Part Three

The Law in Practice

11 Running a business

Every year there is an increase in the number of laws, lawyers, and legal cases in the courts. To a large extent, this increase is due to the economic growth in the world; more business means more transactions, more possibilities for conflict and confusion, and, consequently more legal activity to regulate business. If you set up a business, even a very small one, you will buying and selling products and services, and perhaps, employing people, buying or renting land, and borrowing money. In order to engage in all of these activities, you need to have some knowledge of basic legal principles such as contract, tort, and land law. And you will need to know about any laws specifically relevant to your kind of business, such as statutes regulating companies. If you do not run your business honestly you may also need a knowledge of criminal law! In 1991, a series of Japanese companies faced fines or suspension of activities for making illegal payments to certain clients. Imelda Marcos has been charged both in Manila and in the United States with improperly handling millions of dollars while her husband was President of the Philippines.

Nearly every general area of the law is relevant to running a business, and nearly every country has its own set of laws designed specifically to regulate business. The attempts of the European Community to create a single market by 1993 show just how difficult it can be to harmonize business laws. In this chapter we will try to make some sense of this complex area of the law by taking English law as a model and making some international comparisons. Throughout the world, most businesses face similar problems; they must determine their organizational form; duties to clients; investors and employees; tax liabilities; and ability to minimize losses if the business fails.

Unlike many legal systems, English law has never developed a comprehensive code of company law. Instead, the relevant law is found partly in cases decided according to the principles of common law and

equity and partly in statutes. Between 1985 and 1986, a series of statutes was passed to consolidate many previous statutes. The most important of these was the 1985 Companies Act.

Organization

If you want to set up a business under English law, the first question to consider is whether or not to form a **limited company** (or **corporation**). A corporation is a kind of artificial legal person, with the right to sue and be sued. It may consist of a single person, or several persons, but in each case it has a legal identity separate from these individuals. The members of a limited company have **limited liability**. This means that if the business has difficulties, the members can be made to pay its debts only up to a certain limit. Normally this limit is the amount unpaid on shares they hold (**limited by shares**), or the amount they have guaranteed to contribute to company assets (**limited by guarantee**). The company's liability itself is not limited; as long as the business has money or assets, creditors may sue. But they cannot sue the members as individuals beyond their stated limits. In Britain, a limited liability company has the word "limited" or the abbreviation "ltd." after its names. The equivalent to this kind of company can be found all over the world: for example Société Accréditée (SA) in France and Kabushiki Gaisha in Japan.

Certain very large companies are registered as public limited companies (PLC) They raise capital by selling shares to the general public, and these shares are listed on the Stock Exchange.

Selling shares is one of the ways in which companies raise capital. A share is ownership of a proportion of the company, and thus the right to a proportion of any profit it makes (**dividend**). Shareholders cannot insist on the payment of a dividend every year, since this is up to the directors to decide. But if they are dissatisfied with the management of the company, as members they have the right to remove the directors (see below). The more shares a member holds, the more voting rights he will have in general meetings. Shares may be acquired when the company is first set up; or at a later share issue. Or they may be bought or received from an existing shareholder. Sometimes a company gives existing members the right to buy shares from another member before he is allowed to sell them to a new member. Each share is equal in value. But that value may be greater or less than the nominal value. For example, a member of a successful company who bought shares at $10 each may be able to sell them at a premium—perhaps $12 each. But he may also find that he

has to sell them for less than their nominal value—at a discount. Sometimes a company issues shares at a premium: for example, it sells $10 shares at $15 each.

Another way for a company to raise capital is by issuing **debentures**, or **bonds**, in return for loans. Debentureholders are entitled to an annual payment of interest, and this is not linked to the company's profits and losses. In general, they have the right to sell their debentures back to the company (that is, call in their loan), or sell them on to someone else. If possible, the lender will make sure his loan is secured by a charge over a company asset, so that he will have the right to take company property should there be no money to repay him.

A limited liability company is not the only way to run a business. A single person may operate as a sole trader, and even if he employs many people, he alone is responsible for management and, thus, for any debts. Another way to run a business is for two or more people to form a partnership in which they share management, profits, and liability to debts. The share is not necessarily an equal one, but depends upon the partnership agreement among them. This usually reflects the amount of capital each partner has invested in the business. Partnerships can be formed very easily and the legal position of partners is not very different from that of sole traders. Unlike members of a company, partners may find their personal property is at risk if they are sued by creditors. It is also possible to form an **unlimited company**. Since members' liability is unlimited this is, in effect, similar to a partnership.

If the advantage of forming a company is that it offers members some protection in case of bankruptcy, the disadvantage is that there are many regulations to observe in setting it up and running it. Under English law, there must be a minimum of two people, and they must sign a document called a **memorandum of association**, which must be filed with the national registrar of companies. The memorandum contains the name of the company, its objects, whether it is limited by shares or guarantee, and the amount of share capital. There are some restrictions on the choice of name: for example, the registrar will not accept a name that is the same or very similar to a company already registered, since this could confuse consumers and clients.

The objects clause of the memorandum is very important because a company may not engage in activity beyond its registered objects. Such activity is said to be **ultra vires**—outside its capacity. It used to be the case that both the company and its clients lost the right to remedies for breach of contract over an ultra vires transaction. The purpose of the doctrine was

to stop company assets from being used for unauthorized activities. However, partly because of pressure to conform to European Community law, it is now possible for someone contracting with the company on ultra vires matters to be protected, provided the matter was authorized by the company's directors. In any case, companies usually draft very wide objects clauses to include any activities that the business is likely to be engaged in now or in the future.

As well as the memorandum, there are several other documents a new company has to register. When this has been done it receives a number and a certificate of incorporation and is ready to do business (unless it is a public limited company, in which case it must first obtain a trading certificate).

Internal management

The internal management of the company is regulated by a document called the **articles of association**. Although these need not be registered (except for companies limited by guarantee), they must conform to an authorized pattern. They detail rules about such matters as when and at what notice meetings must be held; members' voting rights, and the size of majority required to pass resolutions; issuing of shares; and the appointment, powers, and removal of directors. Under the Companies Act every public company must have at least two directors, and every private company, at least one. A director need not be a member (that is, a shareholder), but details of any shares he holds must be registered. He is not an employee of the company, but may be paid for his work as long as the members of the company agree to this. He has a duty to exercise a reasonable standard of care and not to make secret profits from company business. If he holds an interest in another firm with which the company is doing business, the law requires him to declare that interest at a board meeting (meeting of the directors).

The law also requires a limited company to keep accounting records at its registered office, including entries of receipts and payments and a record of assets and liabilities. These records must be open to inspection at any time by the company's directors and secretary, and a copy must be sent to the registrar each year. A profit and loss account, together with a financial report by the directors and a report from an independent auditor (inspector), must be put before a general meeting of the company's members every year. Breaking these regulations may result in criminal prosecution.

Another possible cause of criminal prosecution is **insider trading**. This

means using inside knowledge to gain private profit when buying and selling company shares. Directors and employees of companies are often in a position to know if a company's shares are likely to rise or fall long before ordinary shareholders. As a result, they could make profits by buying or selling before everybody else, or by selling their special information. In 1990, a New York stockbroker was imprisoned for this offence. The crime was not even recognized in English law until 1967. The 1985 Company Securities (Insider Dealing) Act lays down a maximum penalty of two years imprisonment, but the recent discovery of how widespread this practice is means the penalty is likely to be increased as a deterrent.

Termination

There are several ways in which a company may be terminated (**dissolved**): its registration may be cancelled, as happened to Lindi St. Claire (Personal Services) Ltd. in 1980 because its objects turned out to be prostitution, which is illegal in Britain; it may be removed from the register if it has simply ceased to function as a company; or, it may be **liquidated**, or **wound up**. This means that its resources will be used to pay creditors in an established order of priority. It is likely that the reason the company is being wound up is that it is **bankrupt**—that is, it cannot pay all its debts. This mean that creditors may only get a proportion of what they are owed. As mentioned above, shareholders may be liable for up to the value of shares they hold but have not yet paid for. Sometimes liquidation is voluntary, at the insistence of most of the shareholders, and sometimes it is ordered by the court.

There are also laws regulating transactions in the years before liquidation. These laws prevent companies from transferring funds to third parties whom the creditors cannot touch before the firm goes bankrupt or from giving unauthorized preference to certain creditors.

Setting up, running, and winding down a company are not the only legal matters businessmen have to deal with. At some stage, most of them employ the services of lawyers for advice on how to minimize their tax liabilities and to make sure their business does not exceed noise or pollution regulations. Company directors, partners and sole traders alike have to consider the legal implications of making contracts to buy and supply goods and services, and the torts they may face if a product injures a consumer. More about consumers will be said in Chapter 13. In Chapter 14 legal obligations to the workforce will be discussed, and in Chapter 15, the protection of designs and inventions.

Figure 11.1 *Lindi St. Clare, whose business was declared illegal in Britain.*