10 Companies (1): Characteristics and formation

This is the first of two chapters which consider the law relating to companies. This chapter considers the characteristics of companies and the way in which companies are formed. The following chapter considers the rights of shareholders, how companies are managed and how they are wound up. The shareholders in a company are known as the members of the company.

There are around 2.5 million registered companies in the UK. The law regards each of these as a legal person, with its own legal rights and obligations. All companies are now governed by the Companies Act 2006 which has replaced earlier Companies Acts. However, many sections of the 2006 Act are identical to sections of earlier Companies Acts. Therefore, in many areas of company law cases decided under the earlier Acts still apply to the 2006 Act.

THE COMPANIES ACT 2006

The Companies Act 2006 was introduced to improve the UK's competitiveness in the twenty-first century. It aims to do this by providing a sound, flexible framework for UK company law.

The 2006 Act has four main objectives:

- To enhance shareholder engagement and to foster a long-term approach to investment.
- To adopt a 'Think Small First' approach and ensure that companies are better regulated.
- To make it easier to create and run a company.
- To provide flexibility for the future.

Enhancing shareholder engagement and fostering a long-term approach to investment

As we shall see, the directors of a company are elected by the shareholders (the members) to run the company. One of the main objectives of the 2006 Act is to create a good understanding between directors and shareholders. The Act aims to ensure that their roles are clearly defined and that they should find it easy to communicate with each other.

The Act encourages companies to communicate with shareholders electronically. It is hoped that this will not only save money but encourage more shareholders to be involved in a dialogue with the company. The Act also intends to make directors more accountable to their companies. To achieve this aim, it has introduced a new 'derivative claim' which allows members to sue, on the company's behalf, if the directors breach their duties.

The 'Think Small First' approach and better regulation

Ninety per cent of companies have five or fewer shareholders. However, the earlier Companies Acts were written mainly with large companies in mind. The 2006 Act takes a new approach with its 'Think Small First' approach. Some technical rules have been abolished in relation to private companies and new model articles of association have been introduced. The articles of association are the internal rules of the company and one set of new model articles has been designed for use by small, private companies.

The members of a company have always been able to make decisions by passing resolutions. The 2006 Act envisages that most resolutions of private companies will be passed as written resolutions. A written resolution allows shareholders to vote in favour of a resolution merely by signing it, rather than by having to attend a company meeting and vote there.

The Act has removed the rule that private companies must have a company secretary. So it is now possible for one person to be the sole shareholder and the sole director, and to run a company without help from any other person.

The 2006 Act envisages three tiers of companies: private companies; public companies which are not quoted on a stock exchange; and public companies which are quoted. Private companies are presumed to be small. In many areas they will have minimal regulation imposed on them if they do not positively introduce more extensive rules. If a private company is large, as many are, it can opt for its own more extensive regulation.

Ease of formation and flexibility

As we shall see later in this chapter, the Act has made it easy and quick to register a new company. In the following chapter we shall see that it has also become easier to run a small company.

The 2006 Act has been written in such a way that it will be relatively easy to amend it in the light of changing circumstances, thus allowing for flexibility in the future.

THE CHARACTERISTICS OF COMPANIES

A company is created by registration under the 2006 Act. The process of registration is considered later in this chapter. Here it is enough to say that the people who want to create the company, the promoters of the company, must send certain documents to the Registrar of Companies. The Registrar is the head of a Government agency called Companies House. If the documents are in order, the Registrar will issue a certificate of incorporation and the company will then exist as a corporate body.

Incorporation has several important consequences. To some extent these are interconnected, but they are easier to understand if considered separately.

The company is a separate legal entity

The most important consequence of incorporation is that a company is regarded as being a legal person in its own right. This means that a company has a legal identity of its own which is quite separate from the legal identity of its owners. If a wrong is done to a company, it is the company, and not its owners, which has the right to sue. Conversely, if a company injures a person that person can sue the company but cannot sue the owners. This well-established principle was laid down in the following case.

Salomon *v* Salomon & Co Ltd [1897] (House of Lords)

For several years Mr Salomon had carried on a business as a boot repairer and manufacturer. He formed a limited company and sold his business to the company for £39,000. The company paid the purchase price in three ways, as follows: first, by issuing Salomon with 20,000 £1 shares; second, by regarding him as having loaned the company £10,000; and third by making up the balance in cash. Salomon took all of the company's assets as security for the loan which had been made to him. Unsecured creditors lent the company a further £8,000. Shortly after its incorporation, the company got into financial difficulty and was wound up. The assets of the company amounted to about £6,000. Creditors who have been given security for their loan are entitled to be repaid before unsecured creditors. Salomon therefore took all of the £6,000. The unsecured creditors claimed that Salomon should repay their loans personally because he was the same person as the company.

Held The company had been formed properly and without any fraud. Although Salomon owned all but seven of the issued shares, he was one person and the company was another. Salomon therefore had no more obligation to pay the company's debts than he had to pay his next-door neighbour's debts.

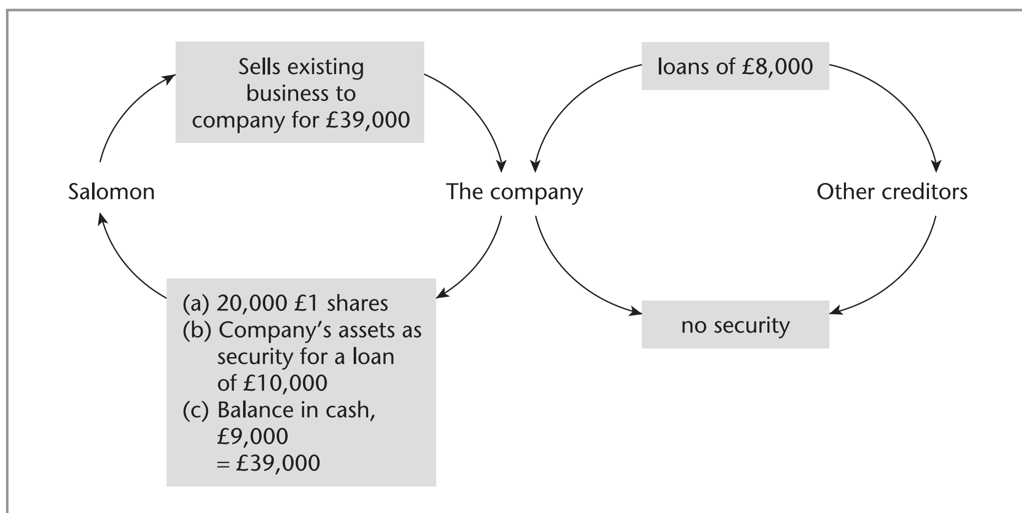

Figure 10.1 Salomon *v* Salomon & Co Ltd

Salomon's case is regarded as one of the most important in English law, mainly because of the protection which it offers to the owners of limited companies. However, the decision that a company has a legal identity of its own has many other consequences, as the following two cases show.

Macaura *v* Northern Assurance Ltd [1925] (House of Lords)

Macaura owned almost all of the shares in a timber company. The company owed money to Macaura but not to anyone else. Macaura insured the company's timber in his own name. Two weeks later, the timber was destroyed by fire and Macaura claimed on his insurance.

Held Macaura could not claim on the insurance policy because he did not own the timber. The company owned the timber, and it is a rule of insurance law that only the owner of goods can insure them.

Tunstall *v* Steigmann [1962] (Court of Appeal)

Mrs Steigmann ran a pork butcher's shop and leased the shop next door to Mrs Tunstall. Mrs Steigmann wanted to end the lease. As the law stood at that time, Mrs Steigmann could order Mrs Tunstall to leave the shop only if she intended to occupy the building herself, to carry on a business there. Mrs Steigmann did intend to occupy the shop herself, to carry on her butchery business. But before the case came to court she turned her business into a company. Mrs Steigmann claimed that as she owned all but two of the shares in the company she was still the person who wanted to take over the premises.

Held It was not Mrs Steigmann who wanted to take over the business, her company wanted to take it over. Willmer LJ said: 'There is no escape from the fact that a company is a legal entity entirely separate from its corporators – see **Salomon *v* Salomon & Co**. Here the landlord and her company are entirely separate entities. This is no matter of form; it is a matter of substance and reality. Each can sue and be sued in his own right; indeed, there is nothing to prevent the one suing the other. Even the holder of 100% of the shares in a company does not by such holding become so identified with the company that he or she can be said to carry on the business of the company.'

Although a company is regarded as a legal person, it does not have human characteristics. For example, in **Richmond London BC *v* Pinn and Wheeler Ltd [1989]** the Divisional Court held that a company cannot drive a lorry. Pill J said: 'The act of driving a lorry is a physical act which can be performed only by natural persons.'

Limited liability

In **Salomon's case** we saw that Salomon was not personally liable for the debts of the company. When people buy shares in a limited company, the only commitment they make is that they agree to pay the price of their shares. Often, they do not pay the full price immediately. When the public utilities were privatised, for example, investors generally paid half of the share price when subscribing for the shares and remained liable for the other half. If one of these privatised companies had gone into liquidation before shareholders had paid this second instalment, the shareholders would have been liable to pay the amount outstanding. However, beyond this they would not have been liable to contribute any more money. A shareholder who has already paid the full price of the shares held has no liability to pay any more.

It must, of course, be emphasised that it is the shareholders who have limited liability, and not the company. If a company has debts it must pay these debts, even if this means selling all of its assets and going into liquidation.

Perpetual succession

A company can be liquidated at any time if the members of the company pass a special resolution that it should be liquidated. (A special resolution is passed if at least three-quarters of company members who vote are in favour of passing it.) If a company is liquidated, then the company will

cease to exist. However, companies can continue in existence indefinitely, and therefore they are said to have perpetual succession.

Shareholders, of course, must die. But even if all the shareholders in a company die, their shares will be inherited by others and the company will continue in existence. For example, the Hudson's Bay Company has been in existence since 2 May 1670. Generations of its shareholders have died, but the company still exists.

As we shall see in Chapter 12 on p. 327, the death of a partner ends a partnership. The existing partners might agree to carry the partnership on but, technically at least, the firm will be dissolved when a partner dies.

Ownership of property

A company can own property, and this property will continue to be owned by the company regardless of who owns the shares in the company. This can be important when a company is trying to borrow money because the company can give its own property, both present and future assets, as security for a loan.

Contractual capacity

A company has the power to make contracts and can sue and be sued on these contracts. This power must be delegated to human agents, and it is the company directors and other agents who actually go through the process of forming the contracts. But the important point is that it is the company itself which assumes the rights and liabilities which contracts create.

A company can also sue and be sued in tort. (A tort is a civil wrong other than a breach of contract, for example negligence, trespass or defamation. See Chapter 8.)

Criminal liability

To commit a crime a defendant must generally commit a guilty act while having a guilty mind. At first sight it would seem that companies cannot commit crimes because they have not got minds of their own. However, the courts are sometimes prepared to regard the controllers of the company as the minds of the company.

In **Tesco Supermarkets Ltd *v* Nattrass [1971]** the House of Lords held that a person who was sufficiently senior in a company could be regarded as the mind of the company. If a person senior enough to be regarded as the mind of a company had a guilty mind then the company could be regarded as having a guilty mind. Persons who were not senior enough could be regarded only as the hands of the company. If such a person had a guilty mind then this could not be regarded as the guilty mind of the company. In the case it was held that a supermarket manager employed by Tesco Ltd was not senior enough to be regarded as the mind of the company, whereas a very senior manager might have been.

The Corporate Manslaughter and Corporate Homicide Act 2007

The Corporate Manslaughter and Corporate Homicide Act 2007 has created a new offence of corporate manslaughter (corporate homicide in Scotland). The offence can be committed by companies and by other incorporated bodies, such as LLPs, as well as by some types of unincorporated associations, such as partnerships. The Director of Public Prosecutions must consent to a prosecution being brought.

Section 1(1) provides that the offence of corporate manslaughter is committed by a relevant organisation if the way in which its activities are managed and organised:

(a) causes a person's death, and

(b) amounts to a gross breach of a relevant duty of care owed by the organisation to the deceased.

Section 1(3) provides that an organisation is guilty of the s. 1(1) offence only if the way in which its activities are managed or organised by its senior management is a substantial element in the breach to which s. 1(1) refers. Section 1(4)(b) provides that a breach is a 'gross breach' only if it falls far below what can reasonably be expected of the organisation in the circumstances.

Section 1(4)(c) defines 'senior management', in relation to an organisation, as the persons who play significant roles in:

(i) the making of decisions about how the whole or a substantial part of its activities are to be managed or organised, or

(ii) the actual managing or organising of the whole or a substantial part of those activities. The penalty for commission of the offence is a fine.

Section 2(1) provides that a 'relevant duty of care' is a duty of care owed under the law of negligence. (See Chapter 8, pp. 212–14.)

Whether or not a duty of care was owed is a question of law for the judge, not a question of fact for the jury. Whether there was a gross breach of that duty is a question for the jury. In deciding this the jury should consider all relevant matters. However, s. 8 highlights several matters. Section 8(2) provides that the jury must consider whether the evidence shows that the organisation failed to comply with any health and safety legislation that relates to the alleged breach, and if so (a) how serious that failure was; and (b) how much of a risk of death it posed. Section 8(3) provides that the jury may also (a) consider the extent to which the evidence shows that there were attitudes, policies, systems or accepted practices within the organisation that were likely to have encouraged any such failure as is mentioned in s. 8(2), or to have produced tolerance of it; and (b) have regard to any health and safety guidance that relates to the alleged breach.

Section 9 allows a court to make a remedial order requiring a breach of s. 1(1) to be remedied. Section 10 allows a court to order a convicted organisation to publicise the conviction in a specified manner.

The corporate veil

We have seen that a company has a legal identity of its own. A natural consequence of this is that only the company can be liable in respect of a wrong done by the company. The owners of the company will normally be free of any liability. They are said to be protected by the 'veil of incorporation'. This image regards the company's artificial legal personality as a veil, which hangs between the company and the members of the company.

As we have already seen, the idea that the members of a company are not liable for the company's wrongdoings is very well established. But there are circumstances in which a court or a statute will lift the corporate veil so that the members of the company are not protected by the company's artificial legal personality.

There is no rigid list of circumstances in which a court will lift the corporate veil. They have, however, done so in the following circumstances:

(i) Where the company was formed for a fraudulent purpose.

(ii) If the company can be characterised as an enemy in time of war.

(iii) Where groups of companies are regarded as one.

(iv) Where a company is treated as a partnership in order to wind it up.

(v) In other situations where statute allows this.

Where the company was formed for a fraudulent purpose

Gilford Motor Co Ltd *v* Horne [1933] (Court of Appeal)

Mr Horne was employed as managing director of GMC Ltd. In his contract of employment, Horne agreed that after leaving GMC he would not solicit its customers. When his contract was terminated, Horne did begin to solicit GMC's customers. He knew that GMC would not allow him to get away with this, so he formed a company, the sole purpose of which was to employ him while he continued to solicit GMC's customers. Horne's defence, when sued by GMC, was that his promise in his contract of employment was binding only on himself, not on the new company.

Held An injunction was granted preventing either Horne or the company from soliciting GMC's customers. Hanworth MR said: 'I am quite satisfied that this company was formed as a device, a stratagem, in order to mask the effective carrying on of a business of Mr E.B. Horne. The purpose of it was to try to enable him, under what is a cloak or a sham, to engage in business . . . in respect of which he had a fear that the plaintiffs might intervene and object.'

If the company can be characterised as an enemy in time of war

A country at war with another country it is likely to restrict the activities of citizens of the other country, who may be regarded as enemy aliens. If a company is owned by enemy aliens, then the court may lift the veil and regard the company as having an enemy character.

Daimler Ltd *v* Continental Tyre and Rubber Co Ltd [1916] (House of Lords)

The Continental Tyre Co was registered in England. It was owed money by Daimler and sued to recover the debt. Daimler argued that, as all but one of the 25,000 shares in the Continental Tyre Co were owned by German residents, the company should not be allowed to sue on the debt when Britain was at war with Germany.

Held The company could not sue on the debt. The company had assumed an enemy character and therefore anyone trading with it would be trading with the enemy.

Groups of companies regarded as one

Commonly one company, known as a holding company, owns a majority or all of the voting shares in another company, known as a subsidiary company. As a general principle, the veil of incorporation will hang between the two companies. In very exceptional circumstances a court may lift the veil either on the grounds of agency or on the grounds of economic reality. However, the modern approach of the courts has been not to do this.

Treating a company as a partnership in order to wind it up

In **Ebrahimi *v* Westbourne Galleries [1972]** the House of Lords wound up a small company by treating it as if it were a partnership. The business had originally been a partnership and was

founded on a personal relationship. It is only in a tiny number of cases that a court would be prepared to treat a company as if it were a partnership in this way.

Other situations where the veil may be lifted

Various statutory provisions may lift the veil. In **Conway *v* Ratiu** [2005] EWCA Civ 1302 Auld LJ said that the veil would be lifted to do justice when common sense and reality demanded that this be done. However, in recent times the courts have shown a reluctance to lift the veil except in specified circumstances.

CLASSIFICATION OF COMPANIES

Companies can be classified in several different ways, but from a business perspective only four classifications are useful.

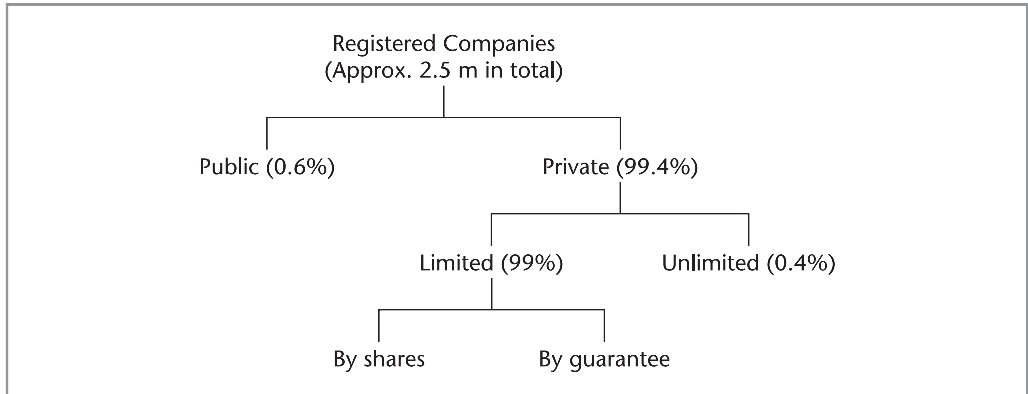

Figure 10.2 Classification of companies

Public companies and private companies

Public companies can offer shares and debentures for sale to the public. The articles of private companies usually restrict the sale of the company's shares. The most common restrictions are either that the shares must first be offered to other members of the company, or that the shares can be sold only to persons of whom the directors approve. No matter what the articles of association say, it is a criminal offence for a private company to offer its shares for sale to members of the public.

Although public companies make up less than 1 per cent of all companies they tend to be very much larger than most private companies. The assets of all public companies would far outweigh the assets of all private companies.

Although plcs can be listed on the London Stock Market, most are not. Only about 2,000 plcs are listed. The shares of many more plcs are traded on the Alternative Investment Market.

It is possible for a private company to re-register as a public company and vice versa. If this is done, a new certificate of incorporation is issued. Most plcs began as private companies and made the change after they had become very successful. A special resolution is needed to change from a private company to a plc or to change from a plc to a private company. (The different types of resolutions, and how they are passed, are considered in the following chapter at pp. 291–3.)

Table 10.1 Differences between public and private companies

Public companies	Private companies
Name must end with the words 'Public Limited Company' or 'plc'	Name must end with 'Limited' or 'Ltd' (unless the company is unlimited)
Must have £50,000 allotted share capital, one quarter of which must be paid up	No limit on share capital
Shares can be listed on stock exchange (no requirement that they should be listed)	Shares cannot be listed on stock exchange, or advertised for sale
Must have at least two directors	Need have only one director
Shares allotted by the company must be paid for in cash (or qualified auditor must value assets given as payment)	Shares can be given away by the company
Must have a company secretary, who must be suitably qualified	No need to have a company secretary. If there is one, does not need to be qualified
Must hold AGM every calendar year	No AGM unless positive decision taken to hold one
Cannot pass written resolutions	Can pass written resolutions

Unlimited companies

Slightly under half of one per cent of registered companies are unlimited companies. These companies do have a legal personality of their own, distinct from that of the company members, but the members have agreed that they will assume unlimited liability for the debts of the company. Public companies may not register as unlimited companies.

Unlimited companies enjoy some advantages over limited companies. For example, their accounts need not be published or delivered to the Registrar of Companies. However, these advantages are generally considered to be far outweighed by the unlimited liability of the members.

The names of unlimited companies must not contain the words 'limited' or 'Ltd'.

Limited companies

Limited companies can themselves be classified into two types: companies limited by shares and companies limited by guarantee.

Companies limited by shares

The vast majority of companies are limited by shares. As we have seen, this means that in the event of liquidation of the company a member's liability is limited to paying off any amount unpaid on his or her shares. (When any reference to a company is made it should be assumed that the company is limited by shares unless there is an indication to the contrary.)

Companies limited by guarantee

The liability of members of companies limited by guarantee is restricted to paying an amount which they have agreed to pay in the event of the company going into liquidation. This amount is usually small, typically £5, and is spelt out in the application for registration, a document which must be registered with the Registrar of Companies when the company is formed.

Before the Companies Act 1980 a company could register itself as limited by shares and by guarantee, in which case the members were liable to pay both the amount guaranteed and the amount unpaid on their shares. Some such companies, formed before 1980, continue to exist. However, since the Companies Act 1980 a company must either be limited by shares or be limited by guarantee.

Public companies have never been allowed to be limited by guarantee: they must be limited by shares. Most companies limited by guarantee are educational or charitable. Guarantee companies are not a suitable medium for trading companies.

Method of creation

Companies are created by registration under the Companies Act, a procedure which is examined later in this chapter. Some very few companies have been created by Royal Charter or by statute. However, these methods of creation are not significant in a business context. Almost all companies currently in existence were created by registration under the Companies Act. The process is quick and cheap, and it is generally understood that when people speak of a company this is the type of company which they mean.

Size of company

Single member companies

It is possible for any company, public or private, to have only one member. New companies can be created with only one subscriber to the memorandum, or an existing private company can allow its membership to fall to one.

Small and medium-sized companies

Companies which can be classified as small can submit abbreviated accounts to the Registrar of Companies, although full accounts will still have to be delivered to the members.

A company is regarded as a small company if it meets two out of the following three requirements:

(i) The company's annual turnover is £5.6m or less.
(ii) The total assets of the company are £2.8m or less.
(iii) The company has 50 or fewer employees.

Medium-sized companies can omit certain matters from the business review which directors have to submit for each financial year. A company is regarded as a medium-size company if it meets two out of the three following requirements:

(1) The company's annual turnover is £22.8m or less.
(2) The total assets of the company are £11.4m or less.
(3) The company has 250 or fewer employees.

FORMATION OF REGISTERED COMPANIES

Registration under the Companies Act 2006

A registered company is formed by **promoters**, who must pay a fee and register certain documents with the Registrar of Companies. If the Registrar is satisfied with the documents he will issue a certificate of incorporation, and the company will then exist as a corporate body.

The 2006 Act has changed the process of registering a company. Companies which were registered before the 2006 Act came into force will have been registered under the old procedure. They will not need to re-register. Almost all companies currently in existence were registered under the old procedure. It is therefore necessary to describe that old procedure to some extent. First, the new registration procedure is described.

Registration documents

Section 9(1) of the 2006 Act provides that in order to register a new company the following must be sent to the Registrar, along with a £20 fee:

- A new-style memorandum of association;
- An application for registration of the company;
- The documents which s. 9 requires the application to contain; and
- A statement of compliance.

A company may not be formed for an unlawful purpose.

The new style of memorandum of association

The new style of memorandum is quite different from the old style of memorandum, which existed before the 2006 Act came into force. A new style of memorandum merely states that the subscribers, the people who sign it, wish to form a company under the Act and that they agree to become members of the company by taking at least one share each. This memorandum will not be capable of being changed later. It gives a 'historical snapshot' of the company members on formation of the company.

The application for registration

Section 9(2) requires that the application for registration must state:

(a) the company's proposed name;
(b) whether the company's registered office is to be situated in England and Wales (or in Wales), in Scotland or in Northern Ireland;
(c) whether the liability of the members of the company is to be limited, and if so whether it is to be limited by shares or guarantee; and
(d) whether the company is to be a public company or a private company.

The documents which the application must contain

The documents which s. 9 requires the application to contain are set out in ss. 9(4) and (5). These are:

(a) a statement of share capital and initial shareholdings, or a statement of guarantee if the company is to be limited by guarantee;
(b) a statement of the company's proposed officers;
(c) a statement of the intended address of the company's registered office; and
(d) a statement of any proposed articles of association, to the extent that model articles are not being used.

The **statement of capital and initial shareholdings** is required by s. 10(2) to state the following:

(a) the total number of shares to be taken on formation by the subscribers to the memorandum;
(b) the total nominal value of those shares;

(c) for each class of shares:
   (i) particulars of the rights attached to the shares,
   (ii) the total number of shares of that class, and
   (iii) the total nominal value of shares of that class;
(d) the amount to be paid up and the amount, if any, to be unpaid on each share.

If the company has more than one class of shares then this information must be given in respect of each class of shares. The nominal value of a share represents the face value which the company has agreed that the share should have. This amount can be expressed in Sterling, euros or any other currency. Different classes of shares can have nominal values in different currencies. The total nominal value of shares to be taken by subscribers to the memorandum means the total amount stated to be payable to the company for all of the shares which the subscribers to the memorandum take. So, for example, let us assume that the four subscribers to the memorandum of Acme Ltd each agree to take 250 shares. The nominal value of each share is agreed to be £1 and so the aggregate nominal value of shares taken by the subscribers would be £1,000. It is not possible to agree that the members will pay less than the nominal value of a share. They might, however, pay more because the nominal value of a share does not represent its true value. If more is paid, the extra amount is regarded as a share premium and must be kept in a share premium account. Such an account cannot be used to pay dividends to members.

A **statement of guarantee** is necessary only if the company is limited by guarantee. It must identify the guarantors, who subscribe to the memorandum, and state what contribution they have each agreed to make. These contributions are payable if the company is wound up while a guarantor is a member or within a year of his ceasing to be a member.

The **statement of proposed officers** must give the names and addresses of the first directors and the first company secretary (if the company is to have a company secretary). The statement must also include such information as would be required to be in the register of directors, the register of directors' residential addresses and in the register of company secretaries. (See Chapter 11 on pp. 288 and 299.) The residential addresses of directors need not be disclosed. Directors can give a service address, which can be the address of the company's registered office.

The statement must also contain consent by each person named as a director or secretary to act in the relevant capacity. Once the company is registered they are deemed to have been appointed.

The statement of compliance

The **statement of compliance** merely states that the Act's requirements as to registration have been complied with.

If the Registrar is satisfied that the requirements of the Act have been complied with he registers the documents delivered to him and issues a certificate of incorporation.

The effect of registration

A **certificate of incorporation** is conclusive evidence that the requirements of registration have been complied with and that the company has been duly registered under the Act.

Section 15(2) provides that the certificate must state:

(a) the name and registered number of the company;
(b) the date of its incorporation;
(c) whether it is a limited or unlimited company, and if it is limited whether it is limited by shares or limited by guarantee;

(d) whether it is a private or a public company; and

(e) whether the company's registered office is situated in England and Wales (or in Wales), in Scotland or in Northern Ireland.

From the date of incorporation the company is capable of exercising all the powers of a registered company. The subscribers to the memorandum become members of the company and become holders of the shares to the extent set out in the statement of capital and initial shareholdings. The proposed directors and secretary are deemed to have been appointed.

Old-style registration

Companies which registered before the 2006 Act came into force do not need to re-register. Obviously, for some years to come almost all companies will have completed an old-style registration. This has important consequences for the constitution of those companies. Therefore it is necessary to know the procedure required for an old-style registration.

Under the old-style registration the documents which had to be sent to the Registrar were:

(1) The company's memorandum of association.

(2) The company's articles of association.

(3) A statement giving the names of the company's first directors and of the company secretary.

(4) A statement that all the statutory requirements of registration had been complied with.

Old-style memorandum of association

An old-style memorandum of association was of considerable importance. The constitution of a company registered before the 2006 Act came into force used to be contained in its memorandum and articles of association. The memorandum set out the structure of the company, whereas the articles were the internal rules.

Section 2 of the Companies Act 1985 stated that the memorandum of a company limited by shares had to contain five obligatory clauses. The only one of lasting significance is the **objects clause**. This stated the purposes for which the company was being formed and set out the contracts which the company could validly make. The problems caused by objects clauses, and the extent to which these problems have been resolved, are considered more fully in Chapter 11 on pp. 281–2.

As well as the five compulsory clauses there could be **additional clauses**. If an additional clause was stated to be unalterable then it could not be altered by the members. This is no longer the case. Section 28(1) of the 2006 Act provides that all provisions of an old-style memorandum, except the basic provisions which would need to be contained in a new-style memorandum, are to be treated as provisions of the company's articles. The articles of a company can generally be altered by a special resolution of the members. However, some articles may be entrenched. Such articles can be altered only by a specified procedure which is more onerous than the passing of a special resolution, as we shall see below on p. 272. However, entrenched articles cannot be made unalterable. So it is no longer possible for a company to have an unalterable provision in its constitution.

THE CONSTITUTION OF A COMPANY

Section 17 of the 2006 Act provides that a company's constitution includes the company's articles of association and certain types of resolutions. Other matters can be included in the

constitution. For example, a company's incorporation certificate will state whether the company is public or private and will therefore be constitutionally relevant.

Constitutionally relevant articles

Section 29 sets out the types of resolutions which are constitutionally relevant. Broadly speaking, these are special resolutions, or resolutions or unanimous agreements which would have needed to have been passed as special resolutions. Special resolutions are passed only if a majority of at least 75 per cent of members who vote on the resolution vote in favour of it. The 2006 Act requires some matters to be passed by special resolution (see Table 11.1 on p. 292). Section 30 requires that copies of these constitutional resolutions must be sent to the Registrar within 15 days of their being passed. Section 32 requires an up-to-date copy of the constitutional documents to be sent to members on request.

The articles of association

The articles of association are the rules of the company and they bind both the company and the members of the company. Before the 2006 Act came into force, the rules of the company could be found in the old-style memorandum and the articles. The articles were the internal rules of the company whereas the old-style memorandum set out the structure of the company. As we have seen, as regards companies formed under the 2006 Act, the new-style memorandum is a mere historical snapshot giving information about the company when it was formed. The rules of the company are set out in the articles. As regards companies formed before the 2006 Act came into force, s. 28(1) provides that provisions of an old-style memorandum are to be treated as provisions of the company's articles. This is the case with all provisions of an old-style memorandum except those minimal provisions which would be found in a new-style memorandum. So, again, the articles are the rules of the company.

Section 18 provides that a company must have articles of association and that these must be contained in a single document which is divided into consecutively numbered paragraphs. Different types of model articles, suitable for different types of companies, have been written by the Secretary of State. Section 20(1) provides that these articles will apply by default when a company is formed, if other articles are not registered. It also provides that if other articles are registered the model articles will still apply to the extent that they are not excluded or changed by the articles which are registered. The model articles are designed to allow companies to be formed and do business even if they have not created suitable articles. Existing companies will not be subject to the application of model articles by default, although they will be able to adopt them either wholly or partially. If a company was registered using the old Table A model articles, which could be adopted before the 2006 Act came into force, they will continue to be governed by Table A.

Section 25 provides that an alteration of the articles which increases the liability of a member since he became a member is invalid against that member unless he has given express written consent to it.

Amendment of articles

Section 21(1) provides that a company's articles may generally be amended by special resolution. However, s. 22(1) allows the articles to contain **entrenched articles**. Something more than a special resolution is required to change or remove an entrenched article. The Act does not say exactly what is required. However, since a special resolution can be passed only by a 75 per cent majority of those voting on it, the requirement might be, for example, a unanimous vote or

a vote passed by a 90 per cent majority of all company members. Section 22(2) provides that an article can become entrenched only if the company's articles say so when the company is formed, or if all of the members of the company agree to the articles being amended.

It is not possible to make entrenched articles unalterable. Section 22(3) provides that entrenched articles can always be altered by an agreement of all the members of a company or by a court order.

Where a company's articles are amended so as to include or remove an entrenched article, s. 23 requires the company to give notice of this to the Registrar. A document showing the amendment also has to be sent to the Registrar along with a statement of compliance. This statement will certify that the amendment has been made in accordance with the company's articles. So both the Registrar and any person searching the public register of companies will be able to see whether or not any articles are entrenched and, if they are, how they can be altered.

Before the 2006 Act came into force there was no such concept as entrenched articles. The articles could always be altered by special resolution. However, provisions which might have been in the articles could be made unalterable by putting them in an old-style memorandum and stating that they were unalterable. This practice is now redundant as the new-style memorandum now gives only basic information about the company when it was created.

Whenever a company's articles are amended, whether there is provision for any articles to be entrenched or not, s. 26(1) provides that the company must send the Registrar a copy of the amended articles within 15 days of the amendment taking effect.

If something cannot be done by a company unless the articles authorise it, then a special resolution authorising the thing will not be effective because the articles will not be impliedly changed. However, if the resolution states that it is doing the thing 'notwithstanding anything in the articles' then the thing will be validly done.

When the members do alter the articles they must exercise this power *bona fide* for the benefit of the members of the company as a whole, that is to say for the benefit of the company in its capacity as a separate legal person.

The legal effect of the constitution

Section 33(1) of the 2006 Act provides that the constitution makes a contract between every shareholder and the company and between every shareholder and every other shareholder.

The constitution as a contract between the company and the members

The constitution forms a contract between a company and its members, in respect of their ordinary rights as members. So the company can insist that the members abide by the articles.

Hickman *v* Kent or Romney Marsh Sheep-Breeders' Association [1915]

The Sheep-Breeders' Association was registered as a non-profit making company. One of the association's articles provided that any dispute between the association and a member should be referred to arbitration. One member tried to sue the association.

Held The member had no right to sue the association. He should have referred the dispute to arbitration.

Equally, the members can insist that the company sticks to the articles.

Pender *v* Lushington [1877]

The articles of a company provided that every ten shares commanded one vote, but that no member should be entitled to more than 100 votes. A shareholder who held more than 1,000 shares transferred some of these to Pender, so that the shares could use their full voting power. The chairman of the company, Lushington, refused to accept the votes of Pender's shares.

Held The shares had been properly transferred and so not to accept Pender's votes was a breach of his rights as a member of the company.

It is important to realise that members are bound to the company only in their capacity as members, and that the company is bound to members only in their capacity as members. For example, in **Beattie *v* E and F Beattie Ltd [1938]** a director, who was also a member of the company, tried to rely on one of the articles when he was sued by the company for the return of money which had been improperly paid to him as a director. The defendant was not able to rely on the article. He was not attempting to rely on the article in his capacity as a member of the company but in his capacity as a director.

The constitution as a contract between the members

Section 33(1) tells us that the constitution creates a contract between each member and all the other members. However, this is only true in relation to matters which concern membership of the company.

Rayfield *v* Hands [1960]

An article of the company provided that if any member intended to transfer shares in the company he should inform the directors who 'will take the said shares equally between them at a fair price'. The claimant informed the directors that he intended to transfer some shares and they refused to buy them, arguing that the articles imposed no such liability upon them.

Held The directors were bound by the article and therefore had to take the shares at a fair price. The article in question was concerned with the relationship between the claimant as a member and the defendants as members of the company.

The constitution does not make any contract with outsiders.

Off the shelf companies

An alternative to the promoters themselves forming a company is for them to buy an 'off the shelf' company. Some businesses form companies in large numbers, in the hope that customers will wish to buy the companies. A person who forms such a company registers himself as the company's first director and takes one share. Then, when a customer wishes to buy an off the shelf company, the share is transferred to the customer. The original director resigns, having appointed the customer the new director, and notifies Companies House of this change. Before

the 2006 Act came into force, the risk involved in this could be substantial, because a company's articles must be suitable for that particular company. Many businesses, in too much of a hurry to become incorporated, adopted unsuitable articles, either by buying an off the shelf company or by adopting the old Table A model articles without considering their effect. Of course, it is always possible to alter these articles while the promoters or the creators of the company hold all the shares in it. However, all too often the members were in too much haste to set the company up to realise the importance of ensuring that the articles suited their needs. Promoters of off the shelf companies are now likely to use the new model default articles. These are far more likely to be suitable for the company than the old Table A articles. However, the purchasers of the company should still ensure that the articles are tailored to their needs.

CONTRACTS MADE BEFORE THE COMPANY IS FORMED

A company does not come into existence until the registrar issues its certificate of incorporation. It follows that until the certificate is issued the company has no capacity to make contracts.

However, those who wish to form the company, the promoters, might want to make contracts on the company's behalf in advance of incorporation. For example, if a shop intended to begin trading as a company on 1 October then the promoters would need to buy stock in advance of that date.

Section 51(1) of the Act provides that:

> A contract which purports to be made by or on behalf of a company when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly.

It will be noticed this section applies 'subject to any agreement to the contrary'. It is therefore possible for the promoter to disclaim personal liability when making the contract on the company's behalf. However, it would be inadvisable for others to deal with the promoters on this basis. In effect they would be making contracts which could be enforced against themselves but which they might not be able to enforce against anyone.

Suppliers to the company might do well to insist that the company is actually formed before they make any contract. Another way around the problem would be for the supplier to make two contracts. The first draft contract would be with the company, stating that it will pay as soon as it is formed. The second contract would be made with the promoters, who would agree that they would pay in the event that the company does not.

THE COMPANY NAME

The name of every public company must end with the words 'public limited company' or the abbreviation 'plc'. The name of every private limited company must end with the word 'limited' or the abbreviation 'Ltd'. (We have seen that if the company's registered office is in Wales then the Welsh equivalents of these names may be used.) So the word 'limited' must appear in the names of both types of companies, although of course it is not the company's liability which is limited, but the liability of its members.

Unlimited companies may not include the word 'limited' in their names.

The word 'company' is not often included in the names of companies. Strangely, the word appears in the names of partnerships more frequently than in the names of companies. For

example, a business called 'Brown & Co' could not be a company unless it was an unlimited company. Almost always, a business with such a name would be a partnership. Partnership names are considered in Chapter 12.

Prohibited names

The Act prohibits the use of certain names:

(i) The words 'limited' or 'unlimited' or 'public limited company' can be used only at the end of the name.

(ii) The Registrar will refuse to register a name which is identical to the name of another company already on the register.

(iii) The Registrar will refuse to register a name the use of which would, in the opinion of the Secretary of State, constitute a criminal offence or be offensive.

(iv) Regulations made by the Secretary of State prohibit the use of certain words without permission. These words suggest a connection with Government or with local authorities. Other Regulations prohibit the use of certain words unless permission is granted by an appropriate body. Currently about 100 words are listed, including 'Building Society', 'Chamber of Commerce', 'English', 'Insurance', 'National', 'Prince', 'Queen', 'Royal', 'Trade Union', 'Trust', and 'Windsor'.

The Regulations explain from whom permission to use the words must be gained. For example, the words which suggest a royal connection can be used only if the Home Office gives permission.

Objection to a company name

Section 69(1) allows any person to object to a company's registered name on the ground:

(a) that it is the same as a name associated with the applicant in which he has goodwill, or

(b) that it is sufficiently similar to such a name that its use in the United Kingdom would be likely to mislead by suggesting a connection between the company and the applicant.

The applicant must make the objection to a **company names adjudicator**, who can order that a name be changed. A right of appeal lies to the courts.

Before the 2006 Act came into force a business would bring a passing-off action to prevent a company registering a name which was so similar as to be likely to divert trade away from the business. The 2006 Act has not removed the common-law right to bring a passing-off action. Such an action would be appropriate if damages were being sought. A passing-off action will be successful only if the use of the name is likely to divert customers away from the established business or cause confusion between the two businesses (see Chapter 12 at 325).

Publication of name and address

All companies must publish their names:

(i) Outside the registered office and all places of business.

(ii) On all letters, invoices, notices, cheques and receipts.

(iii) On the company seal, if the company has a seal.

If the company does not publish its name as required then all of its officers, all the directors and the company secretary, are liable to be fined. Furthermore, a person who signs company letters or cheques which do not publish the company name will be personally liable to any creditor who relies on the document and loses money. This liability will also be imposed if the company name is incorrectly stated.

For example, in **Penrose *v* Martyr (1858)**, a company secretary signed a cheque on the company's behalf and was held personally liable because the word 'limited' was omitted from the company name.

Change of name

Section 77 provides that a company may change its name by special resolution, or by an ordinary resolution following a direction from the Secretary of State or a decision from the company names adjudicator, or by other means provided for by the company's articles. Where a name is changed, the company must give notice to the Registrar.

The same prohibitions will apply to a change of name as applied to the use of a name on formation of a company. The Registrar must register the changed name and has the same powers to refuse.

The Registrar of Companies

The Registrar of Companies is an official of the Department of Trade and Industry and is the head of an agency known as Companies House. The Registrar has many other duties besides registering newly formed companies. The main duties of the Registrar are:

(i) To issue a certificate of incorporation when a company is first registered. This is conclusive evidence that the company has been formed and, if appropriate, that it is limited.

(ii) To issue a certificate of incorporation on change of company name. Although a new certificate is issued the company remains the same legal person and its registered number remains the same.

(iii) To keep a list of the names of all UK registered companies, limited partnerships and limited liability partnerships.

(iv) To issue certificates of re-registration when a private company changes to a public one, or vice versa, or from unlimited to limited, or vice versa.

(v) To receive the annual return and the annual financial statements of companies.

(vi) To register and keep safe the documents which statutes require him to hold.

(vii) To issue certificates which register mortgages and charges granted by companies.

(viii) To strike companies off the register when they are dissolved.

(ix) To allow any member of the public to see the file of a particular company.

(x) To register special and extraordinary resolutions.

(xi) To publish in the *London Gazette* the fact of receipt of various documents.

Section 107(5) gives the Registrar the power to correct a document informally, if it appears incomplete or inconsistent with itself. However, the company must consent and give instructions in response to an enquiry from the Registrar. Section 108(1) allows the Registrar to make certain annotations to registers, showing such things as the date a document was received, corrections which were made to it or materials which were removed from it.

ESSENTIAL POINTS

- **A company is a legal person, with a legal identity of its own.**
- **The members of a limited company have limited liability for the debts of the company.**
- **Public limited companies (plcs) can offer their shares for sale to members of the public. It is a criminal offence for a private company to offer its shares for sale to the public.**
- **Plcs must have at least two directors. Private companies need have only one director.**
- **Private companies can pass written resolutions and do not need to hold annual general meetings.**
- **Companies are created by registration with the Registrar of Companies. Once registered, a company will be given a certificate of incorporation and will exist as a legal person.**
- **A company is formed under the 2006 Act by sending a memorandum of association to the Registrar together with an application for registration of the company, the documents which s. 9 requires and a statement of compliance.**
- **The articles of association are the internal rules of the company. They bind the company and all of the members as if they had been signed by all of the members.**
- **The names of public companies must end with 'public limited company' or 'plc'.**
- **The names of private limited companies must end with the word 'limited' or the abbreviation 'Ltd'.**

PRACTICE QUESTIONS

1 It is now possible for a person to own all of the shares in a company. If X owned all of the shares in X Co Ltd, and X Co Ltd owed no money to any creditors:

(a) Could X steal from the company?

(b) Could X sue the company?

(c) Could X be employed by the company?

2 In **Lee *v* Lee's Air Farming Ltd [1961]**, Mr Lee owned 2,999 of the 3,000 shares in a crop-spraying company. While at work Lee crashed his plane and was killed. His widow sued under a statute which required employers to pay compensation if an employee was killed at work. The company's insurers refused to pay, arguing that Lee was employed by himself, and could not therefore be an employee of the company. Did the insurers have to pay up?

3 The decision in **Salomon's case** means that investors in a limited company do not have to pay the company's debts. They may lose the value of their shares, but they can lose no more. Why is this regarded as such an important rule in a capitalist society? In what way would society be different if members of companies could not enjoy limited liability?

4 A business is registered under the name Acme Trading Ltd. Which one of the following might the company be?

(a) A public limited company.

(b) A partnership.

(c) A private limited company.

(d) Either a limited private company or an unlimited private company.

5 Arthur owns 100 shares in a private limited company which has gone into liquidation with heavy debts. Arthur has paid half the price of his shares. Which one of the following statements would be true?

(a) As the company is limited it need not pay its debts.

(b) Limited liability will mean that Arthur has to pay nothing towards the company's debts.

(c) Arthur must pay the amount unpaid on his shares. Beyond that he need pay no more.

(d) The amount of the company's debts must be paid by all shareholders in proportion to their shareholding.

6 Which one of the following statements is true?

(a) A public company need only have one director.

(b) A public company cannot be unlimited.

(c) A public company's shares must be quoted on the Stock Exchange.

(d) A public company's shares must be offered for sale to the public.

7 Which one of the following statements is not true of a private limited company?

(a) The company will continue in existence indefinitely unless it is liquidated.

(b) The company can sue on contracts made in its name.

(c) The company can employ the person who owns all the shares in the company.

(d) A major shareholder in the company cannot hold shares in a rival company.

TASK 10

A friend of yours from France is considering setting up a business in England. Your friend has asked you to draw up a report briefly explaining the following matters:

(a) The characteristics of a company.

(b) The distinction between a public company and a private company.

(c) The names which a company may use and the places in which the company name must be displayed.

(d) How a company is formed.

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Use Case Navigator to read in full some of the key cases referenced in each chapter.