Chapter 7 Choosing the right legal structure for the business

In this chapter you will learn about the main types of business ownership. In setting up a business an entrepreneur has to accept certain legal obligations which are different depending on the type of ownership. You will learn that business ownership is not just about making a profit, but that some businesses operate 'not-for-profit'.

Sole traders, partnerships, private limited companies and public limited companies

WH Smith, Marks & Spencer and Sainsbury's are big businesses now but, as their names suggest, they all began with the ideas and efforts of just one or two business owners. Trace the history of any large business and you are likely to find key moments when ownership and organisation changed. In the private sector of the economy, businesses are owned by individuals, not the government. There are four main types of business organisation within the private sector:

- sole traders
- partnerships
- private limited companies (Ltd)
- public limited companies (plc).

Limited liability

In choosing the ideal type of ownership, the first decision is what legal status to give the business.

UNINCORPORATED BUSINESSES WITH UNLIMITED LIABILITY

Unincorporated businesses tend to be small organisations, and include sole traders and partnerships. The law does not see these businesses as being separate from their owners. This means that if the business runs into financial trouble and cannot pay the money it owes, the owners are responsible for paying the debts. This is known as having **unlimited liability**.

INCORPORATED BUSINESSES WITH LIMITED LIABILITY

The alternative option is to incorporate the business by setting it up as a company that, in the eyes of the law, is separate from the business owners. **Incorporated businesses** are known as limited companies because they have **limited liability**. This means that the owners do not have to pay off any debts using their personal finances – all they would lose is the money they had originally invested in the business. If there was not enough money left in the business to pay all those to whom it owes money (its creditors), the debts would go unpaid. There are two types of limited company: a private limited company (Ltd) and a public limited company (plc).

Key terms

Flotation Becoming a plc by issuing shares for general sale on the stock market.

Incorporated business An organisation with a separate legal identity from its owner (a limited company).

Limited liability Where a business owner can only lose the amount of money invested into the business if it fails, and not their personal wealth.

Shareholders The joint owners of a limited company, whose investment entitles them to vote on major decisions and take a share of the profit.

Unincorporated business A business that is not legally separate from its owner (sole traders and partnerships).

Unlimited liability Where the business owner can lose personal wealth to pay off business debts.

Guru's views

'The key to success is to exploit the advantages of being a sole trader and yet to take seriously the disadvantages.'

–Business Bureau-UK

Sole traders

A sole trader is a business owned by just one person. There are more sole trader businesses in the UK than any other type of business. The single owner of the business has full control over decision-making and receives all the business profits, although there may be a number of other employees working for the business. The popularity of the sole trader as a form of business ownership is largely down to its simplicity.

BEING A SOLE TRADER

Advantages

- Easy to set up the business – few forms to complete, allowing the business to be set up swiftly and cheaply.
- Complete control – the single owner makes all decisions about running the business. This allows the business to adapt quickly to customers' needs. Many sole traders find the independence of self-employment crucial to job satisfaction.
- Keep all the profit – with no other owners, the sole trader will not have to share business profits or discuss with others how they should be used.
- Personal service – a business owned and run by the same person, the sole trader, can get to know customers well and ensure their needs are met. This quality of personal service can be an excellent tool for gaining customers and keeping them loyal.
- Privacy – the business's financial information does not have to be published (except to Her Majesty's Revenue and Customs for tax purposes).
- There may be more of a chance of securing credit terms.
- There may be some types of tax advantages to being a sole trader.

Disadvantages

- Unlimited liability – if the business fails, debts must be paid by the owner; personal possessions may be at risk.
- Shortage of finance – the owner's savings may be the only source of financial capital. A bank loan may be difficult (but not impossible) to get if the business idea is a risky one. Shortage of finance may prevent expansion.
- Pressure of responsibility – running your own business can involve long hours, stress and difficulty during times of illness.
- Lack of expertise – sole traders usually have an area of expertise that led them to set up the business; but they are unlikely to have all the skills needed to manage a business successfully.
- Lack of continuity – because the business is not legally separate from the owner, if the owner retires or dies the business must be wound up (closed down).

Partnerships

A partnership is the joint ownership of a business by more than one owner. These joint owners will each:

- contribute their own financial capital to the business
- share the responsibility for decision-making and control
- share the business profits.

A partnership, like a sole trader, may have unlimited liability and so the personal finances of partners could be taken to pay off business debts. In 2001, a new law was passed that allowed Limited Partnerships

to be established. There are certain rules and regulations that have to be adhered to if applying to be a limited partnership.

The workload and profits are shared between the partners, though not necessarily equally. The partners can draw up a Deed of Partnership when they set up the business. In this they can state:

- what share of the profits each partner receives
- the role each partner can play in decision-making
- rules and procedures for solving disagreements between partners.

The Deed of Partnership is a legal document that can help to prevent disputes over who is entitled to what. It is not required by law, but without it there is an assumption that all profits will be shared equally.

PARTNERSHIPS

Advantages	Disadvantages
• Extra financial capital – with more than one business owner contributing finance, the business has more capital with which to grow. • Additional skills – partners may bring different skills to the business, allowing each to specialise in their own area of expertise. • Shared workload – the running of the business and the decision-making is shared between the business owners.	• Unlimited liability – the personal possessions of partners are at risk in the event of business failure. This will not apply if the business has successfully applied to become a Limited Partnership. • Shared profit – the downside of having partners to share the workload is that the profit has to be shared out as well! • Disagreements – having more than one person making decisions can lead to conflict and slow down decision-making. The business could lose its flexibility. • Shortage of capital – although there may be more financial capital, the amount available is still limited to the owners' contributions and what can be borrowed from a bank.

Limited companies

The alternative to being a sole trader or partnership is to set up a limited company. A limited company has a separate legal identity from its owners and so brings the protection of limited liability. Capital is invested in a limited company through the purchase of shares. A share is a part-ownership of a business. The business owners are therefore known as **shareholders**.

Shareholders have a right to share in decision-making and in profits. The more shares owned by a shareholder, the greater their power in decision-making and the greater their share of the profits. A board of directors, headed by a chairperson, is elected by shareholders to carry out the day-to-day running of a limited company.

SETTING UP A LIMITED COMPANY

Setting up a limited company involves following the formal process of incorporation by registering the business with the Registrar of Companies.

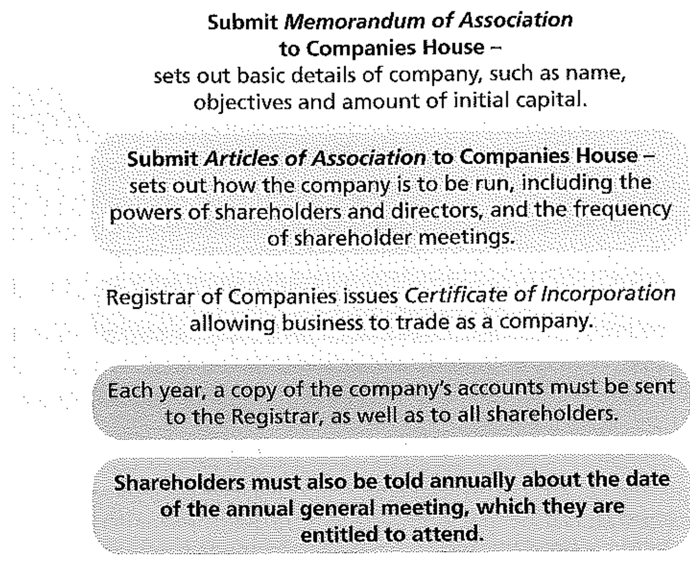

Figure 7.1 Limited company legal requirements

Private limited companies

A private limited company (Ltd) is the smaller of the two types of limited company. It is suitable for a new business start-up or for an existing sole trader or partnership seeking the benefits of limited liability. The shares it issues cannot be advertised for sale or traded on the stock market. This is why it is a private limited company – any transfer of shares must be done privately and with the agreement of all shareholders. Many Ltds are family businesses, with the family members being directors and shareholders.

PRIVATE LIMITED COMPANIES

Advantages	Disadvantages
• Limited liability – the key benefit over a sole trader or partnership. If the business fails, shareholders lose only the value of their share capital. • Sources of finance – the security of limited liability makes it easier to attract investors and so raise finance. • Continuity – the separate legal identity of the business means that it continues to exist even if one of the owners dies.	• Legal requirements – the added burden of legal duties (see Figure 7.1) takes time and money. • Loss of privacy – the need to declare business accounts to Companies House means that anyone (including competitors) can find out about a company's financial position. • Limited growth – the restriction of share capital to a maximum of £50,000, and the inability to sell shares to the public, limits the opportunities to raise finance and expand. • Some limited companies find it harder to secure loans and credit terms because of their limited liability status.

Public limited companies

A public limited company (plc) is a much larger type of company that must have at least £50,000 of share capital and has its shares traded on the stock market. The majority of the big and famous high-street names are either plcs or are owned by plcs. When a company decides to become a plc, it must be floated on the Stock Exchange. This involves publishing a prospectus to advertise the company to potential shareholders and can be an expensive process. Once a plc has a listing on the stock market, any member of the general public can buy and sell shares in the company.

PUBLIC LIMITED COMPANIES

Advantages	Disadvantages
• Sources of finance – the key benefit compared to a Ltd. Enormous potential to raise large amounts of capital as shares can be advertised to the general public, and bought and sold with ease. • Expansion – the capital available to a plc allows it to expand and benefit from the increased business size and market power. • Credibility – plc status is likely to give the business more credibility with lenders, suppliers and customers.	• Costs – initial **flotation** on the stock market is expensive, as are the requirements to publish detailed accounts and to keep large numbers of shareholders informed each year. • Loss of control – by selling shares on the stock market, the original owners' control of the company can be lost. Other individuals or businesses could take major shareholdings in a plc and maybe influence key decisions, even launching a takeover. • Business size – the growth of a plc could lead to problems, such as a lack of flexibility or loss of personal touch with customers or employees.

DIVORCE OF OWNERSHIP AND CONTROL

This can introduce a divide between those who own the company (the shareholders) and those who are controlling it on a day-to-day basis (the board of directors). This divorce (separation) of ownership and control can have important effects on the business. Decisions could be taken that meet the needs of the directors – for example, greater financial bonuses – but are not in the best interest of the business owners. Shareholders can, in theory, use their power at the annual general meeting to overrule or remove directors, but these meetings occur only once a year and are often poorly attended. In addition, many shareholders are very large so-called 'institutional investors'. These are insurance companies, other companies and pension funds who are often the largest group of owners of shares in plcs.

The effects of business ownership

The important effects that business ownership has on the way businesses operate and develop include:

- The ability to expand – a successful business might want to grow and limited company status will allow this to happen.

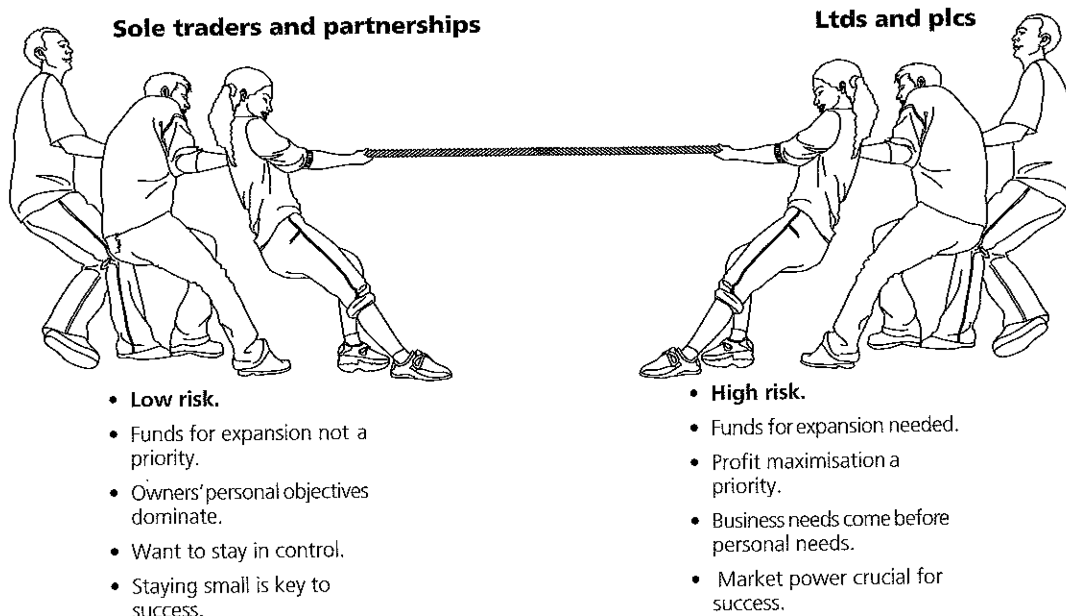

Figure 7.2 The business ownership tug-of-war

- Who is in control – from the sole trader, where a single owner is in complete control of decision-making, to a plc, where shareholders play a limited role in decision-making, business ownership determines who is in charge.
- The effects of business failure – for a sole trader or partnership, business failure can mean personal ruin. The owners of a failed limited company, on the other hand, could be back in business with a new company almost instantly. These consequences of limited liability, however, also mean that anyone who is owed money (a creditor) by a failed limited company may never be paid.

Not-for-profit businesses

A not-for-profit business is one which is formed for reasons other than generating profit. This does not mean that such an organisation does no more than cover costs – they do. However, rather than describing this as 'profit' it is more generally referred to as 'surplus'. Not-for-profit organisations can be set up for charitable, educational, scientific, research and religious purposes. As such, any surpluses that the organisation does make are ploughed back into the organisation rather than going to shareholders or the owners.

Most not-for-profit organisations share similar features with normal business organisations that exist to make profit. They have unlimited liability and are separate legal entities which can sue and be sued. However, if the organisation folds then any assets it possesses must be distributed to other similar non-profit organisations. In addition, no individual in the organisation should get any specific personal gain from the organisation.

Not-for-profit organisations are not just charities; in many respects they operate differently from charities and some of the entrepreneurs

who set them up look at specific problems and apply their skills to solving those problems. When the problem is solved they move onto other problems. Not-for-profit organisations are often referred to as social entrepreneurship and the idea is becoming increasingly popular. There may be tax advantages for such organisations. Examples of these types of organisation include the Grameen Bank which offers small, largely unsecured loans to people in poor countries, the Aravind Eye Hospital in India which carries out over 200,000 cataract operations every year, and possible plans for nurses in the NHS to form a not-for-profit organisation to sell services to primary care trusts and the National Health Service.

Further material and resources relating to this section can be found at **www.collins.bized.co.uk**. Keep checking for updates.