

FORMS OF BUSINESS ORGANISATION

COMPANY LAW LECTURE 2 (2023-24)

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1 Introduction

- 1.1 While the focus of this module is on companies, it is useful at the inception to explore the position and role of companies amongst other business organizations. The primary aim of this lecture is to place business organizations structured as companies into context. This will enable you to compare and contrast the various forms of business organization and determine which form is more effective at facilitating investment, minimizing risk, flexibility and providing an organizational structure.
- 1.2 In proposing to commence any type of business activity, the question, which inevitably arises, is whether such activity should be carried on through a company or another legal form (such as a partnership or a sole trader, the latter of which may not be a legal form at all).
- 1.3 As you learn this topic-think of inputs required to run the business, think of how these inputs impact upon the decision to choose which legal form you choose. Also think of the risk involved and the expected return. Finally, if incorporation is chosen, think of the consequences of incorporation.

2 Sole Traders

- 2.1 A sole trader is an individual who offers goods or services to others in return for payment (independent contractor).
- 2.2 No legal person separate from the individual is created. Therefore, the sole trader carries on an unincorporated business.
- 2.3 Advantages:
 - 2.3.1 No legal filing requirements or fees and no professional advice is needed to set it up. You just literally go into business on your own and the law will recognise it as having legal form. You will however, have to pay taxes so you will need to keep records and file a self-assessment.
 - 2.3.2 Simplicity – one person does not need a complex organisational structure.
 - 2.3.3 Control of the business
 - 2.3.4 Privacy
 - 2.3.5 You can trade under your own name or choose another name.
- 2.4 Disadvantages:
 - 2.4.1 It is not a particularly useful business form for raising capital (money). For most sole traders the capital will be provided by personal savings or a bank loan.

- 2.4.2 Unlimited liability – the most important point to note in terms of comparing this form to the company in that there is no difference between the sole trading business and the sole trader himself. The profits of the business belong to the sole trader but so do the losses. As a result, he has personal liability for all the debts of the business. If the business collapses owing money (an insolvent liquidation) then those owed money by the company (its creditors) can go after the personal assets of the sole trader (e.g. his or her car or house) in order to get their money back.
- 2.4.3 There is also no perpetuity of business. Death or abandonment can end the business.
- 2.5 There are over 3 million sole proprietorships in the UK.

3 Partnership

- 3.1 Based on law of agency with each partner becoming an agent of the other.
- 3.2 Is it right to say Partnerships are limited to small numbers?
 - 3.2.1 There was a Victorian attempt to segregate the two forms according to the number of people involved
 - 3.2.2 There is no longer a 20-partner limit (abolished in 2002) - a number of professions –notably solicitors and accountants who have formed large and multinational partnerships.
 - 3.2.3 In reality since *Salomon*, small numbers of people wishing to form business have had a choice between partnership and corporate forms.
- 3.3 The Partnership Act 1890 has set out the basic structure of partnership law with no significant substantive change for over a century. Most Partnerships draw up a Partnership Agreement, which override the Act.
 - 3.3.1 Section 1 deems a partnership to exist by applying a statutory test to the facts: an agreement by two or more people in common to carry on a business.
 - 3.3.2 The relationship between members of a company is not a partnership by virtue of s.1 (2), which deems that relationship between members of a company is not a partnership.
 - 3.3.3 Two rules in the Act which are frequently opted out and replaced by long and complex provisions are the (1) capital and profit sharing rule and (2) the management rule (s.24 PA 1890).
- 3.4 A Partnership is an unincorporated association.
 - 3.4.1 Partnerships are not legal persons or entities distinct from partners.
 - 3.4.2 Partnerships do not have limited liability.
- 3.5 Property: A partnership cannot own legal property. Generally, partnerships use trusts to vest legal title in a limited number of partners to be held by all partners.

- 3.6 Contracts: Partnerships cannot enter into contracts. Contracts, even those, which appear to be with partnership because the firm is named as a party, are in fact with the individuals who are the partners.
- 3.6.1 In default, partners have the authority to bind the other partners of the partnership to contracts (agents).
- 3.7 Partnerships are also not subject to public disclosure.
- 3.8 Attention must be drawn to one of the most distinguishing features between partnerships and registered companies.
- 3.8.1 This is **transferability of shares**: the ability of a company to continue unaffected by changes in ownership is in stark contrast to partnerships, (at least in theory). In practice, tax rules and appropriate rules in partnership agreements can mean that a change in partners would not mean that the partnership is wound up and the business continues largely as before.
- 3.8.2 While limited liability is another distinguishing feature-this now takes on another form as 'entity shielding', i.e. where the assets or property of business are protected from the claims of the owner's personal creditors. While the personal creditors of a partner can demand pay-out of the partner's share of assets to meet the debts of the partner, the only 'entity shielding' that exists is a weak form whereby the claims of the personal creditors are subordinated to the claims of the creditors of the partnership.
- 3.9 While reform of the law relating to Partnerships was contemplated by the Law Commission in 2003 (Law Comm. No 283)-these proposals were not implemented in relation to general partnerships (rejected) but some of the reform was implemented in relation to Limited Partnerships. See - https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jxou24uy7q/uploads/2015/03/lc283_Partnership_Law.pdf
- 3.10 Please also note the current reform to Transparency and Corporate Register
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/919356/corporate-transparency-register-reform-consultation-government-response.pdf

4 Limited Partnerships

- 4.1 Limited Partnerships are unincorporated firms provided for by the Limited Partnership Act 1907. They should not be confused with LLPs.
- 4.2 Limited Partnerships have at least one general partner and one or more limited partners who contribute an agreed sum to the partnership and are not liable for the debts and obligations of the firm beyond that amount. This permits for limited partners to invest alongside unlimited partners.
- 4.3 Limited partners may not participate in the management of the partnership and have no power to bind the firm. Is this a disadvantage?
- 4.4 Limited partnerships have been popular with private equity firms for use as venture capital funds to acquire companies. However, they have also been misused in recent times.
- 4.5 Limited legislative reform took place in 2009- Legislative Reform (Limited Partnerships) Order 2009 SI 2009/1940): one of changes being that new Limited Partnerships include 'Limited Partnership' or 'LP' or equivalent at end of their names.
- 4.6 Please also note the proposed ability for Courts to strike off Limited Partnerships in the public interest- https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/919356/corporate-transparency-register-reform-consultation-government-response.pdf
- 4.7 Following on from above, also note proposed changes to the law relating to LPs probably towards the end of 2023- <https://www.gov.uk/government/publications/economic-crime-and-corporate-transparency-bill-2022-factsheets/fact-sheet-limited-partnerships>.
- 4.8 A sub category came into being in April 2017: Private Fund Limited Partnership [PFLP]. This was aimed at reducing the administrative and financial burdens that have had an impact on private funds using LP structure.
 - 4.8.1 One of the key differences between a LP and PFLP is that Limited partners in a PFLP are not required to contribute capital or property to the PFLP. If they do contribute capital or property, they may withdraw it without being liable for debts and obligations to the amount withdrawn. (*further detail not required*)

5 Limited Liability Partnerships (LLP)

- 5.1 LLPs are incorporated organisations governed by the Limited Liability Partnerships Act 2000. A hybrid between a company and a Partnership, The general law of partnerships does not apply except to the extent set out by *Limited Liability Partnerships Act 2000* [*think of it as a type of company-which has partnership characteristics-structure of company with flexibility of a partnership*].
- 5.2 'A limited liability partnership **is a body corporate** (with legal personality separate from that of its members) which is formed by being incorporated under this Act'; s1(2) *Limited Liability Partnerships Act 2000*.
- 5.3 Governed by Company Law to a large extent. The principal regulation: Limited Liability Partnerships (application of Companies Act 2006) regulations 2009 (SI 2009/1804) apply to LLPs many of the provisions of the Companies Act 2006 with respect to formalities and governance.
- 5.4 Registration requires two or more persons for carrying on a lawful business with a view to a profit (note view to a profit).
- 5.5 LLPs are however, 'tax transparent' i.e. the HMRC looks through the LLP ignoring its existence and treats profits of LLP as if they have been earned by the members themselves (*just as in an ordinary partnership*).
- 5.6 In comparison to a partnership, the greatest advantage of a LLP is that a member will in most cases have **no personal liability** for obligations of LLP or other members.
- 5.7 However, in some circumstances a member may have to contribute to the **LLP's** assets. For example, if a member:
- is guilty of misfeasance or falls within special **claw back** provisions under the Insolvency Act 1986
 - must contribute by agreement between the members; or
 - is a sole member of the **LLP** trading as such for more than six months
- 5.8 An **LLP** has the organisational flexibility of a partnership. The members are free to agree:
- how to share profits;
 - who is responsible for management and how decisions are made;
 - when and how new members are appointed; and
 - the circumstances in which members retire.
- (Section 5, *LLPA 2000*.)

- 5.9 Any members' agreement (**LLP** agreement) is a private document that is confidential to the members. It does not need to be publicly filed.
- 5.10 LLP has no share capital. There are no capital maintenance requirements and, unless otherwise agreed between the members, there is no obligation for members to contribute capital to the **LLP**. Its accounting and filing requirements are broadly the same as those of a company
- 5.11 It can create **floating charges**.
- 5.12 LLPs are much nearer to a company than a partnership.
- 5.13 Advantages:
 - 5.13.1 Legal entity distinct from members-i.e., LLP can do anything that a legal person can;
 - 5.13.2 Members have limited liability (there are exceptions);
 - 5.13.3 Organisational flexibility of a partnership on profit sharing/management
 - 5.13.4 Privacy
- 5.14 Disadvantages:
 - 5.14.1 Tax transparent

6 The Company

- 6.1 While there are many types of companies (as illustrated), a company has been traditionally used to identify an organisation reserved for those associated for economic gain. However, it is worth noting that companies do not have exclusivity with regard to being an association of persons coming together for purposes of economic gain (partnerships are also associations of people coming together for gain) and companies incorporated under the Companies Acts may be used for not-for-profit businesses.
- 6.2 Companies today can be formed by a single member. *Salomon v Salomon* [1897 AC 22] in effect allowed the incorporation of a company with a single member. EC Directive 89/667 required private companies to formally be capable of being formed with a single member. The 2006 Companies Act extended this to public companies-s.7(1).
- 6.3 There are over 4 million companies registered in the UK.

7 Companies Limited By Guarantee

- 7.1 Not unlimited in the sense that members are free from any liability BUT enables them to agree that in the event of liquidation they will if required subscribe an agreed amount(usually very small).
- 7.2 While widely used by not-for-profits, this does not exclude companies limited by shares from being used for not-for-profit purposes.
- 7.3 The important advantage with respect to a guarantee company (in comparison to a company limited by shares) is that admission to membership and resignation from a guarantee company is easy and similar to joining and leaving a club or society.
- 7.4 A primary disadvantage with this corporate form is that it is limited in terms of raising finance for its activities.
- 7.5 A guarantee company is however, unsuitable for companies whose primary objective is to carry on business with a view to a profit.
- 7.6 Network Rail Ltd is a private company limited by guarantee. It is a not for profit organisation that receives significant funds from government and has responsibility for the UK's rail network.

8 Unlimited Companies

- 8.1 Companies, the liability of whose members to contribute on a winding up to the company to enable it to pay its debts is not limited.
- 8.2 You might wonder what is the attraction here? There is no obligation to file accounts with the registrar of companies. It goes without saying that where the risk of insolvency in this case is remote-such as in an investment holding company-the privacy offered is attractive.

9 Companies Limited by Shares

- 9.1 Companies limited by shares have shareholders who own shares in the company and their liability is limited to the amount, if any, unpaid on the shares held by them'; s3(2) *Companies Act 2006*.
- 9.2 Fundamental difference with guarantee company is the assumption that there is working capital available by share contributions-but this is not always the case as share capital can be paid up or with a call.

- 9.3 Companies limited by shares may be public or private companies. The principal difference between a PLC and a Limited company is that public companies may offer their shares to the public. A private company cannot offer its shares to the public.
- 9.3.1 The name of a public company must end with 'plc' or 'public limited company' and the name of a private limited company with 'Ltd' or 'Limited'
- 9.3.2 Ltd can have one director, plc needs a minimum of two (s.154).
- 9.3.3 Plc's have an authorised minimum share capital
- 9.3.4 Membership of Limited: Constitution may contain pre-emption clause and commonly restrict membership to persons of whom Directors approve
- 9.3.5 Plc's are not necessarily listed on a Stock Exchange
- 9.3.6 The default rule is that a company is a private unless the company states that it is to be registered as a public company.
- 9.4 Public companies: A 'public company' is a company ... whose certificate of incorporation states that it is a public company'; s4(2) CA2006. •But unlike many European jurisdictions- in England one piece of legislation to deal with both private and public companies.
- 9.5 Private companies: 'A 'private company' is any company that is not a public company'; s4(1) CA2006.

10 Advantages of a Company

10.1 Limited Liability

10.2 Facilitating Investment

10.2.1 By Limited Liability

Richard Posner: "Incorporation performs the same function of encouraging investment by enabling the risk averse to limit their risk of loss to their investment.

Far from externalizing the risk of business ventures, the principle of limited liability in corporation law facilitates a form of transaction advantageous to both investors and creditors; in its absence the supply of investment and the demand for credit might be much smaller than they are."

10.2.2 By Subdivision of Shares

10.2.3 By Limited right of participation

10.3 Organisational Structure:

10.3.1 Perpetuity: Freedman study: 28% of unincorporated associations reported that non-perpetuity of business form was a disadvantage.

10.3.2 Evolution: Small private company ~ Large private Ltd company ~ Public Ltd company. An example would be Alliance Boots plc, the company that owns Boots high street chain of chemists. It was acquired by AB Acquisitions Limited (a company controlled by private equity funds) in June 2007. Since its acquisition, the shares are no

longer traded on a stock exchange, it is no longer a quoted, traded or listed company, and Alliance Boots plc has been reregistered as a private company, Alliance Boots Ltd.

10.3.3 Permits limited rights of participation

11 Disadvantages of a Company

- 11.1 Cost of Limited Liability = Administrative Burden
 - 11.1.1 To create a company, need to file with Registrar:
 - 11.1.2 BUT: CA2006 relieves small companies of range of administrative burdens, E.g. AGM requirements, Separate models articles for private companies
- 11.2 Bank's insistence on personal guarantees negates benefit of limited liability
 - 11.2.1 Freedman study: 54% small companies stated directors/spouses had provided personal guarantees
- 11.3 Limited right to participate in management of company
 - 11.3.1 Freedman study: 83% of unincorporated businesses did not incorporate so as to retain personal control over business
 - 11.3.2 Potential for abuse of minority shareholders. BUT: statutory remedy in s994 CA2006.

12 Attributes of a Company

- 12.1 Legal Personality:
 - 12.1.1 Corporate law's function is to permit a firm to serve as a nexus of contracts by providing for the creation of a legal person—a contracting party distinct from the various corporate constituents
 - 12.1.2 Affirmative asset partitioning
- 12.2 Limited Liability:
 - 12.2.1 Corporate form imposes default term in contracts between firm and its creditors so that creditors limited to making claims against only firm assets
 - 12.2.2 Defensive asset partitioning
- 12.3 Transferable shares:
 - 12.3.1 Enables firms to conduct business without interruption despite changes in owners
 - 12.3.2 Enhances liquidity of shareholders' interests and makes it easier for shareholders to hold diversified investment portfolios
- 12.4 Delegated management with a board structure
 - 12.4.1 Delegation permits the centralization of management necessary to coordinate productive activity

12.4.2 Fundamental decisions are put in hands of a board of directors which is separate from the managers of the corporation, distinct from the shareholders, elected by the shareholders and has multiple members

12.5 Investor Ownership

12.5.1 Gives investors the right:

To participate in control— (i.e. voting) and

To receive the firm's residual earnings proportional to the amount of capital contributed to the firm

13 What is the goal of Company Law?

- 13.1 To provide business enterprises with a **legal form** that possesses five core attributes
 - 13.1.1 Legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership
- 13.2 Enables entrepreneurs to transact through the medium of the corporate entity and thus lowers **transaction costs**
- 13.3 Constrains value-reducing forms of opportunism among the constituencies of the corporate enterprise i.e. **agency costs**
 - 13.3.1 Conflicts between: managers and shareholders, among shareholders, and between shareholders corporate constituents

Please remember to keep reflecting on the goals of Company law as we continue with the module.