STARTING A COMPANY

BACKGROUND

Businesses may trade as sole traders, partnerships or companies. The purpose of this briefing note is to give an overview of the different type of incorporated and unincorporated companies and explain the issues which must be addressed once a decision has been made to incorporate a company.

TYPES OF COMPANY

A number of institutions are incorporated by Royal Charter or by special legislative provisions. However, the vast majority of companies are incorporated under the Companies Acts which have recently been re-enacted by the introduction of the Companies Act 2006 ("the Act") which came fully into force in October 2009. The Companies Acts and related legislation enable different types of companies to be created for different purposes namely:

PARTNERSHIP

(Partnership Act 1890)

Section 1 of the 1890 Act defines a partnership as follows:

"...partnership is the relationship which exists between persons carrying on business in common with a view to profit"

Features include:-

- *"between persons"*
- The minimum number of partners is two. There is no longer a maximum number of partners.
- The partners have unlimited liability for the debts of the partnership.
- It is not a requirement, but some form of Partnership Agreement is strongly advisable when establishing a partnership. Such an agreement is used to formalise the relationship between the partners.
- In Scotland, a partnership has a separate legal persona.

LIMITED PARTNERSHIP

(Limited Partnership Act 1907)

A Limited Partnership must have a minimum of two partners: a Limited Partner and a General Partner. The Limited Partners have limited liability but are precluded from taking part in the management of the partnership. They can however benefit from the profits. The General Partner manages the partnership and has unlimited liability. Limited Partnerships are uncommon although they are increasingly being used by Venture Capitalists and the administrators of certain other investment funds. In structures used for such purposes, the General Partner is typically an incorporated body. This is in order to 'cap' the unlimited liability of the General Partner.

LIMITED LIABILITY PARTNERSHIP

(Limited Liability Partnership Act 2000) Designed to be a hybrid between the traditional Partnership and a Company, partners all have their liability limited to the sum invested at the formation of the partnership. This type of partnership is most often used by professional firms such as accountants, solicitors and medical practitioners. They are also used as General and Limited Partners of Limited Partnerships by fund managers.

PUBLIC LIMITED COMPANY (PLC)

A plc must have an issued share capital of £50,000 which must be at least 25% paid up and it must obtain a certificate from the Registrar of Companies before it can commence trading. A company must be a plc if its shares are listed on a Recognised Investment Exchange (RIE). However, it is a common misconception that all plcs are listed on a RIE. All plcs must file full accounts within seven months of their financial year end.

UNLIMITED COMPANY

An unlimited company does not have to file its accounts and it may reduce its share capital. However, the members of an unlimited company are personally liable for its debts if it fails. This form of incorporation was popular with professional firms who did not wish to file their accounts and who felt that their clients would expect the principals to stand behind the business. However, as incorporation has become more widely accepted, those firms which choose to incorporate increasingly seek the benefits of limited liability.

COMPANY LIMITED BY GUARANTEE

This structure is often used by charities, members' clubs and trade associations. The members do not directly own any interest in the company. When the company is wound up any surplus assets may be distributed to the members. If the company is a charity, any surplus assets must be distributed to another organisation with similar charitable objectives. Charitable companies which trade actively normally incorporate a wholly-owned limited company to undertake the trading activity. The profits from such activities are covenanted to the company limited by guarantee so that the corporation tax can be reclaimed. This type of company is also used by some business angel groups.

COMPANY LIMITED BY SHARES

The vast majority of limited companies are private companies limited by shares. They may not offer their shares to the general public, they must file their accounts within nine months of the financial year end and there are certain relaxations for small- and medium-sized companies and groups to file modified accounts.

The introduction of the Act has meant that private companies are no longer required to hold annual general meetings unless the Articles of Association of the company require it or the company shareholders wish it.

TAXATION OF A LIMITED COMPANY

A company is charged Corporation Tax on its profits. The tax rates are currently as follows:

- *Gross Profit up to £300,000: 21%*
- *Gross Profit between £300,001 and*
- *£1,500,000: 30% (but is reduced through the application of Marginal Relief)*
- *Gross Profit over £1,500,000: 30%*
- *There is a 20% rate for Unit Trusts and Open-Ended Investment Companies*

SALARY/BONUSES

Any Director is taxed on income he receives from the Company. There is a potential

advantage to incorporation in that director could be paid in salary, dividends or fees.

Note however that a Director receiving a salary will pay income tax and there will be a charge to National Insurance for both the director and the company.

DIVIDENDS

A Director of a company can be a shareholder and receive dividends (and a tax credit). As dividends do not attract a charge to National Insurance, this could potentially result in considerable tax savings. However, dividends must come from distributable profits, and must be declared on all shares of the same class. This means that this method of receiving a portion of income may not be suitable for early stage companies.

THE CONSTITUTION OF A COMPANY

Prior to 1 October 2009, the constitution of a company comprised three documents, namely:

- *The Certificate of Incorporation;*
- *The Memorandum of Association; and*
- *The Articles of Association*

THE CERTIFICATE OF INCORPORATION

The Certificate of Incorporation is granted by the Registrar of Companies and it is proof of:

- *The date of incorporation;*
- *The company number. Each company has its own unique number which can never be changed;*
- *The country of incorporation (Scotland or England and Wales). Once a company has been incorporated it cannot move from one jurisdiction to the other;*
- *The name of the company on incorporation.*

THE MEMORANDUM OF ASSOCIATION

The Memorandum of Association contained the following information:

- *that the subscribers wish to form a company;*
- *that they agree to become members of the company and, in the case of a company that is to have a share capital, to take at least one share each;*
- *The memorandum had to be in the prescribed form and authenticated by each subscriber;*
- *The name of the company (which may be changed by Special Resolution);*
- *The country of incorporation;*
- *The objects of the company. The objects clause set out the objects for which the company was incorporated and the powers which it has to implement its objects. A company cannot act outwith its objects (ultra vires) and the objects of a company are therefore usually very widely drawn. It may also be incorporated simply as a "general commercial company" which enables it to undertake any form of legal business activity;*
- *A statement of limited liability (if it is a limited liability company or a company limited by guarantee); and*
- *A statement of the authorised share capital of the company on incorporation and the number of shares taken up by the subscribers.*

In October 2009 the content and purpose of the Memorandum of Association was amended to dispense with much of the above content. Henceforth, the Memorandum will only be used in practical terms as a source of reference showing when a company was founded and who founded it.

For companies formed prior to October 2009 the provisions and information contained in their Memorandum will be treated as if they are part of the Articles.

Additional changes implemented in October 2009 mean that companies no longer need to specify an authorised share capital. This means that a resolution to increase the share capital is not required prior to an investment, unless an authorised share capital is specifically imposed in the Articles.

THE ARTICLES OF ASSOCIATION

The Articles of Association are the internal regulations of the company dealing with its share capital, meetings and directors. The Articles are currently usually based on the Model Articles.

There follows a brief summary of the main points in the Articles which should be considered by those wishing to incorporate a company. However, the list is not exhaustive and detailed professional advice should be taken in every case:

Share capital - There is no longer the requirement to stipulate the authorised share capital of a company. Instead, those forming the company must include a statement of capital. This details the denomination and class of the shares and to whom they are allotted on incorporation.

If the shares are divided into different classes the rights attaching to the different classes of shares will be described in the Articles, together with provisions relating to the protection of the rights of the different classes of shareholder.

Allotment of shares - the Articles may contain a provision giving the directors power to allot shares and to disapply pre- emption rights relating to any such allotments. Such provisions should be used with care as they remove much of the protection given to minority shareholders to protect them from dilution.

Buy back of shares - the Articles will normally contain a provision giving the company the power to buy back its shares subject to compliance with the relevant provisions of the Act.

Share transfer provisions - Many private companies prefer to keep some control over the transfer of their shares and the Articles will therefore typically contain "offer round" share transfer provisions which provide that if any shares are offered for sale they must be offered round the other members in proportion to their respective shareholdings.

There may be provisions which enable shareholders to transfer shares to members of their immediate family and compulsory transfer provisions which provide that in the event of the death or incapacity or cessation of office or employment of any member his or her shares must be offered for sale.

This is usually accompanied by a valuation provision stipulating that, in the event of disagreement, the shares must be valued by the company's auditors or an independent accountant.

The accountant will normally be given directions to value the shares either on a net assets or an earnings basis or on a "going concern" basis and the valuation provisions should state whether the valuation should be discounted if a minority interest is offered for sale or valued at a premium if a controlling interest is offered for sale.

Limitation on Transfer of Control and Tag Along - the Articles may contain a provision to the effect that if an offer is received for a controlling interest in the company it may not be accepted unless a similar offer is made to all of the shareholders and another provision to the effect that, if some agreed majority of the shareholders wish to sell, the minority

must sell on the same terms.

Directors - Private companies must appoint at least one director and public companies at least two. With effect from October 2009 companies must include at least one director who is a natural person.

The Articles may contain provisions stipulating whether directors must have a shareholding or giving different groups of shareholders the right to nominate directors.

Borrowing powers - the Articles may impose some limit on the company's borrowing powers.

A CHECKLIST FOR INCORPORATION

There are a number of substantive issues which must be considered by anyone who wishes to incorporate a company. The list which follows is not in any way exhaustive but covers a number of the major issues which must be considered by everyone incorporating a business:

1. Directors' Duties and Responsibilities

The directors of every new Company must be fully aware of their duties and responsibilities. Please refer to our separate note on Directors' Duties.

2. Shareholders' Resolutions and Shareholder Meetings

Shareholders' resolutions may be passed with the signatures of only the necessary majority of shareholders (over 50% for an ordinary resolution, and 75% for a special resolution).

Shareholder meetings of private companies will require only 14 days notice. Previously, some shareholder meetings required 21 days notice e.g. AGMs.

3. Company Secretary

Private companies are not required to appoint a Company Secretary. However, the functions carried out by the Company Secretary (e.g. giving notice of meetings, writing up the statutory registers), will still need to be carried out. The directors are ultimately responsible for ensuring these functions are carried out, so it is advisable to appoint a secretary. Law firms usually offer a cost effective company secretarial service.

4. Insurance

The Company must take out appropriate employee and third party liability insurance cover as well as such other insurances as are appropriate for its business. This may include litigation protection insurance, particularly if the Company is a knowledge-based business and anticipates that it may have to enforce its intellectual property rights.

5. Issues of Shares

This is an issue of fundamental importance. A new Company may only issue a small number of shares initially but if it is successful the shares will increase rapidly in value. It is essential to consider the percentage shareholdings carefully to ensure that the implications for voting control and blocking control are fully understood. It may also be appropriate to draw up a Shareholders Agreement, particularly if the Company has external shareholders.

6. PAYE/VAT Registration

Newly incorporated companies should register with the Inland Revenue for PAYE purposes and with HM Customs & Excise for VAT purposes if they anticipate that their turnover will exceed the current VAT threshold.

7. Company Correspondence

All company stationary, emails and the company website should include the full name of the company, its number, the address of the registered office and either

the names of all of the directors or none of them.

8. Contracts of Employment

Every employer is required by law to provide employees with a statement of their terms and conditions of employment. In addition to the minimum statutory requirements issues such as confidentiality, the ownership of intellectual property and restrictive covenants should be addressed in the contract of employment.

All directors service contracts for longer than two years must be approved by the shareholders of the company.

9. Domain Names

All companies should consider registering domain names to try and ensure that they are able to use their company name as their Internet address. .co.uk and .com domain names are most commonly used by UK businesses.

10. Intellectual Property Rights

Ownership of intellectual property is increasingly coming to be recognised as one of the most important elements in the value of a knowledge-based business. The directors should carefully review the extent, if any, to which the company owns any intellectual property rights and take appropriate steps to ensure that such rights are properly protected.

11. Terms and Conditions of Trading

It is essential that every company understands the basic contractual relationships which it intends to enter into with its customers and produces appropriate terms and conditions of trading which clearly define the goods and services which it is to provide, retention of title, delivery and payment terms. All too often this basic detail is overlooked until the company finds itself in dispute with a customer.

CONCLUSION

The creation of an appropriate legal structure will have a significant bearing on the success of every business. It is essential that those involved take the time to understand the issues and ensure that a legal structure is designed which meets their specific requirements. If all of the issues are known and understood at the outset and the legal structure is designed with the specific requirements of the founders in mind there is much less scope for disagreement in the future as the basic legal structure will be known and understood by all those involved.

While all reasonable care has been taken in the preparation of this guide, no responsibility is accepted by MBM Commercial LLP for any errors it may contain, whether caused by negligence or otherwise, or for any loss, howsoever caused, occasioned to any person by reliance on it. Individual advice should be sought before considering any of the matters detailed in this guide.

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