Chapter 1 – Business structures

Dean is a successful sole practitioner offering business consultancy services to a number of local companies. His chief competitor is Caroline, who offers similar services. Caroline and Dean decide that they wish to work together, but are unsure as to which business structure would be most appropriate. They seek your advice regarding which business structure would be most suitable, bearing in mind:

- they wish to avoid significant levels of formality and regulation
- they want to have flexibility in establishing the procedures by which the business is to be run
- they want to be able to run their affairs in private
- they want to avoid personal liability for the debts and liabilities of the business
- the process of creating the business should be relatively cheap and quick
- they do not want to invest significant amounts of their own capital in setting up the business and will probably wish to raise capital from outside sources
- they wish to take on employees.

Discuss to what extent the various business structures fulfil all, or some, of the above aims and advise Dean and Caroline which business structure would be most suitable for their business.

Introduction

- This question requires you to discuss the various business structures available and to what extent these structures suit the needs to Dean and Caroline’s proposed new business venture. This will involve a discussion of the advantages and disadvantages of the four principal business structures, namely the sole proprietorship, the partnership, the limited liability partnership, and the company.
- Remember, it may be the case that you cannot provide Dean and Caroline with a definitive answer and their requirements may not be entirely satisfied by any single business structure.

Sole proprietorship

- Dean and Caroline are already engaged in business as sole proprietors (remember that a sole proprietor who is engaged in business as a professional is known as a sole practitioner). You may wish to point out that the sole proprietorship is the most popular business structure in the UK.
- You will want to discuss how a sole proprietorship suits the needs of Dean and Caroline. There is no doubt that a sole proprietorship does satisfy many of their requirements, notably sole proprietorships involve little formality and regulation, they can be run flexibly and in private, setting up a sole proprietorship is quick, simple and cheap, and sole proprietorships are free to take on employees.
However, it is likely that a sole proprietorship will not suit the needs of Dean and Caroline’s new business. They wish to work together and a sole proprietorship consists of a single person engaged in some form of business activity. This could be circumvented by one person acting as sole proprietor and the other being an employee, but it would be likely that neither party would wish to be a mere employee. Further, only the sole proprietor would be entitled to the profits of the business.

Also, Dean and Caroline wish to avoid personal liability for the debts of the business, and the principal weakness of a sole proprietorship is that the sole proprietor is personally liable for the debts and liabilities of the business.

Finally, sole proprietors (like other unincorporated businesses) can find it difficult to attract capital from outside sources. Banks may be unwilling to lend to a sole proprietor, and it is likely that Dean and Caroline will need to invest their own capital into the business.

**Partnership**

- As Dean and Caroline wish to engage in business together, a partnership would appear to be a more suitable business structure than a sole proprietorship. Dean and Caroline could draft the partnership agreement, so that they had an equal stake in the business would each be entitled to an equal share of the firm’s profits.

- Partnerships are subject to more regulation that sole proprietorships (in the form of the Partnership Act 1890), but this level of regulation is not burdensome and in fact, much of the regulation found in the 1890 Act can be excluded by the partnership agreement (notably the implied terms). Partnerships are subject to much less regulation than companies. Having said this, some of the rules by which a partnership is run can cause difficulty (e.g. should one of the partners wish to leave the partnership, this can cause difficulties).

- Partnerships are relatively simple to set up, although the drafting of the partnership agreement does mean that a sole proprietorship is probably easier to set up. Partnerships are certainly easier to set up than companies, and can run their affairs more privately. Partnerships, like sole proprietorships, are free to take on employees.

- The principal weakness of the sole proprietorship also applies to the partnership. Liability of the partners is personal and unlimited. There are, however, two types of partnership that offer their partners limited liability, namely (i) the limited partnership, and; (ii) the limited liability partnership.

**Limited partnership**

- Limited partnerships are created under the Limited Partnerships Act 1907, and offer limited liability to its limited partners (their liability being limited to the amount of capital they have contributed). However, for several reasons, a limited partnership would not be suitable for Dean and Caroline.

- First, all limited partnerships must have at least one general partner, whose liability will be unlimited (Limited Partnerships Act 1907, s 4(2)). It is likely that neither Dean nor Caroline would wish to be such a partner.
Second, limited partners are not permitted to take part in the management of the firm, nor do they have the power to bind the firm (Limited Partnerships Act 1907, s 6(1)).

**Limited liability partnership**

- As noted above, the principal weakness of a partnership is that the partners’ liability is personal and unlimited. This would not be the case if Dean and Caroline were to conduct business through a limited liability partnership (LLP), a business structure created by the Limited Liability Partnerships Act 2000 (LLPA 2000). Usually, the partners (or members as they are known) of a LLP need not contribute anything upon the LLP’s dissolution (although there are exceptions to this).
- Also, a LLP has corporate personality (LLPA 2000, s 1(2)). Accordingly, Dena and Caroline would not normally be liable for the debts and liabilities of the LLP. As we saw, corporate personality also has a number of other practical advantages (e.g. contractual capacity etc).
- However, LLP status has only been taken up by larger professional firms and it is clear that the LLP is not a business structure of general use for several reasons. You may want to provide statistics on the number of LLP registrations to date – these can be obtained from the Companies House website.¹
- First, LLPs are created in much the same way as companies via incorporation by registration (see the LLPA 2000, ss 2 and 3 which establish the registration requirements). Incorporation by registration is more expensive and burdensome than creating an ordinary partnership.
- Second, unless otherwise stated, LLPs are subject to company law. Accordingly, they are subject to much more regulation that unincorporated business structures and their affairs are much more public.

**Company**

- Conducting business through a company offers a significant number of benefits. First, as companies have corporate personality, the members of the company will not usually be liable for the company’s debts and liabilities – the company itself will be liable. As noted, corporate personality also creates a number of other practical advantages.
- Second, the members of the company will also have limited liability. However, it should be noted that, when lending to small businesses such as the one Dean and Caroline propose to create, creditors may require personal guarantees from Dean and Caroline, thereby removing a principal benefit of conducting business through a company.
- Third, companies can raise capital from outside sources via the selling of shares. This could avoid the need for Dean and Caroline to invest their own money in the business. However, it should be noted that it is almost certain that, if Dean and Caroline were to create a company, it would be a private company, and so they could not offer to sell their shares to the public at large. Dean and Caroline would also likely wish to retain control of the company, so the proportion of the company’s shares they could sell would be limited.
- Fourth, companies are free to take on employees.

• However, conducting business through a company does have some drawbacks (many of which have been mentioned when you discussed the LLP).
• Companies are subject to much more regulation than unincorporated business structures. The Companies Act 2006 (CA 2006) imposes a significant range of burdens on companies in terms of disclosure (e.g. disclosure of accounts), procedure (e.g. the procedures relating to general meetings) and obligations (e.g. directors’ duties). The latter is important to note. Should Dean and Caroline incorporate their businesses, they will become directors subject to a range of statutory duties.
• The regulation that companies are subject to limits their flexibility. The CA 2006 imposes many requirements in relation to the running of the company. Caroline and Dean will also lose the ability to conduct their business affairs in private, as the CA 2006 imposes significant disclosure requirements upon companies.

Conclusion

• The conclusion to be drawn is that no single business structure fully satisfies the criteria set down by Dean and Caroline. Do not be afraid to say that there is no definitive answer – indeed, in many problem questions, it will be impossible for you to categorically provide an answer.