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The Legal Function: Starting a New Business – Getting the Structure Right

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When we look at business, we generally focus on large global businesses, such as Apple, Shell or Rolls Royce. While there are around 5.2 million businesses in the UK, in fact 99% of them are extremely small (HM Government, 2014). Despite the rate of business failure being high in the early years, overall numbers of businesses are slowly growing. Most new businesses start small, with a view to expansion. This narrows the choice of business medium, as some forms may not suit a particular business at its current stage of development. The focus of this chapter is on the legal structures for doing business. It adopts terminology from the UK's legal system, but similar structures apply in other countries. The objective is to show when a particular legal structure might be appropriate and to highlight key differences between legal structures for enterprises. We also examine the concept of legal personality, which allows a business to be considered as a separate entity from its members, and allows the members of some organizations to have limited liability for business obligations. Most countries have some business forms where the proprietors carry unlimited liability and others where they can avail themselves of limited liability.

Businesses are either *unincorporated* or *incorporated*. This refers to whether or not a business has been formed by an act of law as a body corporate. Examples of incorporated businesses are British Airways plc, incorporated in the UK, and PetroChina Company Limited, incorporated in China. Unincorporated businesses are used by many tradespeople such as plumbers, and also by some professionals such as doctors and solicitors, though both of these groups also often use the incorporated business forms.

In the UK, incorporated businesses have to be registered at Companies House. Its website is <https://www.gov.uk/government/organizations/companies-house>

Tip

The primary source of most of the law in this chapter is from the UK Acts of Parliament, also called statutes. These are a formal source of law, and are public information that we are all presumed to know. Therefore you do not need to reference them beyond giving their name and year. The main statutes referred to here are:

Partnership Act 1890

Limited Partnerships Act 1907

Limited Liability Partnerships Act 2000

Companies Act 2006

Insolvency Act 1986

You can look them up for free using www.legislation.gov.uk, and there are also subscription databases such as Westlaw. In this chapter there are some references to sections of statutes. Statutes are divided into smaller parts called sections, for example section 1 of the Companies Act 2006.

While devolution of law-making means that parts of the law differ between different parts of the United Kingdom, the statutes discussed in this chapter generally apply to the whole of the UK, with relatively few differences.

Some of the law comes also from cases decided in the courts.

Running your business solo – the sole trader

This is the first of the unincorporated forms of business and the simplest option. There are around 3.3 million sole traders in the UK, or around 62% of all businesses (Federation of Small Businesses, 2014). When deciding to set up as a sole trader, it is important to review one's talents and experience, and do extensive market research. This can be a business form that works well in conjunction with an innovative product, where there is a desire to launch early and at small scale. In the UK there are few formalities, apart from contacting the UK tax authority within 3 months of the start-up date.

Sole traders are not employed, though they often call themselves self-employed. Instead, they are running a business on their own account, and may have employees themselves. However, while they might like to keep their business assets separate from their private assets, in law there is no such separation. This means that should the business fail, personal assets may have to be sold to pay business debts. If all the debts cannot be paid the sole trader may become personally bankrupt and have to sell the family home and other assets.

However this form of business suits many people. Sole traders should obtain insurance against liability to their customers and the public. There is less paperwork involved in being a sole trader than any other legal form: all that is needed is to pay National Insurance contributions, and submit an annual tax return. Any business whose turnover is over a certain limit (£82,000 at the time of writing) needs to register for Value Added Tax (VAT), though businesses may choose to do this even where turnover is below this threshold. The same turnover thresholds and obligation to register for VAT apply to all the business forms discussed in this chapter.

This is a very popular form, particularly when starting a small business. Examples include plumbers and beauticians, as well as accountants and solicitors.

Exercise

What are the attractions of operating your business as a sole trader, and what are the potential pitfalls?

Running a business in partnership

For some, the way to succeed is to work with other like-minded people to spark ideas off each other. There are about 460,000 partnerships in the UK, which amounts to around 9% of all businesses (Federation of Small Businesses, 2014).

There are three forms of partnership in the UK: the partnership under the Partnership Act 1890 (PA 1890), the limited partnership under the Limited Partnerships Act 1907 (LPA 1907), and the relatively new limited liability partnership under the Limited Liability Partnerships Act 2000 (LLPA 2000).

■ The partnership

This business form is regulated by the Partnership Act 1890 (PA 1890). The partnership is defined in that statute as “the relation which subsists between two or more persons carrying on business in common with a view of profit.” The people who form a partnership must be in ‘business’ in a general sense, though the term includes professionals. They must aim to make a profit, even if they do not actually make one. There is no upper limit on numbers of partners nowadays. It is not possible to be a ‘sole partner’.

This form of partnership is created by contract, and a written agreement is unnecessary, though it would be useful in case of dispute. This agreement is a private one between the partners. Partnership is therefore not one of the busi-

ness forms where the entity is formed by incorporation. The PA 1890 contains many rules, for example on how partners share profits and losses, which only apply if the partners have not created their own rules. This provides useful flexibility for partnerships.

In Scotland, though not in England, a partnership is a *legal person*. This key concept will be discussed later. A legal person is treated by the law as being separate from the people who make it up, and it can sue them and be sued by them. However, despite the fact that a partnership in Scotland is a legal person, its personality is incomplete. The statute goes on to say that individual partners may face a claim as a result of an action brought against the firm, and if they, or more than one of them, have to pay, they would have a right of relief against the firm and the other partners. Partners in Scotland are *jointly and severally liable* for debts and obligations of the firm that are incurred while they are partners. The same applies where there have been claims against the firm for wrongful acts by the partnership.

Example

A partnership has failed to pay a debt under contract or has committed a *delict* (the term for a civil wrong in Scotland – in England called *tort*) against a third party. For example the firm has done a bad job installing central heating for a customer (breach of contract), or a brick from a roof under repair falls on the head of a passer-by causing injury (delict).

If the partnership is sued, the joint and several liability of the partners works like this:

Step 1: the other party demands payment of the price or damages from the partnership and the partnership fails to pay.

If nothing happens

Step 2: The other party can now demand that **any one or more or all partners** pay what is owed. Those who do pay have a right of relief against the partnership and their fellow partners.

With joint and several liability, the partners are often sued in the same action with the partnership. This potential for facing unlimited personal liability while the partnership is trading can be a problem for partners. Partners must be chosen carefully to ensure they are adequately funded and sufficiently competent.

There are other things to be mindful of in relation to partnership structures. While in many cases partners will agree before they make contracts, in fact all partners have considerable authority to act autonomously as agents for the partnership, even where they have not been authorized. This is *implied authority*. Under the PA 1890, even if they have not been authorized expressly, every partner has the power to do acts “for carrying on in the usual way business of