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Introduction

27 The law of business organisations is a 300 course offered on the Economics, Management, Finance and the Social Sciences (EMFSS) suite of programmes. It provides an insight into, and understanding of, the workings of business organisations, including their formation and effect, operations and management. The course explores not only the business entity, but also the practical implications of such entities entering into binding obligations and contracts, the issue of liabilities, and protection conferred on management and investors.

This course is primarily concerned with the regulation of organisations whose principle purpose and functions are the undertaking of some business activity. The course recognises that a considerable amount of business activity is undertaken outside the legal structure of the limited liability company and therefore takes into account various business organisations – the syllabus requires consideration of incorporated and unincorporated associations. Sole trader, partnership and other types of unincorporated association are considered, although the focus of the course is the incorporated company. This reflects the view that the courts borrow principles that relate to other business organisations when developing legal principles to apply to the registered company.

Many students approaching this course think that a brief knowledge of the area will suffice, without an understanding of the legal authority. It will not. You must have a thorough understanding of the law and its application. Common mistakes include failing to apply the law to the issues raised or to understand the legal reasoning underpinning the decisions of the courts. You must keep your discussion relevant to the issues and learn to apply the law to the questions in an examination.

This course is particularly relevant for those who want to go on to careers in business, as a basic understanding of the law and legal concepts can be extremely useful. Although you may not be able provide legal solutions, you may well be able to identify legal issues which may require a greater legal experience. This is helpful whether you work in industry, financial services, law-related professions or manage your own business. The course will also enhance your independent study skills.

What you will take away from this course is an understanding of the law applicable to a number of modern business organisations, their significance in the creation of wealth and the law surrounding the personnel involved in the management of such entities. Your study will not only equip you with knowledge of the law in this area, but will also help you develop independent legal study skills.

I hope that you enjoy studying this course and that your study of it will assist and support your daily working life.

Aims and objectives

This course aims to:

- develop in the student an understanding of the core principles of the laws that regulate business organisations
- develop the independent and individual skills needed for students to take their knowledge further, and to apply it in practice, for example in industry, or in an academic environment
- inspire and to stimulate endeavour.
Learning outcomes

By the end of this course, and having completed the Essential reading and activities, you should be able to:

- identify and explain the legal issues arising in some of the main day-to-day dealings of business organisations and provide advice or commentary relating to those issues
- define and discuss the core concepts inherent in the legal structure of business organisations
- interpret the main statutory provision relevant to the areas covered by the syllabus
- demonstrate reading in depth beyond merely the subject guide.

Advice about the coverage of the syllabus

The syllabus, and therefore its assessment by examination, focuses on the legal regulation of business entities and the personnel involved in the running and management of such organisations. However, the syllabus is selective in its focus and you will only be assessed on those aspects that are dealt with within this guide - thus, for example, the duties of directors is a topic within the syllabus and therefore subject to assessment, but there are significant areas of the law relating to directors that are not within the scope of this syllabus. Other personnel, for example the company secretary and promoters, are not within the scope of the syllabus, although for the purposes of background some explanation of the role of promoters is given in the guide.

For most people who study this course, it will be like no other they have studied before – it requires not only knowledge and understanding of the law of business organisations, but also an understanding of certain basic and fundamental concepts which in themselves are extremely important areas of the law, such as the basic difference between contract and tort law and the basic rules of agency law, especially in the area of directors’ duties and the concept of fiduciary duties. Certain basic concepts of legal procedure also need to be understood, for example the doctrine of precedent. Chapter 1 and the Essential reading for that chapter will explain these concepts to ensure that you have a basic understanding of them. Knowledge of these concepts in assumed in the assessment.

Syllabus

This course may not be taken with LA3021 Company law.

Students are permitted to bring into the examination hall unannotated copies of the following: one copy of Blackstone’s Statutes on Company Law; or one copy of British Companies Legislation (Sweet & Maxwell) or any statutes contained therein.

The role of law: The nature and sources of law; the distinction between private and public law; the role of law in the creation and maintenance of business organisations; the nature of contract, agency and trusts and their relevance to the operation of business organisations.

Forms of business organisation: The distinction between:

- individual and collective trading
- registered and unregistered organisations
- incorporated and unincorporated organisations
• public and private companies
• limited and unlimited companies
• companies limited by shares and companies limited by guarantee.

The formation and operation of each of the above types of organisation; the nature of the constitution; how funds are raised for the purpose of carrying out the proposed business.

Limited liability: The meaning and significance of limited liability; who is entitled to limited liability; the concept of the veil of incorporation and the lifting of the veil; fraudulent and wrongful trading.

Dealings between the organisation and the outside world: The relevance of the constitution to the dealings of the organisation; registered as opposed to unregistered organisations; when the organisation will be bound to contracts and other dealings with third parties – the relevance of principles of agency and the alter ego doctrine; the distinction between void and voidable acts.

Surveillance of actions within the organisation: The nature of the relationship between the organisation and its members; the duties of directors of companies and other executive committee members of different organisations; the ratification of breach of such duties; the enforcement of remedies for such breach and the protection of minorities.

Terminating the organisation: Circumstances leading to the dissolution of the organisation; different methods of termination; the importance of the distinction between solvent and insolvent organisations.

For the purposes of studying this course, the focus of the syllabus is English law. Some attempt is made to show significant developments in other common law jurisdictions, where this enhances your studies.

Assessment

In examinations taken in 2012, candidates were required to answer four out of eight questions. The format of the examination may change in future years. Students are advised to check the VLE where any changes to the examination format are advertised.

How to use the subject guide

This subject guide is intended to provide a framework for your studies, which you must supplement by further independent study and, if you so choose, through additional formal tuition. It is not intended as a textbook and you must read the reading specified as essential.

You should work through the subject guide carefully and methodically. Because of the extent of changes introduced by the Companies Act 2006, the guide attempts to be thorough in its discussion.

For each chapter:
• Work through each chapter, and do the Essential reading (using up-to-date texts).
• Try to do the activities as you come across them, making sure at each stage that you understand the basic principles involved. A number of these activities include reading the important cases (although by no means all of them) and understanding the relevant statutory provisions in order to obtain a deeper understanding of how general principles are applied in practice.
• In some chapters you will also find short sections called **self-test and understanding**. These are basic questions which you are asked in order to help your understanding of the topics under discussion. You should use these questions to test your knowledge and understanding. They will also assist with the activities.

• **Further reading** may then be undertaken, including reading other academic literature.

• **Sample examination questions** at the end of the chapter should not be attempted until you are confident that you understand the subject area.

There is also a complete Sample examination paper included as an appendix to this subject guide. You are advised to use this for examination preparation once you have worked through the guide and readings.

Please note that past examination papers for this course are also available, plus Examiners' commentaries which give useful advice on examination preparation and performance.

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**Structure of the guide**

This guide is divided into ten main chapters which cover the main areas of the syllabus.

**Chapter 1: Sources of law and key concepts**

This chapter examines the purpose and role of the law in society and fundamentals such as the outline of the structure of the legal system and the doctrine of precedent. The basic concepts of the law of contract, tort and rules of agency law will be explored, and the concept of equity and trusts examined.

**Chapter 2: An introduction to law**

This chapter is both an introduction to and a summary of certain basic principles of English law. This will aid the understanding of the legal principles relevant to the Law of Business Organisations. The chapter will examine the fundamentals of contract law, which is particularly important for the law of business organisations. It will briefly explain the concepts of the law of tort, equity and trusts, crime and agency law and will also deal with the relevance of these areas of the law to the law of business organisations.

**Chapter 3: The legal classification of business organisations**

This chapter explains the core distinctions between registered and unregistered organisations (e.g. differences between partnerships, friendly societies, provident societies, limited liability partnerships and limited liability companies). The rules relating to formation of a partnership, limited liability partnership or registered company are also dealt with.

**Chapter 4: The registered company**

This chapter looks at the different forms of business organisation and the registered company. The basic types of companies and requirements for registration are dealt with.

**Chapter 5: The principle of separate corporate personality**

The effect of company formation is explored, in particular the effect of the separate legal personality. Similarly, the effect of registering the limited liability partnership are dealt with and compared with the unregistered
organisation and the sole trader. Exceptions to the separate legal personality rule are examined, and possible inconsistencies in approach considered.

Chapter 6: Dealings between the company and third parties

This chapter explores the external aspects of establishing the business, including: the contractual capacity of the registered company and directors and the effect and scope of liability for contracts entered into with third parties. In respect of partnerships, the rules of agency law play a significant role. The effect of s.33 of the Companies Act 2006 and the relationship between the company and its members are explored.

Chapter 7: Variation of the constitutional documents

This chapter explores the statutory requirements which need to be complied with in order to amend or alter the constitutional documents of the company, as well as the equitable considerations that the courts will take into account.

Chapter 8: Directors’ duties

This chapter explores the statutory duties owed by directors and asks: to whom are such duties owed – creditors, shareholders, employees or the entity itself? The effect of pre-2006 cases and rules established pre-2006 is examined, and the statutory duties considered. The extent of partners’ duties is also dealt with.

Chapter 9: Minority shareholder protection

The issue to be explored here is who is the right complainant when a wrong is done to the company and those responsible for the wrong are its directors. Remedies available are examined, as are the impact of the common law and the changes made by the CA 2006.

Chapter 10: Corporate insolvency

The law relating to termination of the business entity will be examined, in particular: the distinction between bankruptcy and insolvency; the personnel involved; the circumstances and orders available; and the effect of insolvency.

Reading advice

Finding the right materials is essential but is only the first step. The ability to read, understand, organise and analyse the material in a clear and methodical way is essential. This will require commitment and time.

Primary materials: A major part of the necessary legal material is the laws passed by Parliament and subordinate bodies authorised by Parliament as well as the judgments of the courts. These are primary materials for the study of the law.

In order to successfully complete this module you must be able to analyse and apply the legal principles to any given examination question. The ability to explain the legal reasoning of the courts is highly important. Even where the law is established through statute the ability to explain how the courts have interpreted and applied the legislation is fundamental. There are several areas of the law where there is judicial and academic debate and the ability to explain the development of the law may be necessary in fully answering an examination question.
Textbooks: These books collect the relevant legal materials and give a commentary on the area of the law and the primary materials. The most appropriate textbooks for this course are books on partnership law and company law. We will also, however, refer to various general principles of contract law, tort law, agency law and equity and trusts, and so you may also wish to refer to basic texts in these different areas, although a basic introduction to them is given in this subject guide.

Essential reading

There is no one book which covers the syllabus in sufficient detail. We have kept the essential books for purchase to a minimum; you may also need to consult other books in order to understand core principles. We recommend the following three for purchase:


Macintyre, E. Business Law. (Harlow: Pearson, 2010) fifth edition [ISBN 9781405899680]. This will give you an understanding of the basic concepts of commercial law, including the influence of common law and equity; core principles of contract law; agency law; and partnership law. There is also a useful introduction to some aspects of company law.

Detailed reading references in this subject guide refer to the editions of the set textbooks listed above. New editions of one or more of these textbooks may have been published by the time you study this course. You can use a more recent edition of any of the books; use the detailed chapter and section headings and the index to identify relevant readings. Also check the virtual learning environment (VLE) regularly for updated guidance on readings.

Recommended reading

It is recommended that you also have access to the following titles:


Further reading

Please note that as long as you read the Essential reading you are then free to read around the subject area in any text, paper or online resource. You will need to support your learning by reading as widely as possible and by thinking about how these principles apply in the real world. To help you read extensively, you have free access to the VLE and University of London Online Library (see below).

Much academic discussion can be found in legal journals and you are referred to:

Journal of Business Law

Company Lawyer.
Certain books also give a commentary on academic literature including the Sealy and Worthington text recommended above and:


We also specifically recommend the following three articles:

Kahn-Freund, O. ‘Some reflections on company law reform’, MLR 7(1/2) 1944, pp.54–66.

Materials to be consulted in the library

You will need to consult various statutes, or parts thereof. They are conveniently compiled in:


Other, similar publications are also available. New editions of statutory compilations tend to be published every year and you are advised to use the most recent edition.

If not available in the compiled form then the following will be needed for reference:

• Partnership Act 1890
• Insolvency Act 1986
• Limited Liability Partnerships Act 2000
• Companies Act 2006.

Statutes are available electronically on government websites or in the Online Library in Westlaw.

Online study resources

In addition to the subject guide and the Essential reading, it is crucial that you take advantage of the study resources that are available online for this course, including the VLE and the Online Library.

You can access the VLE, the Online Library and your University of London email account via the Student Portal at:
http://my.londoninternational.ac.uk

You should have received your login details for the Student Portal with your official offer, which was emailed to the address that you gave on your application form. You have probably already logged into the Student Portal in order to register! As soon as you registered, you will automatically have been granted access to the VLE, Online Library and your fully functional University of London email account.

If you forget your login details at any point, please email uolia.support@london.ac.uk quoting your student number.

The VLE

The VLE, which complements this subject guide, has been designed to enhance your learning experience, providing additional support and a sense of community. It forms an important part of your study experience with the University of London and you should access it regularly.

The VLE provides a range of resources for EMFSS courses:
• Self-testing activities: Doing these allows you to test your own understanding of subject material.

• Electronic study materials: The printed materials that you receive from the University of London are available to download, including updated reading lists and references.

• Past examination papers and Examiners' commentaries: These provide advice on how each examination question might best be answered.

• A student discussion forum: This is an open space for you to discuss interests and experiences, seek support from your peers, work collaboratively to solve problems and discuss subject material.

• Videos: There are recorded academic introductions to the subject, interviews and debates and, for some courses, audio-visual tutorials and conclusions.

• Recorded lectures: For some courses, where appropriate, the sessions from previous years' Study Weekends have been recorded and made available.

• Study skills: Expert advice on preparing for examinations and developing your digital literacy skills.

• Feedback forms.

Some of these resources are available for certain courses only, but we are expanding our provision all the time and you should check the VLE regularly for updates.

Making use of the Online Library

The Online Library contains a huge array of journal articles and other resources to help you read widely and extensively.

To access the majority of resources via the Online Library you will either need to use your University of London Student Portal login details, or you will be required to register and use an Athens login: http://tinyurl.com/ollathens

The easiest way to locate relevant content and journal articles in the Online Library is to use the Summon search engine.

If you are having trouble finding an article listed in a reading list, try removing any punctuation from the title, such as single quotation marks, question marks and colons.

For further advice, please see the online help pages: www.external.shl.lon.ac.uk/summon/about.php

Unless otherwise stated, all websites in this subject guide were accessed in June 2012. We cannot guarantee, however, that they will stay current and you may need to perform an internet search to find the relevant pages.

A note on understanding legal citations¹

Civil cases

The usual form of citation in civil cases is: claimant (plaintiff) v defendant (note italics):

Johnson v Phillips [1975] 3 All ER 682

‘v’ stands for versus but the case is normally referred to orally as Johnson and Phillips’ or Johnson against Phillips’.

¹ Reproduced from Learning skills for law by Howard Senter, Beverley Brown and Sharon Hanson (London: University of London, 2007).
Criminal cases
The usual form of citation in criminal cases is:
R v Lynch (1966) 50 Cr. App. R. 59
‘R’ stands for Rex (the King) or Regina (the Queen). This case would
normally be referred to orally as ‘the Crown against Lynch’ or just ‘Lynch’.

What citations mean
Let’s take the above two citations and break them down:
[1975] 3 All ER 682: the case is reported in the third volume of the 1975
issue of the All England Law Reports, and begins on page 682.
(1966) 50 Cr. App. R. 59: the case is reported in the fiftieth volume of the
Criminal Appeal Reports, which was published in 1966, and begins on page 59.
You’ll note that some dates are in round brackets, and some in square. This
relates to the usefulness of the date when looking for law reports. When
you see round brackets, look at the volume number next to it, as that’s all
you need to find the case (because volumes of that particular law report
began with volume 1 and go up consecutively with each report, and so
the year is for information only). Square brackets mean that the year is
important: to find the law reports containing that case, use the year. Often
each year’s reports are split up into volumes, numbered e.g. 1, 2 and 3.

Report abbreviations
These are some of the most common law report abbreviations:
All ER    All England Law Reports
WLR       Weekly Law Reports
AC        Law Reports: Appeal Cases
QB        Law Reports: Queen’s Bench Division
ECR       European Court Reports
EHRR      European Human Rights Reports
Cr. App. R. Criminal Appeal Reports

Examination advice
Important: the information and advice given here are based on the
examination structure used at the time this guide was written. Please
note that subject guides may be used for several years. Because of this
we strongly advise you to always check both the current Regulations
for relevant information about the examination, and the VLE where you
should be advised of any forthcoming changes. You should also carefully
check the rubric/instructions on the paper you actually sit and follow
those instructions.
Remember, it is important to check the VLE for:
• up-to-date information on examination and assessment arrangements
  for this course
• where available, past examination papers and Examiners’ commentaries
  for the course which give advice on how each question might best be
  answered.
At the end of this guide you will find a Sample examination paper. The
paper will have eight questions of which you are required to answer four.
Where a question has more than one part, you are usually required to
answer all parts. Some questions are essay-based and others problem-based. The latter describe a factual scenario and you will be required to advise one or other of the parties, or the question will ask for a discussion of an aspect of the area of the law. Read the question carefully and answer the question being asked.
Chapter 1: Sources of law and key concepts

Aims of the chapter

This chapter is intended as both an introduction to and a summary of certain basic principles of English law. This will aid the understanding of legal principles relevant to the understanding of the Law of Business Organisations. It will therefore:

• examine the sources of law
• examine the fundamentals of contract law, which is particularly important for the law of business organisations
• briefly explain the concepts of the law of tort, equity and trusts, crime and agency law.

The course does not examine these topics unless and to the extent that they are relevant to the study of law of business organisations, but the discussion here is intended to assist revision of the substantive issues in this course.

Learning outcomes

By the end of this chapter, and having completed the Essential reading and activities, you should be able to explain:

• the sources of law and the role of Parliament and the judiciary in the law-making process
• the rules of precedent and the hierarchical structure of the courts.

Essential reading


Sources of law: overview

Compared to other European countries, the distinctive features of the English legal system are:

1. Absence of a legal code

In most European countries, the law has been codified. This means that the whole of the law on a particular subject, for example commercial law, can be found in one document or code. In contrast, whilst an Act of Parliament in the UK may provide the main legal principles applicable to a particular case, the bulk of English law has been developed by judges in individual cases. The doctrine of precedent (see pages 14 and 15) has helped to develop consistency in approach.

Occasionally, Parliament codifies an area of the law with a statute, for example the Bills of Exchange Act 1882. Such Acts aim to take all the relevant case law on a particular subject and codify it into one comprehensive statute. The CA 2006 has attempted to codify the law on directors’ duties but the relevant sections of the Act specifically provide that the pre-2006 cases remain relevant to the application and interpretation of the duties and the courts will continue to have regard
to the common law and equitable principles. However, the majority of English law remains uncodified.

2. The law-making role of the judges

In most European countries, the judges interpret the legal code. They do not themselves deliberately set out to create law. The English courts are arranged in a hierarchical structure and lower courts must follow the previous decisions of superior courts. Senior English judges have a dual function:

- They interpret the existing law, which is to be found in legislation and previous decisions of the higher courts.
- They create and develop the law by making legal principles which the law courts are bound to follow.

As a result of the UK joining the European Economic Community, the British Parliament passed the European Communities Act 1972. This enacted that Community law should be applied in the UK courts and consequently the UK courts also have to have regard to EU legislation and judgments of the European Court of Justice.

3. Absence of Roman law

The Romans occupied England from 55BC to AD430 but English law has almost no Roman influence compared to other European countries whose civil law systems have their roots in Roman law. Scotland, although not conquered by the Romans, has a legal system based on Roman law.

4. Adversarial system of law

Most European countries have an inquisitorial system of trial where the judge is an inquisitor whose task is to discover the truth. A French examining magistrate, for example, takes over the investigation of a criminal case from the police. He can interrogate, compel witnesses to give evidence and call surprise witnesses. He will take a much more interventionist approach than an English judge, and it is the judge who manages the case, rather than the lawyers.

By contrast, an important aspect of the adversarial system of trial is that it is the task of the lawyers to bring the relevant legal rules to the attention of the court. For example, an English lawyer who states that goods sold in the course of a business must be of satisfactory quality must then provide legal authority for his statement.

The rules of English law come from a mixture of the following:

- legislation
- case law
- European Community law.

The courts draw on a variety of sources to give expression to the general standard of behaviour expected of companies, including rules of common law and equity, legislation and industry codes of practice. Important incentives for an industry to draw up codes of practice are public concerns and governmental pressure (backed by the threat of legislation). The Cadbury Committee (1991), which had no statutory backing, was set up jointly by the Stock Exchange, the Financial Reporting Council and the accountancy profession to consider the subject of ‘corporate governance’. Although not backed by statute, it became virtually obligatory for listed companies to adhere to because the Stock Exchange made it a requirement that every company should provide a statement with its accounts.
indicating whether or not it had complied with the Code and giving reasons for non-compliance. The Cadbury Report spawned a number of other committees: Greenbury (1995), Hampel (1998) and Higgs and Smith (2003). The Hampel Committee also undertook the work of producing a Combined Code, which was revised in 2010, which dealt with matters of corporate governance, incorporating rules of best practice from the Greenbury and Cadbury committees. The work of these committees has helped to determine and establish minimum standards of practice.

**Legislation: Acts of Parliament**

Acts of Parliament are called statutes. The theory of parliamentary sovereignty holds that Parliament has the power to enact, repeal or alter any law it pleases and that the courts cannot question the validity of such legislation. If there is a procedural defect in the course of the passage of a bill through Parliament then Parliament must remedy that matter. The task of the courts is to interpret and apply Acts of Parliament and thereby give effect to the expressed will of Parliament. In *British Railways Board v Picken* [1974] AC 765 the House of Lords expressed the view that: ‘when an enactment is passed, there is finality unless and until it is amended or repealed by Parliament. In the courts there may be argument as to the correct interpretation of the enactment: There must be none as to whether it should be on the statute book at all.’

Parliament cannot pass an Act to bind its successors. It cannot say, for example, that any subsequent provision repealing the law in question shall be void.

**Delegated legislation**

Some Acts of Parliament give or delegate powers to institutions such as the Crown, ministers, public corporations and local authorities to make legislation. This type of legislation is referred to variously as delegated legislation, subordinate legislation or secondary legislation. The Act of Parliament giving or delegating the power to legislate is known as the Parent Act.

Unlike Acts of Parliament, such legislation may be challenged in the courts, for example on the grounds that it is ultra vires, and so the courts may examine the delegated legislation to see if the enabling Act actually empowered the subordinate body to make such laws. Additionally, there are arrangements for some parliamentary control of delegated legislation, often taking the form of provisions for parliamentary scrutiny. Delegated legislation can save a lot of parliamentary time and is particularly appropriate if the subject matter is either very detailed or highly technical, or calls for local knowledge. Such legislation can be altered relatively quickly without the need for parliamentary debate.

**Approaches to statutory interpretation**

When considering the meaning of legislation, a court may adopt one of three rules of statutory interpretation:

- **The literal rule.** Where the meaning of the statutory words is plain and unambiguous, the judges must give those words their plain meaning.
- **The golden rule.** The court will allow itself to construe a statute in such a way as to produce a reasonable result even if it means departing from the prima facie meaning of the words. This rule allows the courts
to prefer a sensible meaning to an absurd meaning where both are possible in interpreting a statue.

- The mischief rule. This allows the courts the look at the common law and determine what mischief the statute was intended to remedy; the act is then construed in such a way as to remedy the mischief.

These rules contradict each other to a certain extent and it cannot be certain which rule a court will apply. The courts tend to use whichever rule seems best suited to achieving justice in the case before them.

Judicial precedent

The doctrine of judicial precedent (stare decisis) holds that judges in lower courts are bound to follow legal principles previously established by judges in the higher courts. Much of the common law has been developed through the doctrine of precedent.

The courts are arranged in a hierarchical structure:

**The Supreme Court (formerly the House of Lords)**

The Supreme Court is the most senior of the English courts. The Supreme Court is not bound to follow any previous precedents but the decisions of the Court are absolutely binding on all inferior courts. Until 1966 the House of Lords, as it was then named, was bound to follow its own previous decisions. A Practice Statement issued by the Law Lords (the judges who sit in the House of Lords) in 1966 stated that Their Lordships recognised that if the doctrine of precedent was too rigidly applied, the development of the law might be hindered and injustice might result in a particular case. The House of Lords, now the Supreme Court, would therefore normally treat its own decisions as binding, but would depart from such decisions where it appeared right to do so. In doing this, Their Lordships would bear in mind the danger of disturbing agreements previously entered into. In reality, the Law Lords only rarely depart from one of their own previous decisions.

**The Court of Appeal**

The decisions of the Court of Appeal are binding on all lower courts and also binding on future Court of Appeal judges. In practice, decisions of the Court of Appeal are extremely important as it hears many more appeals than the Supreme Court. Nevertheless, the Supreme Court will hear cases of greater public importance and its decisions have the greatest authority.

In Young v Bristol Aeroplane Company Ltd [1944] KB 718 it was decided that the Court of Appeal could depart from its own previous decisions in three circumstances:

- Where there were two conflicting earlier Court of Appeal decisions, the court could decide which one to follow and which one to overrule.
- If a previous Court of Appeal decision had later been overruled by the House of Lords (now the Supreme Court), the Court of Appeal should not follow it.
- A previous Court of Appeal decision should not be followed if it was decided through lack of care, ignoring some statute or other high-ranking authority such as a previously decided House of Lords (now the Supreme Court) case.
Although these principles apply both to the Civil and Criminal Divisions of the Court of Appeal, it is generally recognised that the Criminal Division has slightly wider powers to depart from its own previous decisions, especially where justice would otherwise be denied to the appellant.

The Court of Appeal is normally comprised of three judges known as Lord Justices of Appeal. Sometimes a full court of five judges may sit in the Court of Appeal.

The High Court

Judges sitting in the High Court are bound by decisions of the House of Lords (now the Supreme Court) and the Court of Appeal. Decisions of the High Court bind all lower courts. High Court judges are not bound by the decisions of other High Court judges, although they do tend to follow each other’s decisions so as not to lead to uncertainty in the law.

The High Court is divided into three Divisions: The Queen’s Bench Division, the Chancery Division and the Family Division. Each of these three divisions of the High Court has a divisional court, staffed by three High Court judges. The divisional courts hear appeals from lower courts and decisions of the divisional courts are binding on other judges of the divisional court (subject to the exceptions in Young v Bristol Aeroplane Company Ltd), on High Court judges sitting alone and on all lower courts.

The lower courts

The decisions of the lower courts (the Crown Court, the County Court, the Small Claims Courts and the Magistrates Court) are not binding on any other courts. Judges in these courts do not make binding precedent.

All English courts must take into consideration decisions of the European Court of Justice on European Community law. The European Court of Justice does not use a system of precedent. However, decisions of this court are binding on all English courts.

We look in more detail at the European Court of Justice on p.17, and at the structure of the civil courts on pp.18–19.

The binding power of a judgment

The ratio decidendi (the reason for the decision) is the part of a judgment that is binding on other courts. The ratio decidendi could be described as any statement of law which the judge applied to the facts of the case and on which the decision was based. The ratio of a case will be decided by courts subsequently reviewing/applying the cases when considering whether or not they are bound by the earlier case. Cases may contain more than one ratio.

Statements of law which do not form part of the ratio of the decision are known as obiter dicta (things said ‘by the way’, i.e. in passing). Obiter can arise as statements of law based on facts that did not exist in the particular case (e.g. a judgment may state what the law would have been if the facts had been different in some material way). Statements of law, which are wider than is necessary to deal with the facts of the particular case, are also obiter dicta. Such statements are not binding on lower courts but may be considered persuasive.

The impact of the judgments of the European Court of Justice and the effect of opinions delivered by the European Court of Human Rights are discussed on p.17.
Custom

In Anglo-Saxon times, custom (patterns of behaviour recognised and enforced by the courts) was the principal source of law. General customs (i.e. those that are observed throughout the land) have either fallen into desuetude or become absorbed into judicial precedent or statute, but local custom (i.e. customs operative in a particular locality or among a particular group of people in a locality) are even now occasionally recognised by the courts as establishing local law which may be at variance with the general law of the land – although it must not be contrary to statute or to a fundamental principle of common law.

European Union law

The United Kingdom joined the European Economic Community (EEC) in 1973. In order to be admitted as a member of the EEC, the UK Parliament passed the European Communities Act 1972. This enacted that Community law should be applied in British courts. In 1992, the Treaty on European Union (the Maastricht Treaty) renamed the EEC as the European Community (EC). As a matter of convenience, the Community is referred to as the EC rather than the EEC even in relation to matters that occurred before the Maastricht Treaty.

In 1986, the 12 EC Member States signed the Single European Act, which was designed to remove all barriers to a single market by 1992. The Act also strengthened the powers of the European Parliament and created a Court of First Instance to share the workload of the European Court of Justice. In 1992, the Treaty on European Union (the Maastricht Treaty) was signed by the then 15 Member States. The Treaty proposed the creation of a European Union with the three following pillars:

- the European Community
- a common foreign and security policy
- cooperation in the fields of justice and home affairs.

The Treaty gave the European Parliament greater power to legislate and set a timetable for Economic and Monetary Union. The Treaty of Amsterdam was signed in October 1997 and came into force in May 1999. This Treaty aimed for closer political cooperation between the Member States and incorporated much of the justice and home affairs pillar into the EC Treaty, reducing the power of Member States to veto proposals that would affect their national interests.

Sources of EU law

Some EU legislation is directly applicable. This means that it automatically forms part of the domestic law of Member States. However, for claimants to rely on the legislation in the domestic courts it must be capable of having direct effect within Member States. Where EU legislation has direct effect an individual can rely on it directly, either as a cause of action or as a defence, in the domestic courts in his country.

- Treaty articles are directly applicable, as are EU Regulations, but do not necessarily have direct effect. EU legislation cannot have direct effect in Member States unless it satisfies the criteria laid down in Van Gend en Loos v Nederlands Administratie der Belastingen [1963] ECR 1, which provides that the legislation must be sufficiently clear, precise and unconditional. If the legislation does not satisfy these requirements
it can only have direct vertical effect (i.e. an individual can invoke it against the state and government departments) but not direct horizontal effect (i.e. it cannot be invoked between private parties).

• **Regulations** are binding in their entirety and are directly applicable in all Member States without further implementation by the Member State. A Regulation may specify the date on which it is to come into effect; otherwise it will come into effect 20 days after the date of its publication in the Official Journal of the Union.

• **Directives** are addressed to the government of Member States and must be published in the Official Journal of the European Union. Directives are not directly applicable; it is left to each Member State to implement the objectives of the Directive in a manner and form best suited to its own particular political and economic culture. Once an EU Directive has been implemented by the Member State, individuals can invoke the domestic legislation against other individuals.

• **Decisions** are addressed to one or more Member State, to individuals or to institutions. They are binding in their entirety without the need for further implementation by Member States and can only be invoked against the person to whom they are addressed.

• The European Commission has the power to make **recommendations** and **opinions**. These have no binding legal force. Where a Member State passes legislation to comply with a decision or an opinion, a national court may refer a case to the ECJ to see whether it applies and how it should be interpreted.

### The European Court of Justice (ECJ)

The judges of the ECJ are appointed by consent of the Member States and hold office for a renewable six-year term. All the judges, without any indication of dissent, sign the decisions of the court.

EU law can only be effective if it overrides national law. In *Costa v ENEL* [1964] ECR 585 the ECJ stated that the EC Treaty had become a part of the legal systems of the Member States and that the courts of the Member States were bound to apply the treaty. The ECJ also stated that Member States had, by signing the treaty, limited their sovereign rights within limited areas and created a body of law which they are bound to follow.

### The European Convention on Human Rights/the Human Rights Act 1998

In 1951 the UK ratified the European Convention on Human Rights. The Human Rights Act 1998 (which gave effect to the Convention on Human Rights) came into effect in the UK in October 2000. Section 2(1) of the Act states that a court or tribunal determining a question arising in connection with a Convention right must take into account any judgment, decision, declaration or opinion of the European Court of Human Rights. The Act preserves the sovereignty of Parliament by stating that the court is required to take these decisions into account, rather than absolutely binding the UK courts by such decisions.

Section 6(1) provides that ‘it is unlawful for a public authority to act in a way which is incompatible with a Convention right’. In other words, the Human Rights Act creates an enforceable duty on ‘public authorities’ to act in a manner which is compatible with the Convention rights. ‘Public authority’ includes ‘any person certain of whose functions are of a public
nature’, but not if that person is acting privately. Parliamentary debates make it clear that ‘core public authorities’ (House of Lords debate 24 November 1997, cols. 809–11) such as government departments, the Home Office, the Ministry of Justice, local authorities, social services, the police, the Crown Prosecution Service, HM Revenue and Customs, Trading Standards and the Criminal Cases Review Commission are within the scope of s.6 of the Human Rights Act. Significantly, ‘courts and tribunals’ are also designated as public authorities and therefore have to comply with s.6.

Section 7 of the Act confines the class of persons who may bring proceedings against a breach of a Convention right to those who are ‘victims’ of an unlawful act.

The court system

The civil courts

The civil courts are arranged in a hierarchical structure and any civil dispute coming before the courts will commence either in the County Court or in the High Court. From either of these courts there is an appeal to the Court of Appeal, and from there to the Supreme Court.

The County Court

The County Court has unlimited jurisdiction in respect of business disputes which involve a claim for breach of contract or a claim in tort. The High Court also has unlimited jurisdiction to hear contract and tort cases where the claim is for pure financial or economic loss of more than £15,000. If the claim includes one for personal injuries, the claim must be for at least £50,000. The value of the action is the amount that the claimant reasonably expects to recover. However, there is a presumption that even actions where the claim is for more than £15,000 should start in the County Court, rather than the High Court. This presumption may be rebutted and the action commenced in the High Court because:

- It is for an amount of money which exceeds the High Court minimum limit.
- The claimant believes that the case is sufficiently complex to warrant an action in the High Court.
- The outcome is of general public importance.

The County Court can also hear equity actions where the value of the trust or estate is not more than £30,000, or claims for salvage which do not exceed £15,000, as well as certain divorce matters and certain bankruptcy and insolvency matters.

The County Court does not have responsibility for enforcing its judgment. Enforcement is left to the person in whose favour the judgment was given, the judgment creditor.

The High Court

The High Court is divided into three divisions: the Queen’s Bench Division, the Chancery Division and the Family Division. The Chancery Division hears matters which originated in equity (e.g. bankruptcy, mortgages, trusts, wills, company law and partnership law issues). It includes two specialist courts, the Companies Court and the Patents Court. The Queen’s Bench Division deals with contract and tort cases and includes the Commercial Court and the Admiralty Court. The Family Division is
concerned with family matters. Any of the three divisions can transfer a case to another division.

**The Court of Appeal (Civil Division)**
The Court of Appeal is divided into the Civil Division and the Criminal Division. The Court of Appeal (Civil Division) hears appeals from the High Court but not appeals from the divisional court. Permission to appeal must be granted. The Court of Appeal also hears appeals from the County Court.

**The House of Lords (renamed the Supreme Court)**
The House of Lords, renamed the Supreme Court on 1 October 2009, is the Supreme Appellate Court in Great Britain and Northern Ireland. It hears appeals from the Court of Appeal. The Court of Appeal will hear an application for leave to appeal to the House of Lords (now the Supreme Court) and refer it to an Appeal Committee of three Law Lords. The House of Lords (now the Supreme Court) also hears appeals from the Scottish Court of Session and, occasionally, from the High Court when a special ‘leapfrog’ procedure is invoked.

Five Law Lords generally hear appeals to the House of Lords (now the Supreme Court). Seven judges may sit to hear an appeal if a case is considered to be of particular importance, as happened in *Pepper v Hart*.

**Alternative dispute resolution**
Litigation should always be a last resort for a business. Legal action is both costly and lengthy and may lead to intrusive publicity. Alternative dispute resolution methods may therefore be preferred as a means of resolving disputes. Arbitration, mediation and conciliation are potential alternatives to litigation.

**Activity 1.1**

i. Explain the effect of the doctrine of precedent.

ii. What is a *ratio decidendi*?

iii. What is the role of Parliament in making law and how is this role different from that of the courts?

*Feedback: p.20.*
Feedback to activities

Feedback to Activity 1.1

i. You are required to look at the rules under which decisions of the higher courts bind the lower courts. The courts are bound by the doctrine of precedent and the hierarchal structure of the courts.

ii. The ratio decidendi is that part of a judgment which is legally binding and forms a precedent for later courts to follow.

iii. You need to know the function of Parliament in the law-making process - how legislation is passed, the effect of legislation and its duration. The main point to note is that Parliament is a law-making body, although it does have the power to delegate its legislative functions, while the courts both interpret and apply the law.

A reminder of your learning outcomes

Having completed this chapter, and the Essential readings and activities, you should be able to explain:

- the sources of law and the role of Parliament and the judiciary in the law-making process
- the rules of precedent and the hierarchical structure of the courts.
Aims of the chapter

This chapter is intended as both an introduction to and a summary of certain basic principles of English law. This will aid the understanding of the legal principles relevant to the law of business organisations. The chapter will:

• examine the fundamentals of contract law, which is particularly important for the law of business organisations
• briefly explain the concepts of the law of tort, equity and trusts, crime and agency law
• deal with the relevance of these areas of the law to the law of business organisations although the application of these principles of law will only become clearer as you study the module in more detail.

The course examines these topics to the extent that they are relevant to the study of the law of business organisations. The discussion here is intended to assist revision of the substantive issues in this course.

Learning outcomes

By the end of this chapter, and having completed the Essential reading and activities, you should be able to explain:

• the rules relating to the formation of a contract, the terms of a contract and the effect of breach
• the differences between the law of tort, contract and criminal law
• the differences between common law and equity
• the basic rules of the laws of contract, tort, crime and trusts and discuss their effects on business.

Essential reading


The law of contract

The law of contract is fundamental to business transactions. Although the formation of a registered company is governed by legislation, contract law will govern many fundamental aspects of its relations and dealings. Thus, the relationship between the management, its shareholders and employees when the company is incorporated will be regulated by contract, as will dealings between the company and outsiders. In the case of other business units, the existence of the business is regulated by contract; for example, in the case of an ordinary partnership the nature of the partnership, the relations between the partners, their rights of management and so on are all governed by the rules of contract law.

Contracts are made through a process of offer and acceptance whereby one of the parties (the offeror) makes an offer which sets out the terms which will form the basis of a legally binding agreement, if such terms are accepted by the other party (the offeree). Generally, the offer must be made with the intention of forming legally binding relations. If the offeree
accepts (by indicating consent to be bound by the terms of the offer) a legally binding contract will come into existence. An offer can be written or communicated orally, or may be inferred from the conduct of the offeror (e.g. where goods are bought at auction). An offer must, therefore, be distinguished from an ‘invitation to treat’ (an invitation to enter into negotiations which may lead to an offer). The main significance of an invitation to treat is that it is not an offer capable of acceptance. Examples of an invitation to treat:

- The display of goods in a shop window amounts only to an invitation to treat: Fisher v Bell [1961] 1 QB 394.
- The display of goods on shelves in a self-service shop (like the display of goods in a shop window) is an invitation to treat: Pharmaceutical Society of Great Britain v Boots Cash Chemists (Southern) Ltd [1953] 1 QB 401.
- Advertisements. Whether an advertisement is an offer or an invitation to treat depends on the intention with which it is made. If an advertisement amounts to an offer, the contract is concluded when people respond in such a way that they accept the offer (e.g. by conduct). If an advertisement is only an invitation to treat (which is usually the case), a response to the advertisement cannot form a binding contract: Partridge v Crittenden [1968] 1 WLR 1204. However, some advertisements do amount to offers: Carlill v Carbolic Smoke Ball Company [1893] 1 QB 525.

**Acceptance of an offer**

Once an offer is accepted, a contract comes into existence and both sides are legally bound by it.

An acceptance must, however, be clear and unequivocal. Acceptance can be by words or conduct and must be communicated to the offeror: Entores Ltd v Miles Far East Corporation [1955] 2 QB 327. Telex and fax messages sent during office hours are regarded as instantaneous communications and are subject to the same principles as oral acceptances; they take effect when printed on the offeror’s telex or fax machine: Brinkibon Ltd v Stahag Stahl Und Stehlwarenhandel GmbH [1983] 2 AC 34.

Where the offeror requires the acceptance to be in a particular form then an acceptance in some other way may be effective so long as it is no less advantageous to the offeror than the prescribed method: Tinn v Hoffmann (1873) 29 LT 271. However, if the offer states that the acceptance may only be made in a specified manner then the offeree must comply with that method of acceptance, unless the offeror waives the required method of acceptance.

**The postal rule**

It may be extremely important to know exactly when an acceptance becomes legally effective. The offer can be revoked at any time before acceptance (unless consideration is given to hold the offer open for a specific period): Dickinson v Dodds (1876) 2 Ch D 463. When the acceptance takes place by letter or telegram, the postal rule will apply. This states that the acceptance of an offer by post is effective as soon as the letter is properly posted or, in the case of a telegram, when sent: Adams v Lindsell (1818) 1 B & Ald 681.
Chapter 2: An introduction to law

Counter-offer
An acceptance of an offer must be unqualified and unconditional. Acceptance on terms, which effectively amounts to a material alteration of the terms of the offer, may amount to a counter-offer. The effect of such a counter-offer will be to reject the original offer and substitute that offer with the terms of the counter-offer: Hyde v Wrench (1840) 3 Deav 334.

Certainty of terms
A contract will only come into existence if the offer which is accepted contains all the essential terms of the contract. A court must be able to identify with certainty what has been agreed between the parties and the basis of that agreement.
In deciding whether or not the terms of the agreement are sufficiently certain, the courts take an objective approach by asking whether a hypothetical reasonable person would have thought that the agreement was sufficiently certain.

Termination of offers
An offer can terminate at any time prior to acceptance, including by revocation, rejection, lapse of time or death of the offeror or offeree. A revocation is effective only when the offeree receives it.
A revocation will generally be communicated to the offeree by the offeror or his agent, although the courts have held an offer to have been revoked through communication by an unauthorised but reliable third party: Dickinson v Dodds [1876] 2 Ch D 463. If an offer is to be revoked by rejection, that rejection by the offeree needs to be communicated to the offeror.

Intention to create legal relations
The existence of an offer and acceptance will only lead to a legally binding contract if the offeror and the offeree intended to create legal relations.
When deciding whether or not there is an intention to create legal relations the courts divide agreements into two classes:
• business and commercial agreements
• social and domestic agreements.
In respect of business and commercial agreements there is a presumption that the parties intend to enter into a legally binding contract, whereas in the case of social and domestic arrangements the presumption is that there is no such intention. Either of these presumptions can be rebutted by evidence to the contrary. In a business and commercial arrangement, therefore, an offeror or offeree will need to introduce evidence to rebut the presumption that they intended to enter into legally binding relations.
If parties to a commercial contract make it clear that they do not intend their agreement to form a binding contract, this will override the presumption to enter into legal relations: Rose & Frank v Crompton Bros [1925] AC 445.
When considering whether or not a social or domestic arrangement amounts to a contract, the courts will presume that the parties did not intend to create legal relations. However, this presumption can be rebutted by evidence and the circumstances of the case will be examined to ascertain the intention of the parties: Jones v Padavanton [1969] 1 WLR 328.
Consideration

A contract is a bargain, the essence of which is that each party will give up something in order to get something they want. This concept underpins the idea that a contract will only come into existence if each party to the contract furnishes consideration. Consideration is thus the price paid to get the benefit of the contract: Currie v Misa [1875] LR 10 Ex 153. Consideration consists either in the giving of a benefit or the suffering of a loss; for example, in a contract of sale of goods, the buyer's consideration is the promise to pay the price whilst the giving of this promise is of benefit to the seller.

A contract which is not made by deed is known as a simple contract, and consideration must be given in respect of such simple contracts. An agreement made by deed is enforceable as a specialty contract without the need to provide consideration.

Privity of contract

The doctrine of privity of contract is based on two rules:

• Only a party to a contract can take the benefit of that contract or claim rights under it.
• A contract cannot impose obligations on a third party, so that a contractual obligation cannot bind a third party or be enforced against him.

The rule that someone who is not a party to the contract cannot enforce the contract is subject to significant exceptions under the Contracts (Rights of Third Parties) Act 1999. This Act does not abolish the privity rule but allows a third party in some circumstances to enforce a term of the contract.

Section 1 sets out two circumstances in which a third party may enforce terms of a contract entered into by the promisor and the promisee. The promisor is defined as the party to the contract against whom the term is enforceable by the third party. The promisee is defined as the party to the contract by whom the term is enforceable against the promisor.

Thus, for example, where a shop sells goods to X which are not of satisfactory quality, the Contract (Rights of Third Parties) Act may allow Y (third party) to sue the shop. The shop is the promisor, X is the promisee and Y is the third party.

Section 1(1) of the Act provides that a third party to a contract may, in his own right, enforce a term of the contract if:

• the contract expressly provides that he may so do; or
• the term purports to confer a benefit on him (unless on a proper construction of the contract the parties did not intend the term to be enforceable by the third party).

The third party must be expressly identified in the contract either by name or as a member of a class (e.g. through a reference to ‘the employees’ of the party) or as answering a particular description. The third party need not be in existence at the time the contract is entered into (e.g. an unborn child can benefit under s.1).

When a benefit is conferred on a third party by the Act, the third party can avail himself of any remedy which would be available to him had he been a party to the contract, for example damages, an injunction or specific performance. The third party can also avail himself of exclusion or limitation clauses.

1 A deed is a legal document used to grant or transfer a right. In order to be valid, a deed must conform with certain formal requirements.
Section 3(6) of the Act provides that where a third party seeks the protection of an exemption clause in reliance on s.1, he may not do so if he could not have relied on such an exemption clause had he been a party to the contract. Thus, for example, if an exemption clause is held ineffective between the parties to the contract because of the provisions of the Unfair Contract Terms Act 1977, the third party cannot similarly rely on it.

Section 2 of the Act provides that where the third party does gain rights under s.1 to enforce a term of a contract, the parties to the contract may not generally rescind or vary the contract in such a way so as to extinguish or alter the third party's right without his consent. However, this is only the case if a third party has communicated his assent to the contract to the promisor, or if the promisor knows that the third party has relied on a term, or if the promisor should reasonably have foreseen that the third party would rely on the term and the third party has in fact relied on it.

Formalities

Although most commercial contracts are made in writing, there is no legal requirement that this must be the case. Generally, contracts do not need to be made in any particular way. However, there are some exceptions to that rule:
- A conveyance of a legal estate in land must be by deed.
- The creation of a lease of over three years' duration must be by deed.
- The promise of a gift is not enforceable unless made by deed.

Capacity

Generally everyone has full contractual capacity. However, minors (persons under the age of 18) may have limited capacity in some cases (Family Law Reform Act 1969):
- Where necessaries are delivered to a minor, he must pay a reasonable price for them. Section 3(3) of the Sale of Goods Act 1979 defines necessaries as 'goods suitable to the condition in life of the minor...'
- A minor can also validly make a contract of employment as long as the contract is overall beneficial to the minor.
- Contracts giving a minor an interest of a permanent nature (e.g. which impose a continuing liability on a minor) are avoidable by the minor either before he reaches 18 or within a reasonable time (e.g. contract of partnership; contracts to buy shares; contracts to take a lease of land).
- All other contracts are not binding on a minor. However, a minor will only be able to recover any money paid or property delivered under such a contract if there has been a total failure of consideration.

Corporations

Corporations have full contractual capacity (see Chapter 6).

Contractual terms

The terms agreed by the parties will define the scope of the obligations and promises contained in the contract. Express terms are those which are actually agreed between the parties either in words or in writing. Sometimes these may amount to representations, although not all exchanges between the parties form part of the legally binding contract. Additionally, terms may be implied into the contract either by the courts or by statute.
Where there has been a breach of a contractual term this will give the injured party the right to sue for damages and even perhaps to repudiate the contract. The nature of the remedy will depend upon the class of term that has been breached:

- Where there is a breach of **warranty**, the breach is not so serious that it goes to the root of the contract, and the injured party is entitled to sue for damages only.

- Where there is a breach of **condition**, the injured party may repudiate the contract and sue for damages because the breach is sufficiently serious to undermine the whole contract. The injured party may, however, treat the breach of condition as a breach of warranty and merely sue for damages.

- Where there is a breach of an **innominate term**, whether or not the injured party is entitled to repudiate the contract will depend on the severity of the consequences that flow from the breach.

Exemption or exclusion clauses are terms in a contract which try to exclude or exempt a party's liability for breach of contract. The Unfair Contract Terms Act 1997 has limited the effect of exemption and exclusion clauses and the Unfair Terms in Consumer Contract Regulations 1999 have provided additional protection to consumers faced with unfair terms.

The courts may also render an exclusion clause invalid, either by holding that the clause is not a term of the contract in question or by finding that the clause did not exclude liability for the particular breach that occurred. One of the fundamental rules of contract law is that parties are free to contract on whatever terms they agree. Additionally, where the parties freely enter into a written agreement which contains an exclusion clause then, following the doctrine of freedom of contract, that exclusion clause is binding.

However, the courts have recognised the unfairness of exclusion clauses and the fact that the party with the greater bargaining power in reality inserts exclusion clauses into contracts: Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd [1986] AC 80. Such cases usually involve a consideration of what is customary in a trade or what are the reasonable expectations of a party in order to determine whether a clause is unusually wide or onerous.

**The Unfair Contract Terms Act 1977**

Despite earlier attempts of the courts to restrict the scope of the exclusion or limitation clauses, the Unfair Contract Terms Act 1977 (UCTA) was passed to give additional protection to control the effect of exclusion clauses. The 1977 Act is not confined to consumer contracts and this is particularly relevant to the provision of banking services.

**Liability for negligence**

Section 2(1) of the 1977 Act provides that a person cannot by reference to a contractual term or to a notice exclude or restrict his liability for death or personal injury resulting from negligence. Section 2(2) provides that liability for other types of loss or damage caused by negligence (e.g. damage to goods) cannot be excluded except in so far as the term or notice satisfies the requirements of reasonableness. The result of s.2(2) is that a business cannot, by reference to any contract or term, or to a notice given to customers generally or to particular customers, exclude or restrict its liability for negligence unless the reasonableness test is satisfied.
Negligence is defined to mean any breach arising from the express or implied terms of a contract to take reasonable care or exercise reasonable skill in the performance of a contract, or of any common law duty to take reasonable care or exercise reasonable skill (e.g. as an agent).

**Contractual performance**

Section 3 of UCTA applies to two categories of persons:

- those who could deal as a consumer
- those who deal on the other party's written standard terms of business (commercial contracts are potentially caught under this category).

A party to a contract deals as a consumer in relation to another party if (a) he neither makes the contract in the course of a business nor holds himself out as doing so and (b) the other party does make the contract in the course of a business, and the goods are of a type ordinarily supplied for private use or consumption:

\[ R \text{ and } B \text{ Customs Brokers Ltd} \text{ v } \text{United Dominions Trust Ltd [1988] 1 All ER 847} \]

**The requirements of reasonableness**

A term which excludes or restricts liability can only be effective if it satisfies the requirements of reasonableness. The term must have been a fair and reasonable one to include having regard to the circumstances which were or should reasonably have been known to or in contemplation of the parties.

Whether the provisions are reasonable is to be determined at the time the contract is made so that the extent of any loss cannot itself be taken into account (s.11(1)). The onus is on the business to establish that the test is satisfied (s.11(5)). In deciding whether the terms are reasonable, the courts will have regard to a wide range of factors, including those set out in Schedule 2 to the Act. These include: the respective bargaining power of the parties; whether the terms were negotiated (not necessarily between the parties themselves but between representatives, for example, of a bank and of consumer groups); the degree of notification given to the customer; and the length of the contract. Section 11(4) allows the courts to take into account the resources and other factors (e.g. ability to obtain insurance) to be considered in the reasonableness of limitations on the amounts payable on liability for damages.

**The Unfair Terms in Consumer Contracts Directive**

The Unfair Terms in Consumer Contracts Regulations 1999 implement the EU Directive on Unfair Terms. The Regulations leave in place existing UK law and add an additional layer of regulation to consumer contracts. As such they affect the regulation of consumer contracts, but not commercial contracts.

The Regulations apply to any term in a contract between a supplier and a consumer. A consumer is defined as a natural person (and not therefore a company) who is acting for purposes which are outside his trade, business or profession.

Since the Regulations do not require a consumer to be acting wholly outside the business, it would appear that so long as one or more purposes are outside that person's business, he could still be a consumer despite there being a business purpose to the transaction. Thus, for example, in the banking context a small trader with just one current account for both his business and personal matters will still be treated as a consumer.
Additionally, a professional person borrowing for home renovations which are to include a new study so that he does not have to travel to work every day, or a wife who holds shares in her husband’s business, giving the bank security over her share in the matrimonial home for his business, will be treated as a consumer.

**Terms not individually negotiated**

Regulation 5(1) provides that ‘a contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the party’s rights and obligations arising under the contract, to the detriment of the consumer.’

Even if a specific term or certain aspects of it have been individually negotiated, the Regulations apply to the rest of the contract if an overall assessment of it indicates that it is a pre-formulated standard contract. Under the Regulations, the onus of establishing that a term was individually negotiated is on the supplier. Clauses from precedents, manuals, or even one previous agreement would be treated as drafted in advance and therefore be regarded as not having been individually negotiated under the regulations.

**Exclusion of core provisions**

Regulation 6(2) provides that the core provisions of a contract cannot be questioned. In other words, it is only the subsidiary terms of a contract which can be challenged as unfair, although in assessing the fairness of a particular contractual term, the courts may refer to all the other terms of the contract, including core provisions. The terms which are not capable of review under the Regulations are those which relate to ‘the definition of the main subject matter of the contract’ or ‘the adequacy of the price and remuneration’.

**Unfair terms**

To be unfair under the UTCC Regulations, a term must be contrary to the requirement of good faith and must cause a significant imbalance against the consumer. The requirement of good faith in this context is one of fair and open dealing.

Openness requires that the terms be expressed clearly and legibly. Appropriate prominence should be given to terms which might operate at a disadvantage to the consumer.

Fair dealing requires that a supplier should not, whether deliberately or unconsciously, take advantage of the consumer’s necessity, lack of experience of unfamiliarity with the subject matter of the contract, weak bargaining position or other factors listed in Schedule 2: Director General of Fair Trading v First National Bank Plc [2001] AC 481 at 494.

The lack of good faith must cause a significant imbalance in the parties’ rights and obligations under the contract, to the detriment of the consumer. The obvious imbalance between a supplier and a consumer is not the immediate focus of the enquiry, although it may be the reason for the imbalance in the rights and obligations. What the courts are interested in is the imbalance in contractual rights and obligations (e.g. in a default clause in a loan agreement, the scope of the supplier’s rights must be assessed in terms of the clause itself and other aspects of the facility).
Void and voidable contracts

A contract, although otherwise valid, may be unenforceable if, for example, it is illegal either because the purpose of the contract is unlawful or the method of performance intended is illegal. A contract the purpose of which is illegal is unenforceable and therefore void, with the result that neither party can enforce it. Historically, contracts entered into by a company in excess of its objects were deemed to be ultra vires (beyond the powers of the company) and void on the basis of lack of capacity, and therefore unenforceable by either the company or the third party. As neither party could enforce such contracts, neither party could sue for loss.

These contracts may be contrasted with voidable contracts, which are valid and binding until set aside by the innocent party. Historically, the common law would hold a document voidable if it was executed under duress (e.g. as a result of the threat of unlawful physical violence). In recent years the doctrine of economic duress has also been recognised if the pressure amounts to ‘coercion of the will so as to vitiate consent’. Occidental Worldwide Investment Corpn v Skibs A/S Avanti [1976] 1 Lloyd’s Rep 293. In the case of contracts entered into with a registered company the harshness of the ultra vires rule was tempered by the European Communities Act 1972, which allowed the innocent third party who entered into a contract with a company in ‘good faith’ to treat the contract as voidable; that is, the contract was treated as valid unless the third party sought to set it aside.

Law of tort

In addition to the rules of contract law, the rules of the law of tort may also be fundamental to relations governing business organisations. Although the courts have traditionally been reluctant to strike down contracts as unreasonable or unfair, they have intervened where exemption clauses have sought to insulate people from liability for personal injury or death by negligence, or where taking a number of considerations into account the clause is deemed to be unreasonable (UCTA 1977).

A tort is a civil wrong, other than a breach of contract, which renders the defendant liable for his conduct unless he has some valid defence for his actions. Tort is one part of the law of obligations, which tells us when others are liable for wrongs. The other parts are the law of contract and unjust enrichment. Whereas liability in contract is undertaken voluntarily, (i.e. by agreement), liability in tort is imposed by the law on the basis that certain types of behaviour warrant the imposition of tortious liability. If a person is injured by the conduct of another then the injured may bring a legal action for compensation under the rules of the law of tort. Thus, for example, a motorist driving carelessly who knocks over a cyclist may be held liable to compensate the cyclist for injury to his person or bicycle. In almost all cases liability in tort will only be imposed if the person’s conduct does not match up to objective standards, that is, if the person can be said to be negligent either in his personal capacity or professional activity. Thus, directors of a company owe a duty to exercise reasonable skill and care in the discharge of their professional activities (see Chapter 8).

Negligence is an important tort which extends to govern standards of behaviour in the social, personal, business and economic context. In order to establish the tort of negligence the claimant must prove three things:

- that the defendant owed a duty of care;
• that the defendant breached that duty; and
• that it was reasonably foreseeable that damage would be caused by the
defendant’s breach of duty.

Merely owing a duty is not enough for liability to be imposed – the
person owing the duty must act in a manner which amounts to a breach
of that duty and a breach will occur if he has not acted in a reasonable
manner as judged by the standard of the reasonable person. In deciding
whether or not a duty of care was breached, the state of scientific and
technical knowledge which prevailed at the time may be an important
consideration: Roe v Minister of Health [1954] 2 All ER 131.

As a claim for negligence is a civil action, the burden of proof is on the
claimant; he will only recover damages if he can prove that he suffered
a loss and the defendant’s breach of duty caused this loss. Whether
the defendant’s conduct caused the breach is a factual matter which
is generally assessed on a ‘but for’ test: but for the defendant having
breached the duty, the claimant would not have suffered the injury in
respect of which he is claiming.

Finally, the damage suffered by the claimant must be a type of damage
which is reasonably foreseeable, otherwise it will be regarded as too
remote. However, the extent of the damage need not be foreseeable: The

Although tort damages are concerned with compensation in respect
of injury to the person and damage to property, damages may also be
recoverable in respect of economic loss which is the direct consequence
of physical injury or damage to the claimant’s own property: British Celanese

In the context of company law, the courts have to determine whether an
artificial legal entity is capable of committing a tort (Chapter 6).

Criminal law

Criminal law is a set of principles the main object of which is to identify
and define certain behaviour as criminal, and to punish those whose
behaviour is found to be criminal. The parameters of criminal conduct
are usually determined by the state and will often require an intention
to commit a criminal act such as murder. In the case of company law
much discussion has arisen as to whether or not an artificial legal entity
is capable of committing a criminal wrong which requires the necessary
mental intention (see Chapter 6).

Equity and trusts

A trust comes into existence when one person (A) gives money or other
property to another person (B) not for that person’s benefit but for the
benefit of another person (C). B is called a trustee, and C the beneficiary.
Trusts arise not in relation to carrying on businesses but in relation to the
management of wealth. They may be used in an attempt to avoid tax or to
arrange dispositions of property after death. Trusts are also important in
the management of certain types of organisations or their activities. Thus,
directors as agents may have liability imposed on them as trustees. A trust
can arise as a result of the conscious creation of these obligations, but can
also arise because some other circumstances are present; for example,
where a bank receives funds in such circumstances that it realises or ought to realise they have been misappropriated, it may have liability imposed on it as a constructive trustee.

The trust is an **equitable** concept which has devised rules intended to achieve justice and fairness.

### Law of agency

The rules of agency law allow one person (A) to represent another (B) in such a way as to enter into contracts for B without imposing personal liability on himself. The result is that legal obligations and duties are imposed not on the person executing the contract (A), but on the person on whose behalf he acts (B). This concept is especially relevant in the case of registered companies, who, being artificial entities, must act through third-party agents. The directors of the company are treated as its agents and thereby owe duties arising out of that relationship (see Chapter 8).

The scope of contractual authority is relevant with regard to the company's capacity and the personal liability, if any, of the directors. The rules of agency law are similarly important where business is undertaken through an unincorporated association, for example a general partnership where partners act not only as agents for the partnership but are individually and collectively liable for partnership debts and obligations.

### Self-test and understanding

**Why is the law of contract important for registered companies?**

**Activity 2.1**

Explain the difference between a contract and tort.

Feedback below.

### Feedback to activities

**Feedback to Activity 2.1**

A contract is entered into by agreement and governs the relationship of the parties in a particular situation. The parties may sometimes agree on penalties for failure to perform, while on other occasions the level of remedies may be determined by the courts. Liability under tort is the result of a civil wrong or injury done by one person to another. Under the rules of negligence the courts will determine who falls within the scope of the duty of care and whether injury was foreseeable. Both breach of contract and tort are civil wrongs.

### A reminder of your learning outcomes

Having completed this chapter, and the Essential readings and activities, you should be able to explain:

- the rules relating to the formation of a contract, the terms of a contract and the effect of breach
- the differences between the law of tort, contract and criminal law
- the differences between common law and equity
- the basic rules of the laws of contract, tort, crime and trusts and discuss their effects on business.
Chapter 3: The legal classifications of business organisations

Aims of the chapter

The focus of this course is the law of business organisations, and an understanding of the law, of necessity, requires an understanding and knowledge of the types and nature of business entities. This section of the subject guide therefore briefly outlines the common types of business organisations recognised by the law and used as a vehicle for conducting business.

Learning outcomes

By the end of this chapter, and having completed the Essential reading and activities, you should be able to:

• identify the common forms of business organisations and their main features
• outline the legal distinctions between incorporated and unincorporated associations.

Essential reading


Further reading


Introduction

When a group of people decide to get together and form a business association, one of the early and key decisions they will have to make is the form this business relationship should take. The nature of the business association will govern not only their legal relations with each other but also the legal relationship of the business association with third parties, as well as the way business is conducted and its legal consequences. The nature of the business association is fundamental to the long-term activities of the association.

The different types of business associations recognised by the law for the purposes of conducting business may be categorised in several different ways.

Registered and unregistered business associations

The distinction here lies between those organisations (like registered companies, limited liability partnerships, building societies, friendly societies and industrial and provident societies) which can only come into existence by following procedures for registration laid down by an Act of Parliament and those (like partnerships) which are constituted by
agreement between the parties. Regardless of the nature of the business vehicle used, those establishing the business will have to agree to a number of key issues. In the case of a partnership this may be through a deed of partnership (partnership contract) which sets out the terms on which the business will be founded and run; in the case of a registered entity it will be the constitutional documents that will establish the nature and form of the business association and the relationship and rights of the management.

However, in the case of an unregistered association the informal nature of the business entity means that at a basic level all that is required is compliance with the principles of the general law, especially the law of contract. Moreover, if certain circumstances exist (i.e. two or more persons carrying on a business with a view to a profit) the courts may infer that a partnership exists from the nature of the relationship/dealings between those persons.

Incorporated and unincorporated associations

The law is capable of recognising artificial entities upon which are conferred legal rights and which enjoy legal status. The companies legislation, having recognised the possibility of registering certain types of business association, has also conferred certain rights on registered (or incorporated) associations, for example the right to own property, the right to enter into contracts in their own name and on their own behalf, and so on. The word ‘incorporated’ derives from the Latin ‘corpus’ meaning ‘body,’ thus showing that the underlying purpose of registering certain types of business is to confer corporate personality on the organisation. It follows that the legislation, having conferred separate legal status on registered associations, has also given them the benefit of perpetual succession: a registered company therefore has permanent existence and does not come to an end until dissolved.

Unincorporated associations come into existence either by agreement or by legislation, which does not confer the benefits of separate legal status. However, sometimes the courts attribute certain concepts of legal personality to unincorporated associations, and terms such as ‘quasi-company’ have crept into the law.

A popular form of business vehicle is the partnership, which is based on two or more persons joining together with a view to conducting a business and the sharing of any profits. The general partnership is an unincorporated association and the entire business relationship is based on the partnership agreement (i.e. the contract between the partners), although the Partnership Act 1890 may intervene to resolve uncertain aspects of the relationship.

Limited or unlimited liability

The concept of limited liability applies to the liability of the shareholders. Thus, the liability to contribute in liquidation in respect of the company’s debts is limited to the nominal value of the shares held by each individual shareholder. A shareholder who, for example, holds 100 £1 shares must under the terms of issue pay the £100 to the company for his allotment, but that is the full extent of his liability for the debts of the company, even if the company becomes insolvent. The creditors of the company are unable to look to the shareholders for repayment of the company debts. The company is therefore limited by shares, although a creditor of the company, for example a bank, may insist on company directors giving a personal guarantee for the company’s debt. In that case directors will not
only be liable for any unpaid balance on their shares but also separately for the value of the guarantee.

It may be, however, that the company promoters (those who register the company and bring it into existence) wish to show confidence and security to those with whom the company will deal and so they may wish to establish an unlimited company (i.e. one whose shareholders are liable to contribute for the full extent of their estate in the liquidation of the company, and therefore for the full debts of the company).

Finally, within the distinction of limited or unlimited companies there may exist the company limited by guarantee. The purpose of such companies usually is not to trade for profit, but rather the undertaking of business for scientific, cultural or other similar purpose. A profit in such circumstances, whilst desirable where it occurs, is not distributed among the members but put back into the company or used to further the company's public purposes. With the company limited by guarantee, there are members but not shareholders of the company and the company's constitution will set out the procedure by which people become members. As there are no shares by reference to which the liability of the members for the company's debts is limited, the limitation is instead achieved by guarantee. This guarantee is invoked to the extent necessary if the company is wound up and is unable to pay its debts in full, but regardless of the shortfall, the liability of the members is limited to the amount of the guarantee.

Activity 3.1
i. Explain the difference between a registered and unregistered association.
ii. Explain the difference between an incorporated and unincorporated association.
iii. Explain the difference between limited and unlimited liability.
Feedback: p.42.

Common forms of business organisation

Business activity may be undertaken in several different ways. Here, we will look briefly at some of the more common methods by which business may be undertaken.

Sole trader

The simplest business unit is the sole trader - an individual carrying on a business or trade with a view to profit, either entirely alone or by employing others. A sole trader is effectively the business and the person who sets up the business and makes all the business decisions. The sole trader alone owns all the assets of the business, and any profit made belongs to him. He is responsible for paying income tax on the profits of the business and is liable for all the debts and losses of the business. The law does not distinguish between the sole trader in his personal capacity and in his trade or business.

As a business unit, the sole trader is very vulnerable. He can be made bankrupt for his business debts and he can be made legally liable for tortious or criminal conduct carried on in the course of business.

Partnership

Where two or more persons intend to run a business, the main choice of business unit is between an ordinary partnership, a limited liability partnership under the Limited Liability Act 2000, and a registered company under the Companies Act 2006.
An ordinary partnership is a relationship of two or more persons carrying on a business in common with a view to profit (Partnership Act 1890). The Partnership Act 1890 (PA) is a comprehensive but not complete code to a partnership arrangement and the terms of the Act can be ousted, or varied, by an agreement of the partners.

Although the partners may collectively be referred to as a ‘firm’, the ordinary partnership is not a body corporate (however, a partnership may be registered under the Limited Liability Partnership Act 2000 and therefore, like a registered company under the CA 2006, acquire separate legal status). The ordinary partnership is therefore not a substantive legal institution, nor a separate legal entity. Therefore:

- The partners collectively own the assets of the partnership.
- They are liable for the debts of the partnership.
- The partnership has no perpetual succession.

The partnership is the aggregate of the partners who share in the running of the business, and share the profits, debts and obligations arising from the business. The PA 1890, whilst allowing the establishment of a business relationship based on contract, does not confer the benefits of separate corporate status on the business association or the benefits of limited liability on the partners. To that extent the partners are liable for the full debts of the partnership both collectively and individually and to the extent of their personal fortunes. Thus, the creation of a partnership under the PA 1890 does not allow the benefits of separate ownership as in the case of public limited companies, which may have hundreds, if not thousands, of shareholders who neither control nor manage, nor wish to manage, the company.

Under the PA 1890, unless otherwise agreed, each partner has a right to take part in the decision-making (s.24(5)), there is a presumption that all the partners collectively own the assets of the partnership business and the partners are collectively liable for the debts and obligations of the business without any limit. The partners share this liability jointly and severally. If, therefore, one partner does not or cannot pay his share of the debt, the creditor can look to the other partners to pay it (ss.3 and 9 PA).

It is possible under the Limited Partnership Act 1907, to have a sleeping partner whose liability is limited but who in turn cannot participate in the management of the business. It is not possible to form a partnership with only limited partners since there must always be someone who will be liable for the debts of the partnership with no limitation of liability.

The Law Commission recommended that the ordinary partnership become a separate legal personality and like a registered company be conferred a separate legal personality, be allowed to enter into contracts on its behalf, be given the benefits of perpetual succession and continuity when partners die, retire or are replaced or added to, and so on. The limited liability partnership (LLP) was introduced to provide an alternative business medium for those who wanted the relative informality and management structure of a partnership but were concerned about the joint and several liabilities for partnership debts.

Under the Limited Liability Partnership Act 2000 it is possible to register (with the Registrar of Companies) a partnership, which has the effect of conferring artificial legal status on a partnership. The LLP is, broadly speaking, owned by the partners equally unless otherwise agreed, but it has separate personality like a company and so owns the partnership assets. The LLP structure therefore confers the benefits of limited liability
on partners, and LLP partners are like shareholders in a limited business organisation. The partners in the LLP thus enjoy both the formal benefits of the partnership being a separate legal personality and the benefits of limited liability for partnership debts. The consequences of registering an LLP are that such partnerships have to comply with certain formalities; for example, the LLP must, like a company, be registered and must disclose accounts and other information.

Internally, the partners within an LLP are treated like partners in an ordinary partnership; for example, each partner has the right to participate in the management of the partnership business and the law of agency binds the relations between the partners, with fiduciary obligations imposed on the partners.

As with a registered company, the registration of the partnership will confer perpetual succession on the LLP so that, unlike a general partnership, the business organisation does not come to end when a partner retires, dies, becomes mentally incapacitated or leaves the partnership.

Activity 3.2

Explain the difference between a partnership under the PA 1890 and a limited liability partnership under the Limited Liability Partnership Act 2000.

Feedback: p.42.

Registered company

The term ‘registered company’ means a company incorporated or formed by registration under the Companies Act 2006. The Act provides that for the purposes of registration of companies there shall be offices at such places as the Secretary of State for Trade and Industry thinks fit and he may appoint officers for the registration of companies.

A registered company is regarded in law as a legal person and as such can own land and other property, enter into contracts, sue and be sued in its own name, have a bank account, employ people, and so on. The debts of the company belong to the separate legal entity and in the event of insolvency the shareholders can only be compelled to pay any unpaid balance on their shares. The company acts through directors, who are its agents. The company must have members and in case of a company with a share capital they are called shareholders. The relationship between the company and its shareholders is regulated under an implied statutory contract under s.33 of the CA 2006. If shares are partly paid the shareholder can be compelled to pay for them fully if called upon by the company under the terms of issue, or, if the company becomes insolvent, they can be compelled to contribute to that extent to the company's debts.

While the company is a going concern no capital may be returned to it without the consent of the court or without following strict procedures intended to protect creditors.

The company can also raise money by borrowing (loan capital). Persons who lend money may be issued debentures as security. Such persons are creditors of the company, not shareholders, and have no voting rights.

In the context of company law, the courts grapple with the problems which arise out of the fact that essentially the same body of rules are applied to organisations which are economically very different: the legislation attempts to cater for everything from the small private company, where the sole subscriber owns, runs and manages the business, to multinationals.
The reasons for registering a company are many and varied, ranging from the desire to gain the benefits of separate corporate status to the need to raise large amounts of capital through a public issue of shares, to allow for expert management, and so on.

**General Features of a registered company**

A company is a corporation which in law has rights and duties separate and distinct from those persons who from time to time may become members of that company. The distinguishing features of a company are:

- That it has a distinct persona in law (i.e., it is an artificial legal entity and not a natural person) which whilst conferring rights and obligations on the company may also prevent it from pursuing a claim. Thus, in *DPP v Dziurzynski* [2002] EWHC 1380 (Admin) the court held that the company could not bring an action under the Protection from Harassment Act 1997 because the Act had envisaged the protection of human beings from harassment and the company could not be regarded as a ‘person’ for the purposes of the legislation.

- It has perpetual succession, i.e., its existence is maintained although there may be a change in its membership through the death of a member or the sale of shares or removal of members in other ways.

The company therefore remains in existence despite the change in members of the company, whereas in the case of an ordinary partnership the business (partnership) will be dissolved by the death, bankruptcy or retirement of a partner. This can result in a dislocation of the business although some effort may be made to reduce this by appropriate provision in the partnership agreement. A Limited Liability Partnership (LLP) registered under the Limited Liability Partnership Act 2000 is more akin to a registered company, i.e., it has a separate legal persona, and the retirement of a member, therefore, will not result in the dissolution of the LLP.

**Company law in the nineteenth century**

Company law in its modern form may be traced back to the mid-nineteenth century and the enactment of the Limited Liability Act and the Joint Stock Companies Act – that said, an array of business associations had developed long before these statutes, including the partnership. However, with the expansion of international trade, the government sought to create corporations under Royal Charter and Acts of Parliament, granting monopolies over specified territories, for example the East India Company. The Joint Stock Companies Act 1844 introduced the possibility of incorporation of companies via registration. Because the concept of ‘limited liability’ remained a contentious issue that ran contrary to established business practice (i.e., that an individual, whether merchant or trader, should remain personally liable for the debts of his business or trade), the Joint Stock Companies Act 1844 imposed unlimited liability for debts. Fuelled by the needs of the industrial revolution to attract investment, the debate as to whether limited liability ran contrary to accepted business practice continued. There was a view that, in the growing economy, in order to attract investment, a level of protection was required for investors. The Limited Liability Act 1855 allowed any registered company with at least 25 members to limit the liability of its members to the amount unpaid on their shares. However, such companies
were required to include 'limited' as the last word of their name. The Joint
Stock Companies Act 1856 subsequently reduced the minimum number
of members to seven. The Act also provided that the liability of members
of a registered company should only be to the company and not directly
to the creditors of the company. The 1856 Act brought the concept of
registration and limited liability together for the first time and subsequent
Companies Acts have retained those fundamental rules. The 1856 Act did
not, however, prevent such investors from being involved in the day-to-day
management of the company. This allowed the growth of quasi-partnership
companies.

**Companies under the 2006 Act**

These are divided into two main categories:

- public limited companies
- private limited companies.

Section 4(2) of the Act defines a public company as a company limited
by shares, or limited by guarantee and having a share capital. However,
any new companies incorporated since 1985 with a guarantee must of
necessity be private limited companies.

All other companies are private companies. A private company may be
registered with a single member (s.7 CA 2006). The sole member can be
the sole director and there is no requirement to have a company secretary.
Such companies need only have one member and one officer. If a company
secretary is appointed then the company will have a single member and
two officers.

**Public limited company**

A public company must satisfy a number of formalities (s.4 CA 2006):

- The company's constitution must state that it is a public company.
- It must include the words 'public limited company' (or the abbreviation
  'plc') at the end of its name.
- It must satisfy the minimum capital requirements, that is, have an
  issued nominal capital of £50,000, of which at least 25 per cent has
  been paid up.
- The constitution must state that the company is limited by shares.

Any company that does not meet these requirements will be a private
company under s.4 CA 2006, including:

- a private company limited by shares
- a private company limited by guarantee
- an unlimited company.

In general, the key features of the public company are largely similar to
those of a private company but there are some distinguishing features:

- The shares in a public company are available to the public whereas
  there are often many restrictions on the transfer of shares in a private
  company.
- The divide between ownership (through shareholders) and
  management (through directors) tends to be more marked in a public
  company, with shareholders often being major financial institutions
  who invest in the company and leave its running to the directors.
Limited and unlimited companies

Limited by shares
Where the company is said to be limited by shares, that limitation of liability relates to the liability of members to the company itself. The liability of the company is always unlimited and it is accountable for all debts incurred by it. Limitation of liability by shares usually occurs when the company is formed and in such circumstances the liability of the members to contribute to the company’s capital is limited to the nominal value of the shares, but, if the shareholder agrees to pay a premium, his liability will extend to the total agreed to be paid for such shares. Once the member has paid the company for his shares, his liability for the company’s debts is discharged and he cannot be made liable for any outstanding debts of the company in excess of the value of his shares or any shortfalls arising from the failure of other shareholders to pay for their shares.

Limited by guarantee
Formerly, companies limited by guarantee could be registered with or without a share capital. Now, companies limited by guarantee with a share capital may not be registered and since these companies will not now have a share capital they can only be formed as private companies. Companies limited by guarantee with a share capital registered prior to the Companies Act 1985 were given the option to register either as private limited or public limited companies, on fulfilment of the minimum capital requirements in the case of a public company. Where there is no share capital the members have no liability unless and until the company goes into liquidation. When the company goes into liquidation those who are members at the time are required, if necessary, to contribute to the debts and liabilities of the company and the costs of winding up in accordance with the amount of the guarantee. The guarantee is not an asset of the company but a contingent liability of its members until winding up. If those liable under the guarantee cannot meet their obligations or the debts exceed the guarantee, the liquidator may have access to those who were members during the year prior to the winding-up.

Where the company limited by guarantee has a share capital, its members will have dual liability. They will be required to honour their guarantee and also pay the issue value of their shares (s.74(3) Insolvency Act 1986). Once registered as a guarantee company, there is no provision in the companies legislation to allow for re-registration.

Unlimited Companies
Unlimited companies, while conferring separate corporate status and perpetual succession, do not confer the benefits of limited liability. They must be private companies as a public company must by definition have a share capital. Unlimited companies are formed either with or without a share capital. A share capital may be used if a company is trading and making a profit. Members must pay for their shares in full and if, when winding up, that is not enough to pay the company’s debts and costs of winding up, the shareholders must make a contribution according to the nominal value of their shareholding. Where there are no shares, the members contribute equally until the debts and liabilities of the company and the costs of winding up are paid.
**Distinctions between a public and a private company**

There are several important distinctions between a public and private company which will govern the way the company conducts its business, its relations with third parties and its internal relations:

- A private company need have only one director and need not have a secretary (s.270 CA 2006).
- In a private company two or more directors may be appointed by a single resolution. In a public limited company they must be voted on as individuals (s.160 CA 2006).
- The name of the public company must conclude with the words ‘public limited company’ or ‘plc.’ The name of a private limited company must conclude with the word ‘limited’ or ‘ltd’.
- A public limited company can only commence trading once it has obtained a certificate of entitlement to do business (otherwise known as a trading certificate) (s.761 CA 2006), whereas a private company may commence business on incorporation.
- A public limited company must have a minimum allotted share capital of £50,000 of which 25 per cent must have been paid up, whereas there is no minimum capital requirement for a private company. A public company has an unrestricted right to offer shares or debentures to the public but this is prohibited in the case of a private company. The pre-emption rights under the CA 2006 apply to public companies.
- Any agreement to carry out work or perform services in exchange for the allotment of shares is prohibited (s.585 CA 2006).
- A public company cannot validly acquire non-cash assets valued at one-tenth or more of the company’s issued share capital from subscribers to the memorandum in the first two years of its existence unless an independent auditor’s report is received and the members approve it by ordinary resolution. These restrictions do not apply to private companies.

**Activity 3.3**

i. What are the different forms of business organisation recognised by the law?

ii. What types of registered company are recognised by the Companies Act 2006?

iii. Explain the requirements to be satisfied by a public limited company.

Feedback: p.42.
Feedback to Activities

Feedback to Activity 3.1

i. The distinction is between organisations which can only come into existence following registration (e.g. limited companies) and those which are created by agreement (e.g. members’ clubs; partnerships). Registered companies enjoy certain benefits, for example separation of ownership and management, liability imposed on the registered company, whereas with unregistered associations personal liability is imposed on partners or sole trader, change of partners terminates the partnership, and so on.

ii. Where legislation requires a registration process to be complied with for an entity to acquire legal status, the entity becomes incorporated. It follows that organisations which come into existence by agreement and do not enjoy the benefits of legal personality are unincorporated.

iii. Limited liability limits the liability of members to the value of their shareholding and members are not liable for the full debts of the business. Unlimited liability means that members will be fully liable for the debts of the organisation, for example in the case of a partnership to the extent of their personal estate.

Feedback to Activity 3.2

A partnership is the result of agreement between persons who come together to form a business with a view to a profit. These partners are fully liable for the debts of the business. A limited liability partnership is internally like an ordinary partnership but is registered like a company so that members enjoy the benefits of limited liability.

Feedback to Activity 3.3

i. The CA 2006 recognises various forms of registered and unregistered company, including the public and private limited company, which may be backed by shares or guarantee. It recognises certain modifications to these where the company does not have ‘profit’ as its main motive, for example companies formed for a charitable or educational purpose.

ii. These are divided into two main categories:
   - public limited companies
   - private limited companies.

   Section 1(3) defines a public company as a company limited by shares, or limited by guarantee and having a share capital, although any new companies registered with a guarantee must of necessity be private limited companies.

   All other companies are private companies.

iii. A public company must satisfy a number of formalities:
   - The company’s constitution must state that it is a public company.
   - It must include the words ‘public limited company’ (or the abbreviation ‘plc’) at the end of its name.
   - It must satisfy the minimum capital requirements, that is, have an issued nominal capital of £50,000, of which at least 25 per cent has been paid up.
   - The constitution must state that the company is limited by shares.

   Any company that does not meet these requirements will be a private company.
A reminder of your learning outcomes

Having completed this chapter, and the Essential readings and activities, you should be able to:

• identify the common forms of business organisations and their main features
• outline the legal distinctions between incorporated and unincorporated associations.

Sample examination question

Describe the main features of a registered company and compare it with an unincorporated and unregistered association.