

## Types of businesses – the ‘veil of incorporation’ – teacher’s notes

By Nigel Haines

### Background information

In the leading case of *Salomon v Salomon & Co. (1897)\**, the House of Lords held that, the rights and liabilities of a corporation are separate and distinct from those of its shareholders. The incorporation of a business is like a veil that shields its shareholders from corporate debts and other similar obligations and liabilities. This principle has continued to be upheld by the courts ever since. In the United Kingdom there are essentially five types of businesses, they are:

1. Sole Trader - ST
2. Partnerships - PS
3. Limited Liability Partnerships - LLP
4. Limited Companies – LC
5. Public Limited Companies – PLC

\* You should find plenty of information about this case in most company law books. Here is a link to a brief description, which you might find useful:

<http://en.wikipedia.org/wiki/Corporation>

Look for reference to the case in ‘Legal status’ section and click on the link.

There is a useful resource with detailed information on the Companies House website - a UK government site. Try the FAQs to start:

<http://www.companieshouse.gov.uk/infoAndGuide/faq/fullList.shtml>

**NB: incorporation** is the act of forming a business by drawing up the Articles of Association and registering them with Companies House.

**Aims: to practise the skills of**

- reading and understanding information about the differences between the various types of businesses
- using the information to discuss and give legal advice about examples
- writing a letter of advice to a client about opening a business

**Level:** Upper Intermediate and above

**Student profile:** It is envisaged that students will be studying law, trainees or qualified lawyers

**Time:** The lesson is 5 stages and should take 60 – 90 minutes. Stage 5 could be set for homework.

**Stage 1**

This stage is to establish the basic differences between the types of business. Students may have some ideas about these differences so it is anticipated that they should be able to decide which definition applies to which business.

**Procedure:**

Ask students to quickly match the definitions to each type of business. This should start to raise interest in the differences between them. If students raise questions, point out their answers will be covered in the next stages of the lesson.

**Answers:**

Read these definitions and match them to each of the above:

\_\_\_\_\_ **LC** \_\_\_\_\_ is organized in such a way as to give its owners limited liability so that they will not be required to pay more than the value of their shares

\_\_\_\_\_ **PS** \_\_\_\_\_ by which owners conducting a business jointly have unlimited liability and the actions of one of the owners are binding on each of the other

\_\_\_\_\_ **LLP** \_\_\_\_\_ is formed under applicable state statute in which the partnership is liable as an entity for debts and obligations and the owners are not liable personally

\_\_\_\_\_ **PLC** \_\_\_\_\_ has issued securities through an offering which are traded on the open market

\_\_\_\_\_ **ST** \_\_\_\_\_ has unlimited liability for all the money the business owes

## Stage 2

This stage is to establish the principle of 'limited liability' and which businesses it applies to.

- **Limited liability** means shareholders have no further liability other than the price they paid for their shares or the amount remaining unpaid.
- **Unlimited liability** means owner or owners have the obligation or duty to pay all debts personally.

Students may have some ideas about this difference so it is anticipated that they should be able to decide which definition applies to which business.

### Procedure:

Ask students to quickly decide which business fall into each category. The title of each business should be a clear indication. Again, this should start to raise interest in the differences between them. If students raise questions, refer them to the next stages of the lesson.

### Answers:

According to the definitions which businesses have:

Limited liability	Unlimited liability
LLP LC PLC	ST PS

## Stage 3

This stage is to establish a more detailed understanding about the differences between the types of businesses

### Procedure:

Ask students to divide up the statements between the different types of business. This might be better done as a group activity to broaden discussion and an exchange of ideas. As a variation, you could cut up the statements. Provide feedback carefully and deal with questions as they arise.

Now, look at these statements. Which of them applies to each type of business? Divide them up into the business categories below - some apply to more than one category.

**NB: members** are shareholders in a company or partners.

**Answers – by number**

Sole Trader	Partnerships	Limited Liability Partnerships	Limited Companies	Public Companies
4, 10, 19, 25	2, 8, 10, 11, 14, 22	1, 2, 3, 9, 13, 14, 16, 17, 23, 26	7, 9, 12, 13, 15, 16, 17, 18, 23, 24, 26, 28	5, 6, 9, 13, 16, 17, 20, 21, 23, 24, 26, 27, 29, 30

Below is an alternative way of showing the different features of the types of businesses based on the statements.

You might prefer to give this out to students as an easier record for them to keep for future reference and for the remaining tasks in the lesson.

### **Sole Trader**

No incorporation necessary  
Business comes to an end on death  
Management by owner  
Capital provided by owner

### **Partnerships**

Limited to 20 partners  
No incorporation necessary  
Partners are agents  
Needs at least 2 partners  
Capital provided by partners  
Management by members

### **Limited Liability Partnerships**

Not controlled not by partners but by at least 2 'designated' members  
Partners not responsible for debts  
Must be registered at Companies House  
Incorporation necessary  
Needs at least 2 partners  
Capital provided by partners  
Must be audited annually  
A separate legal personality distinct from members  
Accounts must be filed and are open to inspection  
'perpetual succession' - although there might be changes in the members

### **Limited Companies**

Shares cannot be listed on the Stock Exchange  
Must be registered at Companies House  
Shares can be given away  
Needs only one Director  
Must be audited annually  
A separate legal personality distinct from members  
Needs only one member  
Accounts must be filed and are open to inspection  
Only Directors can manage, not members  
'perpetual succession' - although there might be changes in the members  
No minimum payment for shares necessary  
Incorporation necessary

### **Public Limited Companies**

Needs at least 2 members  
Incorporation necessary  
Shares must be paid for  
Needs at least two Directors  
Must be registered at Companies House  
Must be audited annually  
A separate legal personality distinct from members  
Shares are listed on the Stock Exchange  
Must have minimum issued and paid up capital  
Accounts must be filed and are open to inspection  
Only Directors can manage, not members  
'perpetual succession' - although there might be changes in the members  
Minimum authorised share capital of £50,000  
Must have Company Secretary

## Stage 4

**This section is for students to learn to discriminate between the differences in the types of businesses using practical examples, and give advice.**

### Procedure:

Using information that students have now established, ask them to decide which would be the best sort of business for each of these situations. Students could decide on their own then discuss their answers in groups and feed back to the whole class. Suggested answers below but encourage discussion about possible alternatives.

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Look at these situations and imagine you are acting for each of these clients. What advice would you give about the best sort of business to form in each of these situations, and why?

1. You have a client who in his spare time has designed and set up a website selling hand-printed t-shirts. He has a job as well and does not want to give it up. He thinks of his website as a hobby as he only sells what he can produce.

**Answer:** The advice is to be a sole trader – ST

**Clearly the client does not intend the business to expand and does not need the protection of a formal business.**

2. Two brothers are buying an existing and successful restaurant - not only the contents of the restaurant but its name and goodwill. The landlord of the property has agreed to grant them a new lease so that they can stay at the premises. They plan to run the restaurant and work in it full time but they will need outside investors, as they don't have enough money to buy the restaurant on their own.

**Answer:** The advice is to form a limited company – LC

**The brothers will need the protection of limited liability as they are setting up a business – buying an existing restaurant, entering into a lease as well as probably taking on other substantial obligations including staff, payment of taxes etc. An LC will also enable them to offer shares in order to raise further capital.**

3. A group of four friends have decided to start open a kindergarten together. They are all mothers with children of their own and some of them have primary teaching experience. They also want to offer the facilities to other children in the area and charge fees although the number of children they can look after will be 10 –15 maximum.

**Answer:** The advice is have a partnership – PS

**The group of friends are starting a business which essentially will be for only for their own use and benefit. It will be a small operation that will require minimal capital that will easily be funded from their own resources.**

4. Some colleagues, who all work together as salesmen for a leading car manufacturer, have been offered the chance to take over a showroom, including the premises and stock, at a lower-than-market price. They have also been promised that they will receive redundancy payments to help them.

**Answer:** The advice is to form a Limited Liability Partnership – LLP

**The colleagues will be working partners and it will be their business, but in view of the size of the business an LLP would give each partner better protection against liabilities as well as give them the protection of limited liability.**

5. Your client is a successful businessman. He now wants to buy an existing chain of retail clothes shops and open some more in order to create a new high street brand. His investment would be substantial, but he wants to raise additional capital through offering stock, which would increase in value as the business expands and grows.

**Answer:** The advice is to form a Public Limited Company - PLC

**This is intended to be a high-profile business and a PLC would be necessary in order for the client to capitalize on his investment as well as raise additional funds through an offer of shares to the public.**

## Stage 5

**This stage is for students to plan and write a letter, and give formal written advice on a situation as a lawyer acting for a client.**

### **Procedure:**

This will probably be set for homework so that students have time to consider the advice they give. It also will serve as an exercise in writing a formal letter giving advice from a lawyer to a client.

The task is written in an ambiguous way so that students could advise to form either an LLP or LC or PLC. Although each of these would offer the client limited liability, there are also other various reasons, as follows:

- **LLP** – this could be used if the client and his friends want to have a simple business and want to divide the income equally. Probably not suitable for a

business that involves manufacturing and possibly substantial sales on a global basis.

- **LC** – this would be suitable as the client could allocate the shares so that he could have a controlling interest (51% or more) and protect his investment. Future investment would mean raising money through conventional means (banks and outside investors), which might mean relinquishing further shareholding in the company as well as offering other security or personal guarantees.
- **PLC** – if the investment is substantial and the need for outside capital is a requirement, then this would be most suitable as it would be an ideal way to raise money. The client could also retain a controlling issue. There is a risk as there is no guarantee that a floatation of the company on the stock exchange would immediately be successful.

Below is an outline draft letter for students might require support with this task. You could either give this in its complete form or cut up for students to order. This might help students focus more on the task and enable them to write a better letter.

Remind students to be concise in their advice and not go into lengthy descriptions. Maybe select examples from students work to show good/bad versions of the letter or choose sample sentences for error correction.

Also below is a blank form for students to use to write their letter.

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You have a rich client who wants to start a business with a friend, and his friend's wife. The business is to manufacture and sell a new office product that will revolutionize the way people work. Your client is putting up the money and his friend will assign the ownership of the patent of the product to the business.

Your client envisages that the product will be very successful and probably sell in large quantities around the world over the forthcoming years. What is your advice about the best type of business to form?

Remember who you are acting for. Your client is putting up the money and needs to have his investment protected.

Write a letter to your client outlining your advice and why you recommend the particular form of business you are advising as well as opposed to the other alternatives.

Dear Sir,

You have asked me to advise you about the type of business you should form in connection with your new venture. Essentially, there are three types as follows:

1. A Limited Liability Partnership - LLP
2. A Limited Company - LC
3. A Public Limited Company - PLC

Give reasons why ST and PS are not the best form of business for this venture

Outline the features of an LLP, LC and PLC

Outline differences between LLP, LC and PLC

Choose the best form of business and say why

I hope that this advice sets out the position clearly, and if you have any further questions please do not hesitate to contact me.

Yours faithfully,

