BOUNDARIES, CORPORATE DECISION-MAKING AND RESPONSIBILITY*

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Background

In the realm of corporate decision-making and responsibility boundaries are both important and difficult. The importance of the boundaries of the firm was discussed by Belcher:[1]

> "Boundaries are of the utmost importance because they establish size and shape. In so far as changes in the law affect the elements making up the boundaries of the firm, such changes can be expected to have an impact on the size and structure of firms. Theories which are capable of explaining how operations within the firm are different from those outside can be used to draw the boundaries of the firm and so to define its essence or nature."

Difficulties concerning the boundaries of the company are perhaps best exemplified by English case law on the lifting of the corporate veil between group companies. This article re-examines both the importance and difficulties of corporate boundaries. Without taking away from the importance of corporate boundaries, various different types of boundary are considered. The idea of corporate outsiders and insiders is one that has been used in corporate governance. One of the difficulties explored in this article is that some "key participants in companies"[2] are for some purposes insiders, but for other purposes outsiders.

As a starting point, the article takes various theoretical positions drawn from different disciplines and designed to answer different questions about the nature of the firm or the company. First in relation to corporate legal theory, a theory of the company is needed in the context of corporate criminal responsibility in order to answer the questions "how does a company act?" and "how does a company think?", and a theory of the company is needed in the context of corporate regulation to answer the question "how much mandatory corporate law or regulation is optimum"? Second in relation to economics, a theory of the firm is needed to answer the question "why does production occur in firms"? Finally, in relation to management work on competitive advantage, normative propositions have been put forward to answer the question "what can a company do to gain or maintain a competitive advantage over others"?

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1 A Belcher "The Boundaries of the Firm: The Theories of Coase, Knight and Weitzman", *Legal Studies*, 1997, 17, (1), 22-39.

2 This phrase is used by B. Cheffins *Company Law: Theory, Structure and Operation* (Oxford, Oxford University Press, 1997) to cover shareholders, creditors, employees, directors and management. This article does not cover creditors as a category.

There are large volumes of work both supporting and disputing the opening positions taken in this article. However, it is not the aim of this article to cover these debates in detail. For the present purposes it is more important to demonstrate the coherence of three initial theoretical propositions that come from three different disciplines. In terms of corporate criminal responsibility theory, this article takes a "realist" position. The argument of the "realists" is that a company is best thought of as something beyond the individuals involved in it. This position does not map directly onto a single corporate legal theory, but it is perhaps furthest from legal theories based on the company as a nexus of contracts and closest to theories based on the company as a social entity.[3] In terms of economic theory the article draws on explanations of the nature of the firm found in Coase's famous article on that subject and on Knight's ideas on decision-making under conditions of true uncertainty.[4] In terms of management theory the article uses ideas labelled the resource- or knowledge- based view of the firm that have their roots in the work of Penrose.[5]

The article covers a wide set of ideas with the aim of examining both their coherence and their implications for existing company law and its future development. In section 2 the three chosen theoretical strands are set out and their coherence in the context of a single company is examined. In section 3 some theoretical boundary problems are explored. The applicability of the theories to groups of companies, in a UK legal setting, is investigated in section 4. This includes consideration of the UK law on lifting the veil of incorporation. Section 5 provides some conclusions and indicates directions for some further work.

The main object of this work is to tell a coherent story about what companies can do, the decision-making background to these capabilities and the responsibilities that flow from their use. The article sees the company as an entity capable of real action. Decision-making within a company is described as occurring under two distinct sets of conditions; conditions of risk and true uncertainty. In the risk-based framework the company is seen as using information efficiently, weighing expected costs against expected benefits, and minimising transactions costs in the way envisaged by Coase.[6] Under conditions of true uncertainty, which Knight identifies as something of a distinctly different character from conditions of risk,[7] the company is seen as a place where difficult decisions are made, and it is in making these

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[3] J Dine, *The Corporate Governance of Groups* (Cambridge; Cambridge University Press, 2000), 26.

[4] R H Coase "The Nature of the Firm", *Economica*, 1937, 386-405; F. Knight *Risk Uncertainty and Profit* (New York: Houghton Mifflin & Co, 1921). 232; and Belcher, 1997 *op.cit*.

[5] E. Penrose, *Theory of the Growth of the Firm*, (Oxford; Basil Blackwell, 2nd ed. 1980) first published 1959. For work on the resource-based view of the firm see B Wernerfelt, "A resource-based view of the firm" *Strategic Management*, 1984, 5, 171-80; JB Barney, "Strategic factor markets" *Management Science*, 1986, 32, 1231-41 and JB Barney, "Firm Resources and Sustained Competitive Advantage" *Journal of Management*, 1991, 17, 99-120.

[6] R. Coase, *op. cit.*

[7] A. Belcher "'Something distinctly not of this character': How Knightian uncertainty is relevant to Corporate Governance" 2007, paper presented at the SLSA conference, University of Kent., April.

decisions well that successful companies create business knowledge[8] and gain their competitive edge. The advantage of the corporate form as a vehicle for successful decision-making is seen as flowing from at least two sources. First, there is the authority, bounded but real, that the employment contract gives employers over employees coupled with the harnessing of employees' intrinsic motivation if they are trusted to be part of the creation of business knowledge. Second, there are the powers given to directors under the normal corporate constitution which requires shareholders to entrust directors with responsibility for the majority of the corporate decision-making.[9]

Three Theoretical Strands

Corporate Legal Theory

The chosen theoretical approach under this heading has been labelled "realist" or "holistic". Many expositions of corporate legal theory are directed towards solving the issue of how much company law there should be and of what character. However, the basis of the "realist" strand of theory employed in this article is corporate criminal responsibility. It is a theory that first and foremost acknowledges that a company is both a separate legal person and an entity capable of "real" action. Dine has put it this way: "The difficulty is not in whether or not it [the company] can act but in determining how its decision is to be ascertained."[10] In the field of corporate criminal responsibility the realist approach can be contrasted with the nominalist approach that has held sway until the recent Australian and UK developments. Commonwealth jurisdictions have traditionally approached corporate criminal responsibility using the nominalist approach that treats the company as a collection of individuals and locates its criminal culpability derivatively through the culpability of individual actors:

> "The two widely accepted common law bases of corporate responsibility – vicarious liability (whereby the corporation is held liable for the conduct of all its officers, employees or agents acting within the scope of their employment or authority) and the 'identification approach' (under which the actions and mental state of certain individual actors are treated as the company's own) – both proceed from the nominalist conception of the 'company' as a fiction, unable to be conceived as blameworthy in itself."[11]

However critics of the nominalist approach have pointed out how it fails to fit with public perceptions of companies. In relation to the sinking of the car ferry *Herald of Free Enterprise* Wells reported that "the relatives [of the deceased] were keen to see the company properly punished but not the

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[8] A. Belcher "The Evolution of Business Knowledge in the Context of Unitary and Two-tier Board Structures" with Till Naruisch, *Journal of Business Law*, 2005, July, 443-472.

[9] For an analysis see A. Belcher "Trust in the Boardroom" (2006) paper presented at the SLS conference, University of Keele, September.

[10] Dine *op. cit.* 25.

[11] M. Wilkinson, "Corporate Criminal Liability – The Move Towards Recognising Genuine Corporate Fault", *Canterbury Law Review*, 9, 142-178 at 142.

particular individuals whose misfortune it was to be operating the ferry that . . . night."[12] It also fails to capture the fact that organisations such as companies function as real entities that are not reducible to propositions about the individuals that compose them. Holistic theories have been developed that locate genuine corporate fault in the culture of the company.[13] It is these theories that have been given legislative force in the Australian Corporate Criminal Code Act 1995 and are the basis of the Corporate Manslaughter and Corporate Homicide Bill currently before the UK Parliament.[14] The result is to locate a company's criminal culpability in its culture. This is done explicitly in the Australian legislation which defines culture as: "an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in the part of the body corporate in which the relevant activities take place".[15] It is done implicitly in the UK the offences of corporate manslaughter (England and Wales) and corporate homicide (Scotland) that are to be based on the concept of "senior management failure"[16] which could be evidenced by "attitudes, policies, systems or accepted practices within the organisation"[17] if they were likely to have encouraged the failure at the root of the crime. The explanatory notes to the UK Bill state that:

> "The organisation must be in breach of [the] duty of care as a result of the way in which certain activities of the organisation were managed or organised by its senior managers. *This introduces an element of "senior management failure" into the offence"*

and senior management failure:

> ". . . looks at how in practice managers organised the performance of a particular activity, rather than focusing on questions of individual culpability, and *enables management conduct to be considered collectively* as well as individually."[18]

There has so far been no test of the evidence required to establish "attitudes, policies, systems or accepted practices". One suggestion is that the evidence of meetings may be important:[19]

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[12] C. Wells, *Manslaughter and corporate crime*, 138 *NLJ* 931 (1989) at 931 cited *ibid.*

[13] M. Wilkinson, *op. cit.*

[14] The Bill passed its third reading in the House of Lords 28.2.07. For analysis see A. Belcher "Imagining how a company thinks: what is corporate culture?" *Deakin Law Review*, 2006, (2).

[15] Australian Criminal Code Act 1995 part 2.4, s.12.3(6).

[16] Corporate Manslaughter and Corporate Homicide Bill, clause 1 (3).

[17] *ibid*., clause 8.

[18] Corporate Manslaughter and Corporate Homicide Bill, Explanatory Notes, 2006, para.14, emphasis added (Eng. and Scotland) and *ibid.* at para.15 emphasis added. The idea of collective responsibility is explored in more detail in section 3 below. It also connects with the idea of the company as a collectivity found in G. Teubner "Enterprise Corporatism: New Industrial Policy and the 'Essence' of the Legal Person" *American Journal of Comparative Law* (1988) 36, 130-155.

[19] See Belcher *Deakin Law Review*, 2006 *op. cit.*

> "Schwartzman states that 'meetings are significant because they are the organisation or community writ small'.[20] Weick argues that 'meetings define, represent, and reproduce social entities. . . . Because action that occurs in the meetings is organizational action, this must mean that there really is an organization. Momentarily, at least during the meeting, there appears to be an organization, and this appearance is reconstituted whenever meetings are constituted."[21]

The approach of building a case from evidence of corporate decision-making based on meetings of committees and decisions of corporate officers was taken in the failed Scottish prosecution of Transco plc for culpable homicide following a fatal gas explosion.[22] The prosecution failed when the identification principle was applied, but its approach to collecting and presenting evidence may well be revived in the context of the new corporate killing offences. Overall this theoretical strand claims that the company functions as a real entity with decision-making capabilities. These capabilities are not reducible to propositions about the individual actors and may be evidenced in attitudes, policies, systems or accepted practices within the organisation.

Economic Theories

The second theoretical strand is economic theory. At first blush the chosen corporate legal theory may appear to be in tension or even disagreement with economic theory in general. However, the particular economic theories that have been chosen are both old enough to be expressed primarily as narratives rather than in mathematical form and it is submitted that the two narratives can be read together with a realist approach to the company. The article takes the position that the ideas of Coase and Knight continue to be valuable contributions to the theory of the firm.[23]

> "For Coase[24] the boundary is drawn in terms of the price mechanism. Outside the firm the price mechanism operates in all transactions and when the firm deals with the outside world it is ruled by the price mechanism. In contrast, within the firm operations are controlled by the direction of the entrepreneur. Direction by the entrepreneur, by avoiding costs, can be more efficient than using the price mechanism. The usual costs associated with use of the price mechanism include information costs involved in finding buyer or seller, costs of

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[20] H.B. Schwartzman, "The significance of meetings in an American mental health center" *American Ethnologist*, 1987, 14, 271-294, 288.

[21] K.E. Weick, *Sensemaking in Organizations*, (Thousand Oaks CA, 1995), 143.

[22] See *Transco plc minuters / appellants v Her Majesty's Advocate respondent* 2004 SCCR 1 at 22 (Scotland Appeal Court, High Court of Justiciary, March 2003) for the trial judge's analysis of how the prosecution could have proceeded under Scots law – a decision later reversed.

[23] This follows A. Belcher "The Boundaries of the Firm: The Theories of Coase, Knight and Weitzman", *Legal Studies*, 1997, 17, (1), 22-39.

[24] R H Coase (1937) 'The Nature of the Firm', *Economica,* pp.386-405

> making transactions and costs of monitoring and/or enforcing contracts once they are made."[25]

In contrast, Knight draws the boundary of the firm in terms of uncertainty:

> "It is this true uncertainty which by preventing the theoretically perfect outworking of the tendencies of competition gives the characteristic form of 'enterprise' to economic organization as a whole and accounts for the peculiar income of the entrepreneur."[26]

For Knight the decision-making system within the firm that made it particularly suited to conditions of true uncertainty was embodied in the individual entrepreneur. Today, the decision-making system within a company, or group, that deals with conditions of true uncertainty is more likely to be embodied in a number of talented individual leaders sometimes deciding and acting independently (*e.g.* as executive directors within their delegated authority) and sometimes working and deciding collectively (*e.g.* as the board of directors). In order to read Coase and Knight together in a coherent way it is necessary to go more deeply into Knight's claim about the character of true uncertainty.[27] Once risk and true uncertainty are clearly defined in a way that highlights the crucial difference between them , Coase's cost-benefit analysis can be applied to conditions risk and Knight's ideas to conditions of true uncertainty. A final link is to connect abstract theorising with some exemplars of the two types of conditions.

Knight distinguished risk from true uncertainty and defined uncertainty as relating to situations where:

> ". . . there is no possibility of forming *in any way* groups of instances of sufficient homogeneity to make possible quantitative determination of true probability, Business decisions, for example, deal with situations which are far too unique, generally speaking, for any sort of statistical tabulation to have any value for guidance. The concept of objectively measurable probability or chance is simply inapplicable."[28]

The distinct difference between risk and true uncertainty can be seen in the mathematics needed to deal with the two sorts of conditions. Risk is dealt with by probability theory, but uncertainty is modelled using topography; a branch of mathematics that encompasses three forms of bifurcation theory; chaos theory, catastrophe theory and fractal geometry.[29] Probability theory is rooted in an essentially deterministic world, associated with the work of Laplace.[30] In this world extra information is in general useful and helps to

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[25] Belcher 1997 *op. cit.*

[26] F Knight *op. cit.*, 232.

[27] For more detail see A. Belcher 2007 *op. cit.*

[28] F. Knight, *Risk, Uncertainty and Profit* (New York, Houghton Mifflin & Co, 1921), 231.

[29] For an accessible description see I. Ekeland *Mathematics and the Unexpected* (Chicago and London; University of Chicago Press, 1988). See also Belcher (2007) *op. cit.*

[30] For a description see W. Lee *Decision Theory and Human Behaviour* (New York, John Wiley, 1971) 49.

model or predict. In contrast, topography and bifurcation theories can be traced back to the work of Poincaré in the late nineteenth century. Where a mathematical model bifurcates, proceeding one way may be seen as a smooth transition in a known direction, proceeding on the other path may involve a discontinuous jump or "catastrophic" change. What is important about these models is that a known past history will not determine which of the two paths is actually taken at the bifurcation.

Conditions of risk and true uncertainty can also be described in terms or different tomorrows.[31] The first three descriptions that follow fall under the heading of risk. The final description is a way of thinking about true uncertainty without referring to the technicalities of bifurcation models. First, tomorrow can be risky, and the decision-maker can know the range of possible tomorrows and know the probability of each occurring, but not know which of them will occur. Second, tomorrow can be risky and the decision-maker can be limited. Possible tomorrows are knowable, but the search for knowledge of all possibilities and the computation of all possible consequences can be costly. So far, the decision-maker's problems can be reduced by good estimation. Third, tomorrow can be a set of possibilities of which only some are known and therefore a probability of each one occurring cannot properly be formed until others are known. The way to improve prediction in this framework is to discover more of the, essentially knowable, possible tomorrows. The second and third tomorrows can be connected with the concept of bounded rationality:

> "The term 'bounded rationality' is used to designate rational choice that takes into account the cognitive limitations of the decision-maker – limitations of both knowledge and computational capacity."[32]

This is an idea of decision-making found in the work of Simon who first put forward the suggestion of decision-making behaviour as satisficing rather than optimising. "most human decision-making whether individual or organizational is concerned with the discovery and selection of satisfactory alternative."[33] Simon later developed this into theories of bounded rationality. Economists reacted strongly to Simon's ideas because models that are easily tractable and produce straightforward results under the assumption that behaviour is optimising become more difficult and messy in a saticficing world. However, Langlois pointed out that

> ". . . if all that's at stake is some constraint on information-processing and computational capacity, then one's satisficing alternative quickly collapses into substantive rationality –

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[31] S.C. Littlechild "Three types of market process", pp.27-39 in R. N. Langlois (ed.) *Economics as a Process* (Cambridge, Cambridge University Press, 1986).

[32] E. Sent "Sargent versus Simon: bounded rationality unbound" (1997) *Cambridge Journal of Economics*, 21, 332. For early work on bounded rationality see J.G. March and H.A. Simon, *Organizations*, (New York, John Wiley, 1958); H.A. Simon "A behavioural model of rational choice" *Quarterly Journal of Economics*, 1955, 69, 241-260 and for a more recent description see H.A. Simon, *Models of My Life*, (New York, Basic Books, 1991).

[33] March and Simon, 1958, *op. cit.*, 140-141.

> satisficing is actually the optimal course in view of costly computational resources."[34]

Finally, tomorrow can be not so much unknown as non-existent or indeterminate at the time of the decision. The decision-maker's task is then not to estimate or to discover but to *create*.

> "He (sic) must exercise imagination. The agent is aware of the flimsiness of his conjectures about the future and the vulnerability of his plans to the independent imagination of other agents."[35]

This final view of tomorrow is a description of decision-making under conditions of true uncertainty. It is submitted that the very broad decision-making powers vested in directors encompass decision-making under both risk and true uncertainty.

When directors engage in decision-making under risky conditions the assumption that they will operate in a rational way, or at least in line with the Simon's ideas of bounded rationality, is not unreasonable. This sort of decision-making fits with Coase's idea of the firm as a place where organisation costs can be recognised as lower than transaction costs. Coase chose as exemplar of this potential the ability to organise that is at the heart of the employment contract. However, a criticism of Coase's 1937 "Nature of the Firm" article is that he relies on the idea of authority in the employment relationship without explaining how that authority can arise. One possible answer to this problem was offered by Simon. Before he moved on to work on his ideas on saticficing behaviour and bounded rationality, he published a formal model of the employment relationship containing a rational explanation of why two parties may agree that one of them should have authority to direct the other.[36] In Simon's model (where there is risk, but not true uncertainty) the employer, "boss", is given the power to decide which task the employee, "worker", has to do, but the range of possible tasks is agreed when the bargain is made; that is when the employee is hired. The employer can, within limits, select an employee's tasks without further reference to the price, that is the wage. Simon's model of the employment relationship is important because it shows that it is possible to construct a mathematical model that incorporates rational grounds for choice between an employment contract and a contract of the ordinary kind. His model shows that under some conditions (conditions of risk rather than certainty) it may be advantageous to both the rational worker and the rational boss to choose an employment contract over a sales contract. The essence of an employment contract is that it confers on the employer the power to decide; it gives the employer authority. It should also be noted that Simon's model provides an entirely economic explanation for the existence of the employment relationship in which there is no need to refer to institutional, historical or sociological factors. It was, however, this very purity that Simon saw as the model's main limitation. He stated that it was ". . . a model of hypothetically

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[34] R.N. Langlois, *Economics as a Process* (Cambridge, Cambridge University Press, 1986), 226.

[35] Littlechild, *op. cit.* 29.

[36] H Simon "A formal theory of the employment relationship" *Econometrica*, 1951, 19, 293-305.

rational behaviour in an area where institutional history and other nonrational elements are notoriously important"[37] and he concludes the paper as follows: "The most serious limitations of the model lie in the assumptions of rational utility-maximising behaviour incorporated in it."[38] As already pointed out, Simon's work since this relatively early (1951) paper has been concerned with the limits of rationality and the concept of bounded rationality.

Simon's model of the employment contract reveals how transaction costs can be reduced through the employer's authority to direct or organise. If employment as an activity is a good exemplar of low organisation costs, research and development as activities are good exemplars of a tomorrow being created. Research and development can be an express business activity, but the creation of creation of tacit business knowledge can also be a more subtle and invisible process. In the corporate form directors are entrusted not only with routine business decisions, but also with creative and strategic decision-making. If Knight was correct, it is these creative and strategic decisions made under conditions of true uncertainty, that are the ones most likely to make the difference between success and failure in business. This links well with current management thinking on the evolution of business knowledge.

Management Theory

Over the last two decades or so the resource-based view of the firm and the associated knowledge-based view of the firm have been developed by some management researchers:

> "The origins of the knowledge based approach can be found in Penrose's 1959 book *The Theory of the Growth of the Firm.*[39] Other important works that inform the approach are the Richardson's article on the organization of industry[40] and Nelson and Winter's book on evolutionary economics.[41] A general, resource-based, approach has been offered by Wernerfelt[42] and Barney.[43] In the resource-based view, the firm is seen as a bundle of resources and comparative advantage is explained by the possession of a bundle with particularly valuable attributes. Resources are posited to be particularly valuable if they are rare and hard to imitate. This has meant that; 'most interest has centred on internally accumulated resources, such as routines and capabilities, rather

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[37] *ibid.*, 302.
[38] *ibid.*, 305.
[39] Penrose, *op. cit.*
[40] G.B. Richardson, "The Organization of Industry" *Economic Journal*, 1972, 82 883-96.
[41] R.R. Nelson and S.G. Winter, *An Evolutionary Theory of Economic Change*, (Cambridge MA: The Belknap Press, Harvard University Press, 1982).
[42] B. Wernerfelt, "A resource-based view of the firm" *Strategic Management*, 1984, 5, 171-80.
[43] J.B. Barney, "Strategic factor markets" *Management Science*, 1986, 32, 1231-41 and "Firm Resources and Sustained Competitive Advantage" *Journal of Management*, 1991, 17, 99-120.

> than those that can be purchased on factor markets.'[44] This centring on knowledge and skills as key resources focuses the resource-based view of the firm down into the more specific knowledge-based approach."[45]

Various factors have been proposed as producing or influencing a firm's ability to create valuable business knowledge that cannot readily be purchased on the market. Nonaka, Toyama and Nagata suggest that organisational structure, corporate culture and incentive systems are crucial.[46] These are all matters which would properly be decided upon or influenced at board level. Coriat and Dosi state that there are

> ". . . tradeoffs between performance control and learning. While the former is likely to imply rigid task specification, the latter generally involves a lot of experimentation, trial-and-error, 'deviant' behaviors"[47]

Also, O'Reilly found that innovation benefited when employees were given permission to try and fail.[48] Where the company is positioned on the spectrum that runs from rigid task specification to permitted deviance by employees depends on the combination of organisational structure, corporate culture and incentive system put in place by the board. The choice to operate at the less rigid end of the spectrum also has significant trust requirements. This strand of academic thinking can be seen as link between legal responsibility based on corporate culture and the economic idea of the company as a place particularly suited to decision-making under conditions of true uncertainty where tomorrow has to be created. Through the legal, economic and management strands this article has drawn a picture of the company as a place where corporate culture, trust and uncertainty are conceptually important. Corporate culture will increase in importance once its elements become the basis of liability for corporate killing. The fact that directors are entrusted with the running of a company can be seen as one of the defining features of the corporate form. Finally, true or Knightian uncertainty is an important concept to highlight as it is the company's ability to make good decisions under uncertainty, decisions where tomorrow has to be created, that could be its source of competitive advantage. It is submitted

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[44] K. Foss and N. Foss "The Knowledge-Based Approach and Organizational Economics" in N. Foss and V. Mahnke (eds.) *Competence, Governance, and Entrepreneurship* (Oxford: Oxford University Press, 2000), 62-65, 65.

[45] Belcher and Naruisch *op. cit.*

[46] I. Nonaka, R. Toyama and A. Nagata "A Firm as a Knowledge-creating Entity: A New Perspective on the Theory of the Firm" *Industrial and Corporate Change*, 2000, 1-20, 12

[47] B. Coriat and G. Dosi "Learning how to Govern and Learning how to Solve Problems: On the Co-Evolution of Competences, Conflicts and Organizational Routines" 103-133 in A.D. Chandler, P. Hagstrom and O. Solvell (eds) *The Dynamic Firm* (Oxford, Oxford University Press, 1998) 110-111. For a description of a professional event exploring the tensions between Enterprise and Governance as they appeared immediately following the publication of the Cadbury Code of Best Practice see A. Belcher "Gendered Company: Enterprise and Governance at the Institute of Directors", *Feminist Legal Studies*, 1997, 5, (1), 57-76.

[48] C.A. O'Reilly, "Corporate Culture Consideration Based on an Empirical Study of High Growth Firms in Silicon Valley" *Economia Aziendale* 1989, 3, 305.

that these concepts hang together in the picture of a single company and are ingredients in explaining the boundary of the company.

Fuzzy Boundaries

The mathematics of uncertainty has already been mentioned as a branch of mathematics distinct from probability theory. It is also the place in mathematics that deals with fuzziness at boundaries:

> The mathematics that is being used to capture the idea of uncertainty is bifurcation theory which covers both catastrophe theory (for large discontinuities) and chaos theory (for small discontinuities). Discontinuities are usually observed at sharply defined boundaries but some such boundaries "… consist of elements from both sides, as with a slush layer between water and ice that really consists of both … Such mushy boundaries may be dealt with by using 'fuzzy set' theory."[49]

An economic example of this idea is the per capita income at the US / Mexico border. This section of the article explores some of the difficulties in defining the boundary of the company by exploring the inside and the outside from a legal point of view. The decision of the House of Lords in *Salomon v Salomon*[50] established the company's separate legal personality, in particular that the company is an entity separate from its shareholders. However, another line of legal reasoning effectively equates the company with the shareholders. Whilst the test of whether decisions have been taken "bona fide in the interests of the company as a whole" can in some circumstances mean the interests of the company as a commercial entity, in other circumstances it must be understood not in relation to the "a commercial entity, distinct from the corporators" but in relation to "the corporators as a general body".[51] These points reveal fuzziness on the issue of whether shareholders are inside and part of the company or outside and separate from the company. In *R* v *Howe (Engineers) Ltd*,[52] the Court of Appeal held that the level of fines imposed generally for health and safety offences is too low, that fines need to be large enough to bring home the health and safety message "not only to the company but also to its shareholders." This suggests that for the purposes of punishing the company for its criminal acts the shareholders are to be thought of as a legitimate target for the economic pain imposed.

This fuzziness can also be seen in relation to directors. Directors are normally seen as corporate insiders. Before the reform of the *ulta vires* principle, the rule in *Royal British Bank* v *Turquand* offered protection for outsiders dealing with a company for defects in its internal management.[53] In *Mahony* v *East Holyford Mining Co* this was termed the "indoor

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[49] J. Barkley Rosser Jr *From Catastrophe to Chaos: A General Theory of Economic Discontinuities* (Boston and London, Kluwer, 1991) 3.

[50] [1897] AC 22

[51] Test set out in *Allen* v *Gold Reef of West Africa* [1900] 1 Ch 656 at 671; interpretation taken from *Greenhalgh* v *Arderne Cinemas Ltd* [1951] Ch 286 at 291

[52] [1999] IRLR 434

[53] (1855) 5 E & B 248.

management rule" and applied to directors' decisions that were beyond their actual power, but were ostensibly within the power of the company when viewed from outside.[54] However, as corporate governance best practice has developed over the past 15 years the inside/outside boundary has become less clear. At the heart of good corporate governance under the Combined Code is the idea of systems that can provide control and monitoring of directors who might otherwise abuse or misuse their considerable power. However, a major tool employed by these systems is non-executive directors both individually and in governance committees such as the audit, nomination and remuneration committees. The Higgs Report was on the one hand a ringing endorsement of the unitary board, but on the other hand was a report based on the idea of the very special and independent governance roles to be played by non-executive directors. In the unitary board the directors are equal corporate insiders, but the governance role given to non-executive directors requires them to be independent and in this role they are sometimes called "outside directors".[55] References to outside directors are mostly to be found in a US context. For instance, following the Sarbanes-Oxley Act 2002 Backer stated: "The public corporation has become an entity under surveillance by gatekeepers (outside directors, lawyers and auditors) and government" and "outside directors are meant to be part of this contingent of outside monitors"[56]

A third fuzzy boundary concerns the company's employees. For some legal purposes the employees are deeply embedded inside the company. Employment law certainly imposes stronger duties of care and liabilities in relation to employees as opposed to independent contractors and vicarious liability in tort holds the company liable for many acts done by employees. However, in relation to corporate criminal responsibility the issue of where a corporate culture stops and a corporate sub-culture begins has not yet been tested in Australian or UK law. An organisation may have not only an overall culture but also sub-cultures at work within it. A functionalist view of organisational culture suggests that culture is something that can be chosen and shaped by management. An interpretive view of organisational culture suggests that culture is something not under management's control. The idea that senior management can know and influence corporate culture is implicit in the proposition that a company should be held responsible for its culture. There remains the issue of how far a company should be held responsible for its sub-cultures. In the Australian context, Baxt has suggested that the requisite criminality could be attributed to a company as a whole "where one mutinous branch or subdivision was in the practice of engaging in unlawful conduct in defiance of corporate policy."[57] The explanatory notes to the UK Bill state that it

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[54] (1875) LR 7 HL 869

[55] A. Belcher "The Unitary Board: Fact or Fiction?" *Corporate Ownership and Control*, 2003, 1, (1), 139-148.

[56] Larry Cata Backer "Corporate Surveillance after Sarbanes-Oxley" *Company Lawyer*, 2005, 26(1), 3-9, 6.

[57] R Baxt, *Ascribing Civil and Criminal Liability for Company Employees and Directors — Who Carries the Corporate Can?* (Paper presented at Penalties; Policy Principles & Practice & Government Regulation, Sydney, 9 June 2001), 4. – cited in ALRC 95.

> ". . . attributes liability to the organisation only for failures in the way on organisation's senior managers managed or organised an activity. This is intended to focus the offence on the overall way in which an activity was being managed or organised by an organisation and to exclude more localised or junior management failings as a basis for liability (although these might provide evidence of management failings at more senior levels)"[58]

It is submitted that the wording of the UK Bill leaves it open for a prosecutor to argue that a problem sub-culture in itself provides evidence of the requisite senior management failure.

A final boundary issue that has so far commanded little attention is the individual/collective boundary in decision-making at board level. Higgs' first recommendation is that a description of the role of the board should be incorporated into the UK's Combined Code. Higgs states:

> "The board is collectively responsible for promoting the success of the company by leading and directing the company's affairs."[59]

A key question is how the UK law recognises the collegiate nature of the board and its collective responsibility. However, this issue has been mentioned very rarely by the courts. In *Re Westmid Packing Services Ltd, Secretary of State for Trade and Industry* v *Griffiths*[60] the Court of Appeal accepted the following:

> ". . . The collegiate or collective responsibility of the board of directors of a company is of fundamental importance to corporate governance under English company law. That collegiate or collective responsibility must however be based on individual responsibility. Each individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them. . . . A board of directors must not permit one individual to dominate them and use them as Mr Griffiths plainly did in this case."[61]

Boards reporting compliance with the Combined Code of Best Practice should have drawn up a list of matters that they reserve to themselves. This list may not itself define the extent of a board's collective responsibility as there may be a gap between the matters which a board should, in the view of a court, reserve to itself and the matters it does so reserve. Higgs recommended that individual boards should publish in the annual report a statement describing how the board operates and that this should include a high level statement of which decisions are taken by the board and which are delegated to management.[62] Overall it can be concluded that collegiate

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[58] Corporate Manslaughter and Corporate Homicide Bill, Explanatory notes 2006, para.15
[59] Higgs, 2003, summary of recommendations.
[60] [1998] 2 BCLC 646
[61] *ibid*., at 653
[62] Higgs, 2003, *para*.4.8

responsibilities in the boardroom is an area that has not yet been fully worked through in the UK courts.

Boundaries and Groups

The final boundary issue that is explained in this article is in company law a more fundamental one, namely the boundary of the company in the context of corporate groups. Before moving on to the major legal issue of lifting the veil of incorporation, it is worth noting that Combined Code already sets out corporate governance best practice in relation to risk management in the language of the group rather than the individual company:

> "The directors should at least annually conduct a review of the effectiveness of the *group's* system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management."[63]

Lifting the veil has been called the most uncertain part of company law. It is an area of the law that has been developing in the US, so much so that there are calls for a halt to its expansion.[64] Despite an overall lack of success in recent UK attempts to lift the veil it is an issue that is alive and continues to be debated.[65] The analysis in this article is brief as much of it is familiar ground to company lawyers and is framed around a set of tests applied by UK courts in deciding whether to lift the veil: justice requires it; sufficient control of one company by another; a sham company; and impropriety.

Justice Requires It

This test can be glimpsed in the decision in *DHN Food Distributors and Others* v *London Borough of Tower Hamlets*.[66] This case involved three companies forming a group with the parent company wholly owning two subsidiaries. DHN, the parent company, owned the business; a subsidiary, Bronze, owned the land; and another subsidiary, Transport, owned the vehicles. The issue to be decided was whether business disturbance compensation was payable when the land owned by bronze was the subject of a compulsory purchase order. Claims for business disturbance compensation require the claimant to have an interest in the land being purchased under the compulsory purchase order. Introducing the case Lord M.R. Denning said; ". . . one group three companies. For the moment I will speak of it as 'the firm'".[67] Thus, at the outset there was a willingness to look at the group as a whole. But:

> "If each member of the group is regarded as a company in isolation, nobody at all could have claimed compensation *in a*

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[63] Combined Code, internal control provision (emphasis added)

[64] S.M. Bainbridge "Abolishing LLC Veil Piercing" *University of Illinois Law Review*, 2005, (1), 77-106; B. Sahni, "The Interpretation of the Corporate Personality of Transnational Corporations" *Widener Law Journal* 2005, 15, (1), 1-45.

[65] M. Moore "'A Temple built on faulty foundations': Piercing the corporate veil and the legacy of *Salomon* v *Salomon*", *Journal of Business Law*, 2006, Mar, 180-203.

[66] [1976]3A11E.R. 462.

[67] *ibid.*, 464.

> *case which plainly calls for it*. Bronze would have had the land but no business to disturb; DHN would have had the business but no interest in the land."[68]

The claim succeeded partly on the basis that there was a need to look at the realities of the situation because the technical provisions produced injustice.[69] However, Goff L.J. made it clear in his judgment that this would not in itself be sufficient reason for the court to lift the veil.[70] The idea of using the "justice requires it" test was taken forward in *Creasey* v *Breachwood Motors Ltd:*

> "The power of the court to lift the corporate veil exists. The problem for a judge of first instance is to decide whether the particular case before the court is one in which that power should be exercised, recognising that this is a strong power which can be exercised to achieve justice where its exercise is necessary for that purpose, but which, misused, would be likely to cause not inconsiderable injustice."[71]

However, this case that was overruled in *Ord* v *Belhaven Pubs Ltd*[72] where, on appeal, the court refused to lift the veil because no impropriety was alleged and because:

> "There is no facade that was adopted at any stage; there was not concealment of the true facts. . . . it was just the ordinary trading of a group of companies under circumstances where, . . . the company is in law entitled to organise the group's affairs in the manner that it does; and to expect that the court should apply the principles of *Salomon* v *Salomon* in the ordinary way.[73]

It follows that the veil cannot now be lifted simply because justice requires it.

Control

Another factor in the DHN decision to lift the veil was the level of control present. As already indicated, in DHN the two subsidiaries were both wholly owned and had no separate business operations whatsoever.[74] This was interpreted in later cases as a need to establish control. The result was that DHN appeared at first to free the courts to look at the realities including the level of ownership and control, in a group situation, but it was later distinguished on the grounds of control in both *Woolfson* v *Strathclyde*

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[68] *Per* Shaw L.J., *ibid.*, 473 (emphasis added).

[69] For instance: "They are left behind on the quay because of the technical provisions of our company law", *per* Lord Denning M.R., *ibid.* 466; ". . . this is a case in which one is entitled to look at the realities of the situation", *per* Goff L.J., *ibid.*, 468; and the words of Shaw L.J., *ibid.*, 473 given in the text above.

[70] *ibid.*, 468, this is the judgment which has been most approved in the later cases.

[71] [1992] B.C.C. 638 at 647.

[72] [1998] B.C.C. 607 at 615.

[73] *ibid.*

[74] [1976]3A11 E.R. 462 at 468.

Regional Council[75] and National Dock Labour Board v Pinn &Wheeler Ltd and others.[76] In National Dock Labour Board it was held that:

> ". . . the measure of control and ownership by that company of the other two was in analysis tighter than that apparent in the *Woolfson* case. But by the same token in my judgment the position did not approach that set out in DHN."[77]

If the facts in DHN are used as the measure of the ownership and control which must be in place before the veil can be lifted it will be a rare occurrence indeed.

Sham Company

In *Trustor AB* v *Smallbone* (No.4)[78] assets were transferred by a managing director from the company he directed and worked for to a sham company that had only nominee directors and was controlled by the managing director. Transfers were in breach of the director's fiduciary duty. It was held that the corporate veil would be pierced so as to treat receipts by the sham company as receipts of the managing director. This decision follows on from the much older authority of *Guilford Motor Co* v *Horne*.[79] The courts can be seen refusing to lift the veil in the absence of a sham or façade, for instance in *Brookes* v *Borough Care Services*[80] a case where the court was asked to lift the veil to overcome the statutory limitations of the Transfer of Undertakings (Protection of Employment) Regulations 1981. They can also be seen lifting the veil where there is a sham, for instance in *Buckinghamshire CC* v *Briar*[81] a case concerning liability for clean up costs on land where it was held that the corporate veil would be lifted to make B liable when B had transferred the land to a subsidiary, L, and then on to another company, D that had no genuine officers and was a sham. These facts were concealed from the Land Registry and the transfer to D was also held to constitute a fraud on the Land Registry. The criteria for piercing the corporate veil as per *Trustor AB* v *Smallbone* were therefore satisfied.

Impropriety

An important case on liabilities within groups is *Adams* v *Cape Industries plc*.[82] In order for the plaintiffs to gain access to the assets of the UK company, Cape Industries, it was necessary to show that it was either present within the US or that it had submitted to the jurisdiction there. If the veil of

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[75] (1978) 38 P. &.C.R. 521
[76] [1989] B.C.L.C. 647.
[77] *National Dock Labour Board*, *op.cit*., 650.
[78] [2001] 1 W.L.R. 1177 [2001] 3 All E.R. 987
[79] [1933] Ch 935.
[80] [1998] I.C.R. 1198 [1998] I.R.L.R. 636
[81] [2002] EWHC 2821 [2003] Env. L.R. 25.
[82] [1990] Ch. 433 [1990] 2 W.L.R. 657 [1991] 1 All E.R. 929. This case considered a variety of approaches that may have resulted in Cape being present in the US – including the "single economic unit argument and the agency argument. At 822 the case also makes reference to contractual or statutory interpretation as a way of reaching the parent's assets. These two approaches can be seen in *Ringway Roadmarking* v *Adbruf Ltd* [1998] 2 B.C.L.C. 625 and *The Evpo Agnic* [1988] 1 W.L.R. 1090 respectively.

incorporation could be lifted, the group as a whole could be seen as present in the US in the shape of a subsidiary company. If the corporate veil remained in place, the subsidiary would be seen as present in the US, but not the UK parent. The decisions in *Adams* v *Cape Industries plc* and *Trustor AB* v *Smallbone* were most recently considered in *Raja* v *Van Hoogstraten:*

> "A narrow reading of . . . *Adams* v *Cape Industries plc* ... suggested that the corporate veil would only be lifted in circumstances in which the corporate structure had been established for the purpose of avoiding a known and existing, or confidently predicted liability. . . . However, the dividing line could not be so clearly drawn when the corporate structure had been designed for the purpose of avoiding future liabilities. It was possible that a dishonestly constructed corporate arrangement designed to conceal both the true nature of assets and the true beneficiary of the exploitation of those assets, and furthermore to minimise the liability of that individual, could . . . give rise to a successful application to lift the corporate veil."[83]

Also, the court held that based on *Trustor AB* v *Smallbone*, the essential element was impropriety.

In the first part of this article the main thrust of the argument was that law, economics and management can be read together in a coherent way. It is submitted that this reading remains conceptually sound, but that the legal problems encountered in the "lifting of the veil" add in a more major way to the fuzzy boundary issues described in section 3 above. The direct conflict between the principle that a company is a separate legal entity and the reality of the corporate group as an economic entity is a seemingly intractable problem for the law. From the judgment in *Ord* v *Belhaven Pubs Ltd* there is the statement that in the ordinary trading a group of companies is "in law entitled to organise the group's affairs in the manner that it does; and to expect that the court should apply the principles of Salomon v Salomon in the ordinary way.[84] This opens the way for a group to organise, for instance, its most uncertain activities within a subsidiary thus obtaining the protection of the legal, corporate boundary, so long as it achieves this structure by operating within the definition of "ordinary trading". This idea could be taken forward in the future as a the basis for a hypothesis that is empirically testable.

Conclusion

Overall, this article had broad and ambitious aims in relation to the theoretical background to corporate capabilities, decision-making and responsibility. It brings together three theoretical strands from corporate legal theory, economic theory and management thinking. It also highlights three key concepts. First, the recognition in the Corporate Manslaughter and Corporate Homicide Bill of the ingredients of corporate culture is important. The Bill acknowledges their existence and recognises them as legitimate

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[83] [2006] EWHC 2564.
[84] [1998] B.C.C. 607 at 615.

places to locate corporate criminal responsibility. Second, in relation to economic theory there is the explanation in Simon's employment model that under conditions of risk it can be rational to make contracts that give authority to another. Behind this is the need for a degree of trust to be present.[85] The third important concept is decision-making under conditions of true uncertainty. Directors are entrusted with decision-making in the company. For some of that decision-making a risk-based approach is appropriate, but for decision-making under conditions of true uncertainty a risk-based approach will not be appropriate. Finally, the idea that companies are responsible corporate culture can be linked to directors' decision-making about the company's internal structures.

It is submitted that these ideas do work if read together. Issues relating to Fuzzy boundaries, including the major issues of legal liabilities in groups and legal responsibilities and liabilities for collective decision-making, have been identified, but remain significant problems.

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[85] For an description of calculative trust (the trust that comes from considering probabilities and expectations) and behavioural trust (the trust that cannot be calculated and is established through human interaction) see A. Belcher "Trust in the Boardroom" (2006) paper presented at the SLS conference, University of Keele, September. Note also that in employment the duty to maintain mutual trust and confidence is a relatively new, and still developing, duty.