

# Private companies – policy, proliferation, policing

by Andrew Hicks



The Law Commission's work reviewing the law on private companies and now on partnership law creates a unique opportunity to focus on the long term needs of the small business sector. Andrew Hicks argues that small businesses should be given a real choice of corporate form, either the traditional limited company or a new and efficient 'business corporation' which does not confer limited liability on its members.

The small business sector is often regarded as a potential growth area for the economy, particularly in terms of reducing unemployment. Successive governments have therefore been anxious to create favourable conditions for small business start-up and growth and be seen to be doing so. The focus of attention is often on the limited company; and increasing numbers of incorporations are seen to be a healthy economic indicator.

Thus the recently published figures for the year (*Companies in 1996–97*, HMSO) show a continued love affair with the limited company. With 170,000 incorporations over the year, showing an increase of 12%, this long-term proliferation seems set to continue. Companies House has achieved substantial efficiency gains and incorporates a company for the modest fee of £15, by far the lowest in Europe. Over the year they report a 25% increase in the weight of incoming mail, handling 4.2 million documents, weighing 145 tons.

The net result is about a million companies of which approximately 99% are private companies. With only around two thousand public companies listed on the London Stock Exchange, and a few hundred on the Alternative Investment Market, the raising of capital from passive investors is therefore the objective of a tiny minority of companies. The overwhelming majority of companies are private, closely-held, and often family companies. Many or most are undercapitalised. Perhaps only about half are VAT-registered and many have no active business, being nominees holding property, inactive group members, or dormant.

## SERVING THE SMALL BUSINESS SECTOR

Though allowing registration of companies with limited liability was primarily intended to attract capital for the large public concern, the limited company has also come to serve the small business sector well. Since the *Salomon* decision a hundred years ago (*Salomon v A Saloman & Co Ltd* [1897] AC 22), the right to incorporate a single member company and to deal with it, was clearly established. This success story is not easy to question, and anyone who does so may be seen as attacking a fundamental

institution. It is difficult to escape the mind-set that it is essential to encourage as many people as possible to set up limited companies and that to facilitate this, incorporation costs must be minimised and other regulatory procedures 'deregulated'. Another approach is to ask whether an alternative business form could be appropriate; a partnership with corporate form perhaps, but without limited liability. It has to be remembered that about 70% of all businesses are sole traders and partnerships and carry on business without limited liability. A new corporate form without limited liability could therefore be a viable option.

The possible reform of the law for small businesses is of current topical interest in view of the recent welcome involvement of the Law Commission in company and partnership law. In November 1994 the DTI published a consultative document entitled *Company Law Review: The Law Applicable to Private Companies*. This incorporated and consisted mainly of a feasibility study conducted by the Law Commission. One of the options under consideration was a possible new limited liability structure for small businesses. However, this did not find favour and the document concluded:

*'We consider that the reform of partnership law which addresses its main deficiencies, provides a statutory draft partnership agreement and possibly gives partnerships independent legal personality may well be of benefit to small businesses.'*

In February 1997, a review of the law of partnership by the Law Commission and the Scottish Law Commission was announced, with the issue of an initial consultation document. Its terms included particular reference to independent legal personality, and also the somewhat bizarre possibility of the extension of the proposed limited liability partnership, for use by a wider range of businesses than the large professional firms for which it is primarily intended. Fortunately, however, the latter aspect has been set aside for the time being. There is now therefore a valuable opportunity to improve the legal environment for small businesses by modernising the law of partnership.

## THE REAL CHALLENGE

However, the real challenge goes beyond making technical improvements to the law of partnership. What is needed is the provision of an efficient corporate vehicle for small businesses, but not one having limited liability. This would give those starting businesses a real choice, between the traditional private limited company and a simple 'company' form, freed of the regulatory burdens associated with limited liability. I would refer to this new vehicle as an 'incorporated partnership' except that sole traders should also be able to register their businesses in this new corporate form.

No government has adequately reviewed the impact of the *Salomon* decision. The current implication that every corner shop, taxi driver or jobbing builder in the land can have limited liability for a £15 incorporation fee, but has no other real choice of business form, does require review. The Jenkins Committee of 1962 and the 1981 white paper considering a new form of incorporation, drew attention to 'the irresponsible multiplication of one-man companies' and to 'frivolous incorporation', and to under-capitalisation and the abuse of limited liability. The Cork Report reviewing the law of insolvency in 1982 laid great stress on the dangers posed by 'phoenix companies', corporate cowboys and 'fly-by-night operators', and acknowledged the many complaints about the low levels of dividends paid to the creditors of insolvent small companies. The 1994 consultative document on the law of private companies, mentioned above, returned to this theme and discussed how to discourage inappropriate incorporation. Yet despite this cautionary note, governments continue to applaud and facilitate the explosion of incorporations, allowing limited liability to all comers as if this were the only way to do business. The penny has not yet dropped, that the way to discourage the inappropriate use of limited companies is to offer to the huge numbers of business start-ups a more efficient corporate form, but without limited liability. Ironically, the race is now on to create the opposite, namely a limited liability partnership initially for a narrow category of professional firms. This move has been taken without apparent regard for the economic purpose of limited liability.

The primary economic purpose of limited liability is (or should be) to stimulate economic activity by enabling investors to pool their capital for substantial commercial ventures. Such investors are usually in the nature of passive speculators not participating in management. The considerable privilege that they will not be liable for the debts of the company carries with it extensive disclosure and other regulatory obligations. Limited liability thus throws considerable regulatory and compliance burdens on the company itself (disclosure of accounts, audit etc.) and transfers the risk of business failure to creditors. As a complex legal regime, creating a hazard for creditors, one therefore has to ask whether its use is always economically necessary or desirable for so many smaller businesses? To what extent is it used in the small business sector to pool capital; and to what extent is limited liability necessary to induce the small entrepreneur to set up in business?

## ACCA RESEARCH

In 1995, I was commissioned by the Association of Chartered, Certified Accountants (ACCA) to investigate these and a range of other questions by empirical research considering why small businesses do or do not incorporate as limited companies and

what are the consequences of their decision. From extensive interviews with proprietors of small businesses throughout the country, it was discovered that limited liability was often not the important objective for incorporating that it was thought to be. Only about half of small company directors regarded limited liability as an important reason for incorporating and could benefit from limited liability. Of the other half, many gave personal guarantees, thus substantially foregoing the benefit of limited liability, or did not regard limited liability as important; their businesses were often low risk and stable. For these businesses limited liability was not necessary to encourage business start-ups. It also came as no surprise that none of the ninety small companies surveyed had used the limited company form to attract risk capital from outside their small circle or family.

### RESEARCH REPORT AVAILABLE

*Alternative Company Structures for the Small Business*, Hicks, Drury and Smallcombe, Research report no. 42, available from The Association of Chartered Certified Accountants, 29 Lincoln's Inn Fields, London WC2A 3EE.

So, is there any harm in encouraging free access to limited liability, given that many small businesses are happy to start-up without it? First, the risks to creditors have already been mentioned: the potential for abuse of the limited company is considerable. Ex post devices operating on insolvency are, despite the expectations of the Cork Committee, a desirable palliative but only of marginal value. Thus, wrongful trading claims are relatively rare, despite the availability of the much heralded conditional fee. Disqualification of directors for unfitness remains a relatively minor risk for the small company director despite the achievement of 1,040 disqualification orders in 1996–97. There is currently much concern about the problem of late payment, but a curious acceptance of the extent of non-payment caused by directors of small limited companies that continue to run up liabilities, long after failure is inevitable. Had the director/shareholders not had limited liability, they might have called it a day and ceased trading much earlier, thereby minimising the loss to creditors.

A recent report in *The Times* (18 November 1997) covers a report by the Institute of Chartered Accountants that business start-ups in the first half of 1997 are at a seven-year high – up 11.5% on the previous year. However, most new businesses 'have no clear strategy, no written business plan and no set growth targets'. The support network from government and other official bodies is also said to be 'unclear'. One therefore fears the next downturn in the business cycle, when it is again realised that the free availability of limited liability may have encouraged inappropriate or incompetent business start-ups, as well as the responsibly managed business, that will contribute to the economy in the long term.

## HOW EFFICIENT IS THE LIMITED COMPANY?

Apart from the damaging effect on creditors – often themselves small businesses – the question of whether the limited company is necessarily the most efficient form for smaller businesses also arises. The limited company comes with a century and a half's accumulation of legal complexity and a jumbo Companies Act of 747 sections. It will usually have a

constitution based on Table A, an archaic form primarily suitable for a 1920s public company. Small company directors grumble about lawyers and accountants fees; what they are substantially complaining of is the compliance costs associated with limited liability. Disclosure obligations, accounts and audit, maintenance of capital rules, directors' loans, financial assistance and all the fair dealing provisions aimed at ensuring that the directors do not plunder the company at the expense of creditors, impose artificial costs on small companies. Many of the nastier and most complex aspects of company law exist because of the need to protect creditors, the members not being liable for the debts of the company. Consequently, a corporate form without limited liability has no need of these complexities, and can enjoy a much simpler and more efficient legal regime.

The empirical research referred to concluded that important advantages of incorporation for small businesses included prestige and credibility, an inexpensive off-the-peg legal structure for ease of start-up, perpetual succession enabling the holding of property in the corporate name despite changes in membership and clear delineation between personal and business assets. Flexibility in creating ownership rights through shares with special rights and convenient procedures for transfer of shares are further obvious advantages. However, these are all advantages of incorporation, not advantages of limited liability. They can be fully enjoyed in an unlimited corporate form. As suggested, limited liability comes with its own inherent burdens and disadvantages which at present may not bring sufficient benefit to justify incorporation for many small businesses.

#### YOUR CHANCE TO CONTRIBUTE

Andrew Hicks is currently undertaking research for the ACCA on the disqualification of directors and would welcome any views or information on this and related issues.

#### NO REAL ALTERNATIVE

My conclusion is therefore that small businesses often incorporate because it is easy to do so and because there is no real alternative. They often do not need limited liability; they often do not benefit from it if they sign personal guarantees, and they may carry the burdens of compliance and complexity without any real benefit. The limited company often *is* but also often is *not* suitable for small businesses. While there has been a useful attempt at creating efficiency savings through 'deregulation', there are limits to this process, without allowing regulation through disclosure etc. to become minimalistic. The schizophrenia of making the limited company efficient and properly regulated for the paradigm of the big public company and, at the same time for the small private company, would only come to an end by focusing the deregulatory effort on a new unlimited corporate form. If a simple and efficient vehicle is available for small businesses the pressure to take the deregulation of limited companies to an extreme is eased.

Legislation should therefore offer an alternative corporate form offering all the advantages of incorporation except limited liability but none of the burdens associated with it. The details of my proposal for what I have called a 'business corporation' are set out in my report mentioned above. It is encouraging that the Law Commission is currently considering the possibility of the registration of partnerships conferring separate corporate personality. This goes part way towards my proposal for a new 'business corporation'. However, there is no reason to limit its

benefits to partners only. The *Salomon* case made it abundantly clear that a requirement for seven members could easily be sidestepped by a de facto sole trader. Likewise, if sole traders want to register a 'business corporation' they will, and thus should be permitted to do so. The contrary scenario would mean that if husband and wife run a registered incorporated business and following divorce, one drops out, the corporation would have to be deregistered. In any event, if a separate corporate registration offers advantages to partners, it also may offer advantages to sole traders such as perpetual succession, prestige etc.


#### CONCLUSION

In conclusion the use of limited companies need not be actively discouraged. But their use could be moderated by offering all the advantages of incorporation, in a new corporate form, but without limited liability. Small businesses could simply choose between the two forms; the conventional limited company with its extra complexity and compliance costs, or the new business corporation, a simple corporate form based on the law of contract, agency and partnership.

Information technology potentially makes registration of businesses much more feasible and efficient. Widespread registration of 'business corporations', with the register database easily accessible through public access and other computer terminals, is an obvious development. Encouraging registration would provide transparency of ownership<sup>8</sup> of more small businesses and, if extensive, could inhibit the black market and other fly-by-night operators. Giving a registration reference should become a normal aspect of doing business and could provide considerable benefits at little cost to small business operators.

This proposal is not, however, an attack on the limited company which will remain a suitable form for many medium to small businesses. But it will offer an alternative corporate form which will be more efficient for and attract many who now incorporate small limited companies. It is often those who at present inappropriately incorporate with limited liability and who are not equipped or willing to comply with its obligations that end up increasing creditors' losses and find themselves in the hands of the DTI's Disqualification Unit. The new unlimited corporate form will also be attractive and beneficial to the millions of partners and sole traders for whom there is, currently, no suitable off-the-peg business vehicle available.

For maximising the efficiency of many small businesses, to reduce the risks to creditors and to enhance regulation generally, a new unlimited corporate form is now essential as an alternative to the limited company. Such an approach is the only means of providing a real deregulation and efficiency saving without prejudicing basic regulatory objectives.

In matters of business law, legislatures generally tend to respond to short term and technical legal problems, but fail to take a longer view. Creating a new 'business corporation' without limited liability, however, requires a long term and broad view of business needs that the political process rarely seems able to generate. Current review of the law now provides a valuable opportunity to create a new unlimited corporate vehicle for small businesses. 

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