with the Second Council Directive of the EEC of December 13, 1976. So far the public company was the residual form in the United Kingdom and every company that was not a private company was treated as a public company. In compliance with the Second Council Directive, however, a change will be carried out that is already indicated in the Government White Paper on Changes in Company Law.[6] Every company will henceforth be a private company unless it satisfies the requirements for a public company which include, inter alia, a minimum capital of £50,000. If that suggestion is accepted by Parliament, the private company will be the residual form of company.

The following observations will be restricted to the large public company listed at the Stock Exchange.

The Directors

The change in company law philosophy towards social responsibility has led to three changes in the position of directors.

First, in the large public company the managerial mentality has changed. As already indicated, the directors no longer consider themselves as acting solely in the interest of the shareholders; their function is to balance all interests represented in the company. It is, of course, a myth that the structure of the company ever constituted a shareholders' democracy. Even legally shareholders do not have that power. The United Kingdom Companies Act 1948, Sched. 1, Table A, Art. 80, makes it quite clear that the directors shall have residual power to manage all business of the company and exercise all such powers as are not required to be exercised by the general meeting. In practice, the management of the large listed company is self-perpetuating.

Second, it has become clear in modern company administration that the managerial function is divided. This function consists of the planning of long term strategy of the company and the day to day management of its affairs. This division in the function of the directorate is noticeable in most countries of the Western world. In the United States, for instance, in many companies the directors exercise the planning function and have delegated the ordinary management of affairs to managers who are accountable to them. This division in the mana-

6. CMND. No. 7291 (1978).

gerial function is the reason why the German invention of a two-tier board divided into a supervisory or policy board (*Aufsichtsrat*) and managing board (*Vorstand*) has found much attention in modern European company law.

Originally that dualist system was devised in Germany because the banks that provided the capital for the company wanted to maintain control over the use of the capital. Later it was found that that board structure best fitted the division of the managerial function. For that reason the French *loi sur la sociétés* of 1966 gave public companies in France the option either to retain the traditional single board system (*administrateurs*) or to introduce the two-tier system (*conseil de surveillance* and *directoire*). The Dutch company-law reform of 1971 and the Danish reform of 1973 have likewise adopted the two-tier system for large companies. The EEC in its various proposals, particularly in the Discussion Paper on Employee Participation and Company Structure[7] and in the final draft of the Statute for European Companies,[8] likewise favours the two-tier board system.

In the United Kingdom there is considerable controversy whether large listed public companies should have a single board system including a number of nonexecutive directors, or a two-tier board system. The Government White Paper on Industrial Democracy,[9] following the French example, suggests that companies having 2,000 or more employees shall have the option of adopting the single or two-tier board system. In practice there is not a great difference between a single board with a number of nonexecutive directors and the two-tier board system, apart from the fact that under the latter the members of the managing board are appointed by the supervisory board and not the shareholders. The British proposal, however, is different from the German proposal—and in that respect similar to the Danish law—in that the same person may be a member of both boards.

Third, the changed mentality in the attitude of directors of public companies that was noted before is finding expression in certain legal requirements. It is proposed in the United Kingdom that insider trading shall be made a criminal offense and it is intended to lay down in the next companies' statute that a director owes a duty of utmost good faith to the company. The latter provision would not introduce a new principle into English law as these rules have already been developed

7. BULL. OF THE EUROPEAN COMMUNITIES (Supp. 8/75).
8. BULL. OF THE EUROPEAN COMMUNITIES (Supp. 4/75).
9. CMND. No. 7231 (1978).

by the English courts.[10]

These changes in the managerial attitude, the board structures and legal regulations reflect the changes of company law philosophy in the era of regulated capitalism.

The Shareholders

The first problem that arises with respect to shareholders is that the minority shareholder requires protection against unscrupulous and selfish exploitation by the majority. The English Companies Act 1948, s. 210, attempted to solve this problem by giving the minority shareholder relief if the affairs of the company were conducted in an oppressive manner and a petition for winding up under the just and equitable clause (s. 222(f)) would unfairly prejudice the minority shareholder. This remedy proved to be insufficient and unsatisfactory. The legal requirements for its availability were too strict. For that reason the Jenkins Report of 1962[11] made certain suggestions for relaxation of these legal requirements and the Companies Bill proposed in the Government White Paper on Changes in Company Law[12] has taken up these suggestions. The Bill proposes that relief shall be available if the affairs of the company are conducted in a manner "unfairly prejudicial," changed from "oppressive," to the interests of the petitioner, and that such relief shall be no longer alternative to a winding up petition. As in the present law, relief will be available on the petition of a single shareholder or several shareholders.

The attitude of social responsibility indicated by the proposal to extend the protection of the minority against unscrupulous use of the majority position can likewise be detected in the attitude of the English courts when considering the question whether a shareholder may make use of his voting power solely in his own financial interest, without regard to the interests of the other shareholders. This question arose in particular in *Clemens v. Clemens Bros. Ltd.*[13] In that case the minority shareholder held more than twenty-five percent of the voting capital. She could therefore prevent the passing of a special resolution which required a three-fourths majority. The majority shareholder issued new shares, which could be done by the ordinary majority she pos-

10. Industrial Development Consultants Ltd. v. Cooley, [1972] 1 W.L.R. 443 (Birmingham Assize 1971); *see* Schmitthoff, *The Position of Directors in the Modern Business Corporation*, 15 U.W. ONTARIO L. REV. 179 (1976).

11. CMND. No. 1749 (1962).

12. CMND. No. 7291 (1978).

13. Clemens v. Clemens Bros. Ltd., [1976] 2 All E.R. 268 (Ch.).

sessed, and thereby diluted the share capital so that the participation of the minority shareholder sank below twenty-five percent. The minority shareholder thus lost what has been called negative control. The court set aside the resolution increasing the capital on equitable grounds, thus preventing the majority shareholder from exercising her legal rights in the interest of her own financial advantage. The case, undoubtedly correctly decided, has caused much discussion in the United Kingdom.

From the viewpoint of social responsibility, however, another aspect of the position of the shareholder is more important than that of the protection of the minority shareholder. Although in legal theory the shareholders are the owners of the company, this is a myth as far as reality is concerned, at least in the large listed companies. In terms of economic reality, the shareholders do not have a proprietary interest in the company, but a financial one. They are not owners but investors. They have invested their money in the company because they hope for an adequate return on their investment and a participation in the growth prospects of the company in which they have invested. That means that the law has to provide protection for shareholders as investors. A financial collapse such as happened in the twenties and thirties would endanger the public image of the economic system of capitalism, even in its regulated form. But quite apart therefrom, in the United States and in the United Kingdom diverse strata of the population have invested in equity holdings, either directly as small investors, or indirectly through pension funds and insurance companies. Their savings must be protected.

In no country is the protection of the investor as well developed as in the United States. The Securities and Exchange Commission enjoys the highest reputation and has served as a model for similar institutions, particularly in Canada. In the United Kingdom another system has been adopted. The regulation of the securities industry, is not carried out solely on the basis of statutory regulation. It is a mixed system, partly founded on statute,[14] but mostly on voluntary self-regulation contained in the Rules of the Stock Exchange and the City Code on Take-overs and Mergers. These measures of self-regulation are not enforced by law; all that the Take-over Panel can do is administer private or public reprimands or impose fines, but its authority is rarely challenged. The first steps for the voluntary self-control of take-overs and

14. Prevention of Fraud (Investments) Act, 1958, c.45; Licensed Dealers (Conduct of Business) Rules 1960 (issued under the Prevention of Frauds (Investments) Act).

mergers were taken in 1959. The system has thus been in existence for almost twenty years. The surprising thing is that it works, which is due to the fact that those connected with issues, take-overs, and mergers are a relatively small group, almost a club. But it is thought that the system of voluntary self-control will not work forever. Voluntary self-control will have to be supported by fall back legislation providing statutory coercion, but the United Kingdom will try to avoid setting up a bureaucratic machinery comparable to the Securities and Exchange Commission.

That the measures of investor protection operate to avoid fraud against the investor goes without saying. Here the laws of the United States and of the United Kingdom provide, it is thought, adequate protection, although, as the I.O.S. affair has shown, those of some European continental countries would admit improvement. The danger to the investor is today not fraud but discrimination. The danger is that large investors are paid more for their shares in the case of a take-over than small investors. In some European countries this practice is regarded as justified; one talks of an extra payment for the control premium. In the United Kingdom the idea of the control premium is rejected. It is thought that on take-over all shareholders shall receive the same price. General Principle No. 8 of the United Kingdom Take-over Code states—"all shareholders of the same class of an offeree company shall be treated similarly by the offeror." If a bidder acquires thirty percent or more of the voting shares at the Stock Exchange, he has to make a bid for all remaining shares at the highest price he has paid for any stock acquired during the past year. These measures of investor protection clearly express the sense of social responsibility felt by financial circles and government departments charged with protecting the small investor.

The Employees

In no area has the principle of social responsibility found stronger expression than in that of employee participation in the determination of the affairs of the company. The country most advanced in this field is Germany. In the larger companies there exist works councils, economic committees, and co-determination of employees on the supervisory board. Since 1976, three systems of co-determination have existed in Germany. In public companies employing 2,000 or fewer employees the supervisory board consists of two-thirds of shareholders and of one-third of employees. In companies employing more than 2,000 employees the law provides for parity of shareholders and employees on the supervisory board, but the chairman must always be a shareholder and the managing employees are represented on the employees' side. In the Montan industry (coal, iron, steel) there is likewise parity on the supervisory board, but under an independent chairman. The strong participation and co-determination by employees in Germany has undoubtedly contributed to the fairly peaceful labour relations existing in that country.

The German system of works councils below board level has been imitated by many other countries in Europe. It has also become the model for EEC proposals. Further, the Dutch company law reform of 1971 prescribes a supervisory board for large companies but adopts the principle of co-optation; in other words, if there is a vacancy on the supervisory board, it shall be filled by co-option, the shareholders and the employees having a right of veto. If that veto is exercised, a committee of the Social and Economic Council of the Netherlands shall decide whether it has been exercised for good reason. The system has been in operation since 1973; it appears to work well and on only one occasion has the veto been exercised by one of the groups in a Netherlands company. The Dutch model is sometimes referred to as the harmony model and is contrasted with the German confrontation model.

In the United Kingdom, the Government published in 1978 a White Paper on Industrial Democracy.[15] Its leading principles are that there should be a voluntary agreement between companies and trade unions on the formation of so-called joint representation committees which compare with the German works councils. If no agreement can be reached, there should be a statutory fall back right of the trade unions to demand the formation of such a committee. The White Paper provides that only trade union labour shall vote for the joint representation committee but that provision is hotly contested. Two or three years after the constitution of such a joint representation committee, the employees in companies employing 2,000 or more employees in the United Kingdom may demand co-determination on the board which may be either a single board or a two-tier board (in which case co-determination would take place on the supervisory board) and here the relationship would be two-thirds of the members of the board to be appointed by the shareholders and one-third by the employees. In other words, the White Paper suggests the adoption of the old German system, at least for the time being.

To sum up, in all member states of the EEC the principle is recog-

15. CMND. No. 7231 (1978).

nized that employees shall have a say in the determination of the affairs of the company. This principle is also recognized in non-EEC countries, such as Sweden and Norway, but the realization of this principle has not proceeded unanimously. It is most strongly expressed in Germany and most weakly in France and Italy. The principle is strongly advanced by the EEC and much discussed in the United Kingdom.

The Public Interest

That the public interest requires employee representation in the company is widely recognized. Three illustrations may be given. First, the final draft of the Statute for European Companies published by the Commission of the European Communities on May 13, 1975[16] provides that the supervisory board shall consist of one-third appointed by the shareholders, one-third appointed by the employees and the final third co-opted by these two groups. As regards the members of the third group, Article 75(3) of the final draft of the Statute provides:

> Only persons representing general interests, possessing the necessary knowledge and experience, and not directly dependent on the shareholders, the employees or their respective organizations may be nominated.

Second, according to Dutch law, as explained by Professor Pieter Sanders, the following persons may not be members of the supervisory board:

> Persons in the employment of the company; persons in the employment of another company in which the company holds directly or indirectly at least half of the issued share capital for its own benefit; senior officers and persons in the employment of an employees' organization which is usually a party to collective bargaining agreements with the company. The purpose of this provision is to prevent protagonists of special interests being represented on the supervisory board.[17]

Third, the proposed United Kingdom Companies Bill[18] states in Clause 46(1):

> The matters to which the directors of a company are to have regard in the performance of their functions shall include the interests of the company's employees generally, as well as the interests of its members.

The wording of this provision makes it clear that the directors may take into account interests other than those of the employees and members, and that interest can only be the public interest.

16. BULL. OF THE EUROPEAN COMMUNITIES (Supp. 4/75).
17. P. SANDERS, DUTCH COMPANY LAW 189 (1977).
18. WHITE PAPER ON CHANGES IN COMPANY LAW, CMND. NO. 7291 (1978).

The public interest, however, is served also by other provisions of modern company law. The publicity requirements of various countries go far beyond the need to convey information to the shareholders. French company law requires the publication of a social report[19] and the publicity requirements of the United Kingdom Companies Acts 1948-1976 demand the disclosure of many items which can only be justified in the public interest, such as the number of employees and their average remuneration, a general disclosure of the remuneration of the directors and leading employees, a disclosure of the turnover and export performance, and so on.

This tendency may make itself felt more strongly in future years. It is likely that if the division and the function of the management in a policy board and managing board is generally recognized, representatives of the public interest, including consumers, will find a seat as directors on the policy board.

Conclusion

At the end the question may be asked, will the company survive as a form of business organization? Will it continue to exist in the new structure of economy into which we are moving? If the analysis attempted at the beginning of this essay is correct, and we move indeed into an era of regulated capitalism, the private sector of industry will be fully maintained although under the auspices of social responsibility and regulation by the state. As long as we shall have a sector of private business, the company will survive, but its philosophy and aims as well as its structure and organization will change in response to social needs.

19. Le Gall, *The Social Report in French Law*, 1978 J. BUS. L. 394.