CORE TEXT SERIES

Company Law

Eighth edition

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1 Introduction to company law

SUMMARY

Forms of business organisation

1.1 It may be helpful at this early stage to explore an overview of company law by examining the company's place within the various forms of business organisation. In order for us to get some comparative perspective on the relative merits of each type of organisation we need first to set some criteria to judge them by. In essence business organisations are about the effective combination of three things. First, you need capital (money) so a key question in evaluating a form of business organisation is, does it facilitate investment in the business? Second, no business venture is guaranteed to succeed and so the second key question is whether the form of business organisation mitigates or minimises the risk involved in the venture. The third question to ask relates to the fact that wherever you have money, risk and people combined there is potential for disagreement, so does the form of business organisation provide a clear organisational structure?

The sole trader

1.2 The sole trader is the amoeba of the business organisation world. As the name implies it is a one-person operation where someone just operates on their own. There are no legal filing requirements, they just go into business on their own. Sole traders usually provide the capital with personal savings or a bank loan. They contract in their own name and have personal liability for all the debts of the business. Legally there is no distinction between the sole trader's personal and business assets and so if the business goes badly the creditors can go after his or her home, car or other assets in satisfaction of the business debt. As the business is just one individual there is little risk of disagreement (unless the person is schizophrenic) and so there is no need for a formal organisational structure. The sole trader therefore is adequate for a single person with capital but is unsuitable for larger scale investment. The risk to the sole trader of doing business is large but there is no need for a formal organisational structure.

The partnership

1.3 Our hypothetical sole trader's business has been doing very well and there are a number of investors who are willing to provide further capital to expand the business. At this point the trader feels the need for a more complex form of business organisation to facilitate the expansion of the business. Here the trader might consider a partnership. The Partnership Act 1890, s 1 defines a partnership as 'the relationship which subsists between persons carrying on a business in common with a view of profit'. As you can see, this is a very broad definition. Therefore a partnership can come about by oral agreement, it can be inferred by conduct or it can be a formal written agreement specifying the terms and conditions of the partnership. There is no formal process of becoming partners—if you behave as partners the law will deem you are partners, even if you have no idea what a partnership is (see *Khan v Miah* (2000)). The minimum membership required for a partnership is (obviously) two and the maximum is, since 2002, unlimited (prior to that it was 20 unless you were a professional firm (solicitors, accountants etc.) who could exceed the maximum number). The assets of the firm are also owned directly by the partners. This as we will see later is very different from a company where the shareholders do not own the company's assets.

1.4 A partnership which does not expressly exclude the Partnership Act 1890 will be governed by it. This can sometimes be a problem for those who are unaware that they are partners, as under the Act each partner is entitled to: participate in management, an equal share of profit, an indemnity in respect of liabilities assumed in the course of the partnership business and not to be expelled by the other partners. A partnership will also end on the death of a partner. Because of the nature of partnerships it is normal for those who are aware they are entering such an association to modify the Partnership Act and draft a complex partnership agreement. Law firms in particular have very complex partnership agreements governing their operation. This means that the management structure, profit sharing and the life of the partnership can be made to fit any situation.

1.5 What cannot be achieved through a partnership agreement is limited liability, because under the Partnership Act each partner is jointly and severally liable for the debts and obligations of the partnership incurred while he or she is a partner. So if a partner runs away with the clients' funds each individual partner is legally responsible for the whole debt, not just a proportion of it. There are two types of partnership that allow limitation of liability. The first type was created by the Limited Partnership Act 1907 and allows certain partners to have full limited liability. These partners gave rise to the term 'sleeping' partners as they take no active part in the running of the partnership. These types of partnerships have become increasingly common in recent years due to their popularity with the hedge fund industry. The second type was created by the Limited Liability Partnerships Act 2000 and allows for partners in these entities to achieve limited liability up to a point. It allows liability to be limited for general trading debts but individual partners are not able to limit their personal liability for a negligent act they themselves have committed. This type of partnership (LLP) was designed to allow large professional partnerships (law and accountancy firms) to achieve some measure of protection for partners who were not involved in a negligent act.

1.6 A general partnership does therefore facilitate investment as it allows partners to pool their funds. The risk however is large (although reduced in an LLP) but is at least shared by all the partners. The organisational structure is very flexible as the partnership agreement can facilitate almost any situation. Indeed, while we will see that the registered company dominates the business landscape, the government is keen to reform partnership law to make it more attractive to small businesses (see https://www.gov.uk/company-and-partnership-law--2#partnership-and-llp-law for the latest government plans).

The company

1.7 Another alternative for our entrepreneur is to form a registered company. As our entrepreneur is pursuing a commercial venture he/she would be forming a company limited by shares (that is a company where the liability of the shareholders for the debts of the company is limited to the amount unpaid on their shares (see Chapter 2)). There are other types of company (the company limited by guarantee and the community interest company for example) which are designed for charitable or public interest ventures. A company limited by shares is the normal type of commercial company formed to pursue a business venture.

1.8 Setting up a company is governed by the Companies Act 2006 (CA 2006), ss 7–15 and is a relatively simple process. Our entrepreneur is required to provide the Registrar of Companies with the constitution of the company (this contains the internal rules of the company called the articles of association and any objects clause limiting the power the company may have, see later), a memorandum of association stating that the subscribers intend to form a company and become members and an application for registration containing the company name, its share capital, the address of its registered office, whether it's a private or public company, that the liability of its members is limited, a statement of the company's directors' names and addresses and a statement of compliance with the CA 2006. The purpose of registering these documents is to provide certain key information that could be accessed by the general public or government agencies if necessary. This is still the case but in recent years fears that this public information could be abused have led to restrictions on its public availability. For example since April 2002 directors could apply to have their names and addresses removed from the memorandum under provisions introduced by the Criminal Justice and Police Act 2001 if they could show they were at risk of potential or actual violence or intimidation. Media reports have claimed that tens of thousands of directors have done so in order to protect themselves. The CA 2006, s 165 amends this by allowing all directors to choose to have a service address (which may be the company's registered office) on the public record rather than a residential one.

1.9 Prior to 1992 at least two people had to subscribe to become shareholders in a private company (see paras **1.14–1.16** on public and private companies). As a result of the Twelfth EC Company Law Directive (89/667) implemented in 1992 private companies could be formed with a single member but public companies still needed at least two members. The CA 2006, s 7 now provides for single-person private and public companies. Thus our entrepreneur, if he or she wished, could skip the stint as a sole trader and go straight to forming a company.

The memorandum and constitution

1.10 Under the previous companies acts the memorandum formed part of the company's constitution. Now however, s 8 of the CA 2006 has reduced the memorandum of association to a more limited function. The memorandum is now a simple document providing certain basic information and key declarations to the public which state that subscribers wish to form the company and agree to become members taking at least one share each. The subscribers to the memorandum are those who agree to take some shares or share in the company thus becoming its first members. If the application to the Registrar is successful the subscribers become the first members of the company and the proposed directors become its first directors. Under the previous Companies Act 1985, the total amount of share capital that could be issued to investors had to be stated in the memorandum. In the CA 2006, s 10 the provisions have been streamlined and now only require a statement of the total number and nominal value of shares to be taken on formation by the subscribers to the memorandum of association. Additionally any rights associated (see Chapter 9 on class rights) with those shares must be stated along with the paid up and unpaid amount on each share (if any). The value given to each share is known as its 'par' or 'nominal' value. This is both a matter of convenience to facilitate the issue to the shareholders and a method of protecting the value of shares already issued as there are restrictions on issuing shares below their nominal value (indeed it is a criminal offence, see CA 2006, s 542 and Chapter 7). Additionally, the Insolvency Act 1986, s 74 deems the nominal value or any amount paid above the nominal value to be the limit of the shareholders liability in an insolvency. If the shares are paid for immediately they are described as fully paid but shares may also be issued partly paid or even unpaid. In the case of partly paid and unpaid shares the shareholder can be called upon to pay for them at a later date. Shares may be also be paid for in goods and services and not necessarily in cash.

1.11 Taking a simple example let's say the share capital of our entrepreneur's newly formed company is £10,001 subdivided into shares of £1 each. Our entrepreneur subscribed for 5,001 shares on registration and thus is now a member of the company holding 5,001 shares in the company at a nominal value of £1 each. In purchasing the shares she paid for half with cash and the rest are unpaid with an agreement that they are to be paid for in 3 years time. Other investors in the company subscribed for a total of 5,000 shares and now are members of the company holding shares of that amount. It is important to note that in our entrepreneur's company she has majority voting rights by virtue of her 5,001 shares. This gives our entrepreneur the ability by simple majority to elect or remove someone from the board (see para **1.12**).

1.12 The company's constitution or articles of association are a set of rules governing the running of the company. They form the core of the organisational structure of the company—the board of directors (the management committee or organ) and the general meeting (the shareholders' committee or organ)—and generally allocate the powers of each organ. Those forming the company can provide their own set of articles but a model set of articles (historically these articles have been called Table A but are referred to as the model articles in the CA 2006) is provided by the CA 2006, s 20 as a default for those setting up a company. In reality, however, the model articles have been generally adopted with some slight amendments. The CA 2006, s 21 provides that the articles may be altered if three-quarters of the members (a special resolution) vote to amend the articles. Additionally the CA 2006, s 168 gives members the right by simple majority (more than 50 per cent of the shareholders who vote, vote for the resolution) to remove a director for any reason whatsoever. Thus the articles and the Companies Act place the shareholders at the centre of the corporate power structure.

1.13 The articles, according to s 33 of the CA 2006, bind the members of the company, creating a statutory contract between the members themselves and between each member and the company (see Chapter 8). If all the documentation is in order then the Registrar will issue a certificate of incorporation and the company will then come into existence.

Public and private companies

1.14 The Companies Act 2006 recognises a distinction between two different types of company: private companies where the investment is largely provided by the founding members either through their personal savings or from bank loans, and public companies where the intention is to raise large amounts of money from the general public. While this is the key difference there are others.

1.15 Private companies, obviously, are private. The vast majority of companies in the UK are private companies. The law assumes a closer relationship between the members in a private company than in a public company and so private companies commonly restrict the membership of their company (to those approved of by the directors) in the articles of association. In essence if a member wishes to leave the company by selling their shares or a member has died, the directors have a say in who replaces them, if anyone. There may also be a pre-emption clause in the articles which means that if a member wishes to sell their shares they must first offer the shares to the other members. Private companies have also historically been able to adopt an elective regime (CA 1985, s 379A) which recognised that often in private companies the directors and the members of the company are one and the same and so requirements for meetings, timing of meetings and laying of accounts can be suspended to streamline the operation of the private company (additionally in the old Table A articles, article 53 allowed a more informal decision-making process). The CA 2006's main impact has been in reforming company law to suit small private companies and so many of the problematic requirements for private companies to hold meetings etc have been done away with in the 2006 Act (the AGM requirements for example do not apply to private companies, see CA 2006, Part 13, Chapter 14 and CA 2006, s 288 provides for an expanded written resolution regime for private companies). Private companies cannot invite the general public to buy shares (CA 2006, s 755), but they also, unlike public companies, have no minimum capital requirements. The members only need to come up with a nominal amount. £1 or even 1p would suffice and even then the member could purchase the shares unpaid (plus the registration fee for the Companies Registrar) in order to form the company. The members of a private company have limited liability and so the word limited or 'Ltd' must appear after the company's name. Members thereby are liable only for the amount unpaid on their shares and not for the debts of the company.

1.16 Public companies have the aim of securing investment from the general public and can advertise the fact they are offering shares to the public. In doing so the company must issue a prospectus (see Chapter 5) giving a detailed and accurate description of the company's plans. Because the general public are involved and need to be protected the initial capital requirements for a public company are more onerous than for a private one. There is a minimum capital requirement ('the authorised minimum') of £50,000 (CA 2006, s 763). While there is no formal limitation on public companies having restrictions on transfer of shares similar to those that apply to private companies, any such restriction would be highly unusual, given that one of the reasons for forming a public company is to raise money from the general public and such a restriction would discourage them. In any case if the public company is listed on the stock exchange any restrictions on transfer will be prohibited. Note here that public companies are not necessarily listed on the stock exchange. A listing is essentially a private contractual arrangement between a public company and the stock exchange (in the UK the London Stock Exchange (LSE) is itself a listed public company) to gain access to a very sophisticated market for its shares. Some public companies do however exist outside the stock exchange listing system—Sir Alan Sugar's Amstrad plc being a high profile example. The application for registration for a public company must state that it is public and, as with private companies the liability of the members is limited thus the words public limited company (PLC or plc) must come at the end of its name (CA 2006, s 58(1)) both as a statement that the members' liability is limited and to tell those dealing with it that it is authorised to secure investment from the general public.

So why would our entrepreneur form a company?

1.17 Using our criteria of facilitating investment, minimising risk and providing an organisational structure the registered company seems to perform well. It is specifically designed as a capital-raising vehicle. The subdivision of shares allows for a very large number of investors to become members of the company. Those members have limited liability which minimises their risk. This in theory makes raising capital easier as individuals may feel more secure in their investment. Limited liability is also said to increase the entrepreneurial spirit of the directors, encouraging them to take risks in the knowledge the shareholders will not lose their houses or cars if the business venture fails. A company is also impervious to death, and shares are also in theory transferable and so particularly in public companies easily convertible into cash. The company is designed to potentially have a large number of participants and so has a formal constitution outlining its basic organisational and power structure. Technically, the people who control the company are the shareholders. They buy shares in the company which entitle them to certain control rights exercised through the shareholder organ, the general meeting. However, the running of the company cannot be effected by a large number of members as such control would be cumbersome and so they elect people to do it, the directors. The directors operate through the second organ of the company, the board of directors. The shareholders appoint or remove directors by simple majority vote (more than 50 per cent of the votes actually voted) at the general meeting.

1.18 However, our entrepreneur with his/her investors already identified may not have so much to gain from the corporate form. This brings us to a particular problem with the registered company. The statutory model has historically assumed a separation of ownership and control. That is, it assumes that the shareholders are residual controllers exercising control once a year at the annual general meeting (AGM) and that the day-to-day management of the business is carried out by professional managers (directors). For large companies this is the case but for the vast majority of companies in the UK this separation of ownership from control does not exist (see Chapters 13 and 15).

1.19 Freedman (1994) found that 90 per cent of all companies were small private concerns (as our entrepreneur's company would be). She also suggested that for small businesses the corporate form and the regulatory requirements that went with it were burdensome. It was also costly, as they had to employ professional advice to deal with these requirements. One assumed advantage to the small business, that of limited liability, was also negated by the practice of banks requiring the shareholders to provide guarantees for bank loans (a common source of finance among small businesses). Thus any debts owed to the banks could be reclaimed from the personal assets of the shareholders. In Freedman's study one of the major reasons that business people incorporated was the perceived benefits of having the word 'Ltd' after the company's name, namely, that it conferred prestige, legitimacy and credibility on the venture. This may also be the key determinant for our entrepreneur.

1.20 Let us take a look at how the statutory model of the company and its surrounding case law operates in a large company. The annual general meeting is held primarily to elect the directors to the board. The directors will be a mix of professional managers (executive directors) and non-executive (independent outsiders) (see Chapters 13 and 16). The executive directors will normally have a small shareholding but not usually a significant one. The shareholders are also provided with an annual report from the directors outlining the performance of the company over the past year and the prospects for the future (this is rather like a report card on their performance). At the heart of the report are the accounts certified by the auditor (an independent accountant who checks over the accounts prepared by the directors, see Chapter 16). Between the AGMs the directors run the company unencumbered by the shareholders. In a large company the board of directors will be more like a policy body which sets the direction the company goes in but the actual implementation of that direction will be carried out by the company's employees. In carrying out their function the directors stand in a fiduciary relationship with the company. They therefore owe a duty to act bona fide in the interests of the company (this generally meaning the shareholders' interests) and not for any other purpose (such as self-enrichment, see further, Chapter 14). The employees who are authorised to carry out the company's business are the company's agents and therefore the company will be bound by their actions (see Chapter 12).

1.21 The same company law model applies to a small company but with significant differences in effect. The shareholders and directors will often completely overlap. The same people will also be the only employees of the company. To take the example of a two-person company, the two shareholders will also be the two directors and the two employees. There is no separation of ownership from control, the shareholders are the managers, and therefore most of the historical statutory assumptions about the company's organisational structure will not hold. Given that one can also form one person companies the statutory assumption had begun to take on farcical proportions. However the elective regime, as we explained earlier, had historically attempted to address this problem by allowing a 'quasi-partnership' or 'close company' (a company with few participants who know each other well) like this to do away with some of the more onerous aspects of the statutory model and the CA 2006 has significantly improved the difficul-ties close companies faced in using the company. The courts have also tried where possible to recognise and make allowances for these 'quasi-partnership' type companies (see *Ebrahimi v Westbourne Galleries Ltd* (1973); see further, Chapter 11).

1.22 The differences in the types of business that use the statutory model featured heavily in the CLRSG's *Final Report* (2001), Chs 2 and 4. The CLRSG recommended that the statutory requirements for decision making, accounts and audit, constitutional structure and dispute resolution be simplified. They also recommended that legislation on private companies should be made easier to understand. In particular there should be a clear statement of the duties of directors. The White Paper (*Modernising Company Law* (2002)) that followed the *Final Report,* the Consultative Document, March 2005 (*Company Law Reform* (2005)) and the CA 2006 all carried through this focus on the 'quasi-partnership' company with a 'think small first' emphasis. However, it's still not clear if this focus has been entirely successful.

1.23 Private companies present another problem. In a nutshell private companies, because there is often a close relationship between the participants, have more potential for those participants to have disagreements. In these cases company law and the constitution of the company can be problematic for a minority shareholder who has fallen out with the majority. Company law presumes that the company operates through its constitutional organs. In order for the company to operate, either the board of directors makes a decision or if it cannot then the general meeting can do so. It can, however, happen that a majority of shareholders holding 51 per cent (simple majority voting power) of the shares in the company could act to the detriment of the other 49 per cent. A 51 per cent majority would allow those members to elect only those who support their policies to the board. Thus the 49 per cent shareholder would be unrepresented on the board and powerless in the general meeting.

1.24 To take an example, X Ltd has three shareholders, Ron, Cathy and Freeda. The share capital of X is 30 shares of £1 each. Ron, Cathy and Freeda hold 10 shares each. All three are directors and employees of X Ltd. Things go well for a few years but increasingly Ron and Cathy feel that Freeda is no longer contributing much to the company. They decide not to re-elect Freeda to the board of directors and having removed her from the board they transfer all the assets of X Ltd to Y Ltd (a company in which only Ron and Cathy have a shareholding) for a fraction of its real value.

1.25 In this situation Freeda has no constitutional power to block this asset-stripping exercise. She has no voice on the board (even if she did she could be outvoted by the others) and is powerless in the general meeting. Even though there appears to be also a breach of fiduciary duty, as Ron and Cathy are using their directorial powers to benefit themselves and not the company, only the board or the general meeting can instigate an action to remedy the situation (see Chapter 14). Ron and Cathy are unlikely to support an action against themselves. Thus the constitution of the company can be used to facilitate what is known as a 'fraud on the minority'. These situations are also made more acute in private companies where the oppressed minority shareholder cannot sell their shares without board approval and is thus trapped. Although the courts quickly came up with a limited exception to enforcing the constitutional structure (*Foss v Harbottle* (1843), see Chapter 10) there has always been a continuing tension between enforcing the constitutional structure (allowing directors to run the company unimpaired by factions among the shareholders) and protecting minority shareholders against genuinely fraudulent transactions. Eventually a statutory remedy was introduced (CA 2006, s 994 and CA 2006, Part 11) to make it easier for shareholders to bring an action. Additionally the CLRSG and the Government have been keen to encourage companies to use forms of Alternative Dispute Resolution for minority shareholder problems (see Chapter 11).

1.26 Thus, while the company is designed as an investment vehicle, with limited liability for its shareholders and a clear organisational structure, it is designed for ventures where there is an effective separation of ownership from control and thus has been largely unsuitable for the majority of its users who are small businesses. Even given the reforms in the CA 2006 which focus more on small business needs, in many ways the partnership would be more suitable for our entrepreneur and less onerous for small businesses generally, especially given that limited liability is rarely a reality for these types of business. The removal in 2002 of the 20-partner limit will help as it enhances the capital-raising ability of the general partnership. However, the continued use of the corporate form by small companies seems secure given the prestige attached to the tag 'Ltd'.

FURTHER READING

This chapter links with the materials in Chapters 1, 2 and 7 of ***Hicks and Goo's Cases and Materials on Company Law***, (Oxford, OUP, 2011, xl +649p).

Company Law Reform (2005) Cm 6456 (Consultative Document, March 2005), ch 5. http://webarchive.nationalarchives.gov.uk/+/http://www.dti.gov.uk/bbf/co-act-2006/white-paper/page22800.html

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Modern Company Law for a Competitive Economy: Final Report (2001), Chs 2 and 4. http://webarchive.nationalarchives.gov.uk/+/http://www.dti.gov.uk/cld/final_report/prelims.pdf

Modernising Company Law (2002) Cm 5553 Part II. http://webarchive.nationalarchives.gov.uk/+/http://www.dti.gov.uk/companiesbill/prelims.pdf

SELF-TEST QUESTIONS

1 Compare and contrast the various forms of business organisation discussed in this chapter.

2 Why has the partnership fallen out of use by small businesses?