

Business Law: CIMA Year One

Company Formation

There are three main types of organisation: the sole trader, a partnership, and a company.

A **sole trader** is characterised by:

- A single person providing the capital for the company
- A single person holding full liability for any debt, who is subject to the rules of bankruptcy
- The business can have its own name but cannot use “plc” or “ltd” within that name, or use the name of another company or business which is already in use
- The name and address of the sole trader must be published somewhere on their business documents.

A **partnership** may exist when there are up to twenty partners looking to form a common business (however, there may be more than twenty partners in a law or accountancy firm). Partnerships are governed by the Partnership Act 1890, and do not require any formal registration, although many partnerships do have a formal written partnership agreement. The Partnership Act includes many provisions which will apply unless agreed otherwise – for example, the Act states that profit must be shared equally.

A **corporation** is an artificial being, which is created by law and considered by the law as an individual. Corporations are not necessarily owned by their founders, but instead by shareholders.

Partnerships: further characteristics

Like sole traders, partnerships may again have a business name, which may include the word ‘company’ but not “ltd” or “plc”. If the name of the partnership is not just a list of the names of the partners, it must be publicised. In addition, on any formal correspondence the names of all partners must be shown, as well as displayed at the business premises.

Property of a partnership belongs to the partners jointly. However, if land is owned by a partnership of more than four people, then legal title to that land must be vested in at most four (and at least two) senior partners who hold the land on trust.

A partnership is automatically dissolved at the completion of the task it was set up to accomplish. If the partnership was set up for an undefined time, it can be dissolved by any of the partners informing any of the others, and is automatically dissolved by the death or bankruptcy of any one partner.

Partnerships: agency relationships

Each partner in a partnership acts as an *agent* of the organisation (by the Partnership Act section 5). The firm is bound by the actions of any agent. So, for example, if there are five partners in a car repair business, and one partner (John) orders a thousand oil filters, the contract is deemed to be between the oil filter sellers and the partnership.

An agent is somebody who can create legal relationships between parties other than just themselves. Each partner has the ability to bind the partnership into a contract. However, how does the third party know whether a person is truthfully an agent for a partnership?

Actual Authority

This is authority that any agent actually has.

It could be agreed, within the partnership, that some members are limited in the authority they carry. If a partner had no technical skill and knows nothing of the mechanical workings of a car, the partnership may wish that that partner cannot buy oil filters. That partner will then have no actual authority in that particular area.

Apparent Authority

If it appears to the supplier that each partner should be able to buy their good, then any partner can be held to a contract even if they have no actual authority. The supplier has no knowledge over which partners have authority, and it merely appears as standard that they all do.

If a partner acts outside their actual authority, then the partnership itself will need to seek compensation for losses, directly from that partner who had acted outside their authority.

Partnerships: liability for debts

If the partnership has a debt, the creditor can choose to sue any one or number of the partners. Each partner has full liability for the money owed: liability is *joint and several* (by the Partnership Act section 12). Once one partner has been sued, they will then need to spread the cost internally, either through agreed processes or through legal action.

Note that following the Limited Liability Partnerships Act 2000, there is a new type of business organisation. An LLP shares many characteristics with a partnership, but is legally considered to be a separate body, and as such any creditors must sue the partnership as a whole, rather than being the option to sue individual partners. Other differences include continuous business (so the partnership does not need to be wound up if one partner leaves) and the LLP must submit an annual return and audited accounts to the Registrar of Companies.

Partnerships: Internal relations

The Partnership Act gives explicit instructions on how disputes should be settled, but partners are free to alter these instructions when the partnership is formed. As with sole traders, partnerships are vulnerable organisations, and therefore it is important that partners are able to run the business capably.

Corporations: incorporation

Corporations are founded in a number of ways:

- By *Royal Charter*. This is issued by the Crown and is used mostly for non-commercial bodies. Examples of organisations founded by Royal Charter are the BBC, the Bank of England, and the older universities.
- By *statute*. This is analogous to Royal Charter, but is issued by government instead. Examples include local government authorities and new universities.
- By *registration*. This is the most common method, used to form companies under the Companies Act 1985. Companies must register with the Registrar of Companies, and are issued with a certificate of incorporation.

A corporation is a legal entity in its own right. As such, it can act as any other individual; it can sue others (including its own shareholders) and be sued by them; it has its own rights and liabilities; and it can even be a partner in a partnership or own shares in another company (for example, Electronic Arts has bought 20% of the shares of Ubisoft).

Salomon v Salomon & Co. Ltd (1897)

Salomon (S) owned a shoe repair business; he decided to turn this business into a limited company. He created a company called Salomon & Co Ltd, owned by himself, his wife and his five children, all owning one share each. S&C Ltd then bought the business from Salomon. S&C Ltd had to pay for the business:

£10,000 in cash

£20,000 in shares (priced at £1)

£10,000 owed, paid by a debenture (a loan from S to S&C Ltd)

The company offered a security on its assets so if the company failed to pay the £10,000, S had a right to the assets of the company, to recover what he was owed.

A few months later, S&C Ltd folded, left owing £10,000 to other creditors, along with the £10,000 owed to S. The assets of the company were worth around £10,000.

The House of Lords ruled that:

§ S was not personally liable for the debts owed by S&C Ltd

§ S was entitled to the assets of S&C Ltd, since he was a secured creditor (through the debenture)

Macaura v Northern Assurance Co Ltd (1925)

M formed a company to buy his previous timber business. However, he forgot to transfer the insurance from his name to his company. The business burnt down. The insurers were not required to pay out, since it is unlawful to insure against *another person's* loss.

Other features of a company include:

Limited Liability

See the case of Salomon v Salomon & Co Ltd, above. The shareholders themselves are not responsible for the debts of a company, and so did not have to pay the creditors of S&C Ltd.

Perpetual Succession

Unlike a partnership, which breaks up if one of the partners leaves or dies (in which case, a new partnership must be formed), a company continues to exist even if the ownership changes.

Ultra Vires

(This is explained in more detail when looking at company registration)

A company must have an “objects clause” - that is, a written constitution setting out the purpose and capacity of the company. For example, a council is created to maintain roads (among other duties), but not to run public transport networks. It is not allowed to get involved in tasks outside its power.

Bromley London Borough Council v Greater London Council (1982)

GLC required BLBC to increase its rates by 6.1p per pound in order to subsidise public transport schemes. BLBC refused, and it was held that GLC had acted ultra vires – that is, such subsidisation was beyond the powers of the GLC as defined by the Transport (London) Act 1969.

Sole traders and partnerships are free to act however they wish, and can engage in any types of business. A limited liability partnership may have its object defined in its partnership agreement, but it is not a necessity.

Corporations: types of company

Companies can be defined by their limitation of liability, by their share availability, by number of shares, by their purpose, and by size.

By limitation of liability

- Unlimited companies follow most of the traits given above, but if such a company folds, its shareholders are liable to contribute without limit towards paying off its debts (and if these shareholders do not have sufficient funds, some ex-shareholders can also be liable). Unlimited companies do not need to have their accounts audited, and do not need to file copies to the Registrar of Companies (unless the unlimited company is a holding company). Most unlimited companies are charities.
- Companies limited by a guarantee have each member of the company guaranteeing the debts of a company to a certain level. If the company folds, then each shareholder is liable up to their guarantee. This can create confidence in the company. Most companies limited by guarantee are non-trading associations and clubs.
- Companies limited by shares are the most common type of company. The capital of the company is divided into shares; the total value of the shares is the total liability. Each member therefore risks only losing their shares.

By share availability

Shares are initially distributed in return for a payment from each member. Each share will have a nominal value written upon the share certificate: this is normally a round number, like 50p or £1. However, shares may be sold for more than this. If a £1 share is issued at a price of £3, it has a £2 premium on it.

A company limited by shares can be public or private.

- A public limited company must have a name ending in “plc”. Its Memorandum of Association must state that the company is a public one, and the must have at least the authorised minimum nominal capital (currently £50,000).
- A private limited company must have a name ending in “ltd”. There is no minimum authorised capital, and it cannot offer its shares to the public.

Public companies are more heavily regulated, to protect shareholders. However, they have an advantage that competition on the stockmarket can increase the value of their shares, and therefore increase the capital available to them. Differences between public and private limited companies include:

- a) The ending of the name, as described above.
- b) The minimum share capital, again as described above
- c) A public limited company requires both a certificate of incorporation and a section 117 certificate, issued by the Registrar (once the Registrar is certain that shares with a nominal value of at least the minimum have been allocated, at least a quarter of these shares have been fully paid up, and all of any share premium has been paid). A private limited company only requires a certificate of incorporation.

- d) A public company must have two directors (at least), while a private company only requires one.
- e) A public company must have two shareholders (at least), while a private company only requires one.
- f) A private company can be unlimited, but a public company must be limited. Since the Companies Act 1985, no new public company can be limited by guarantee.
- g) Provisions for small companies (see “by size” below) only apply to private companies.
- h) Only public companies may offer their shares for sale to the public.

A public company is “quoted” if its shares (and debentures) are listed on a recognised stock exchange. Each stock exchange will have its own rules over the total value of shares and disclosure.

By number of shares

It is possible for a private company to have only one shareholder. This type of company is known as a “single member company”, formed under the Companies (Single Member Private Limited Company) Regulations 1992. Such a company must have at least two officers: a director and a company secretary. Neither of these need be the shareholder.

NERA UK Ltd is a single-member company. Its only share is owned by Marsh & McLennan Companies, but it has its own company secretary, and its own directors.

By purpose

Many large businesses consist of many companies. Often the component companies are run as a group, and the owner of all companies is known as a holding company. A holding company more accurately is defined as one which:

- is a member of its subsidiaries and controls the composition of the subsidiaries’ boards of directors, or
- holds more than half of the equity share capital of its subsidiaries.

A subsidiary company cannot generally be a shareholder in its parent or holding company.

By size

Regulations imposed on limited companies can be particularly onerous for smaller companies, particularly the requirement to submit detailed audited accounts and have them open for inspection by the public. This requirement is therefore lifted for any company satisfying any two of the following requirements for the previous two years:

- turnover less than £2,800,000

- balance sheet assets less than £1,400,000
- less than fifty employees

Small companies need only file a shortened balance sheet, and not a directors' report or a profit and loss statement. Companies with sales of less than £350,000 need not have their accounts audited by a professional auditor.