1 –The limited company

The nature and purpose of limited liability

At the outset of this detailed handbook for directors, it is important to establish a fundamental principle: when dealing with a limited company, of any sort, there is a need to remember and recognise its independent status as a separate legal person. Although not human, a company can and does enjoy many of the same rights of individuality and recognition as a human being.

Once incorporated, a company exists as a unique legal entity, separate from its members, directors and other stakeholders. It is capable of suing others and being sued by others; capable of committing wrongs; capable of owning assets and incurring liabilities; and all of these in its own incorporated legal name. This Doctrine of Corporate Personality was established in the Companies Act 1862, and the underlying concept often referred to as the 'veil of incorporation' was upheld by the House of Lords in 1897 in the oft-quoted reference case of *Salomon v Salomon*. This continues to form an underlying principle of corporate life today, although there have been – and continue to be – attempts by statute, courts and other authorities to look 'behind the veil' to determine who really owns and controls the entity.

This separation is important from a financial ownership and operational perspective, and from the societal recognition of the limited company as a separate taxable entity. A limited company is taxed on its profitability, with no reference to any people involved in the enterprise, as opposed to a sole trader where the trading entity (name) and the person are treated as one, or a partnership where the trading entity and the partners are treated as having joint and several liability.

Directors' considerations
Do you and your board take an appropriate arm's-length view of your company as a separate legal entity?

This handbook will, from time to time, remind directors of the need to view their company from an arm's-length or third-party perspective. Even the smallest and closest of director/company relationships – a single director/single shareholder company – still needs to be able to view and understand the legal separation between the human being and the incorporated legal entity.

The principle of limited liability is derived from this legal separation. This means the liability of each shareholder is limited to the nominal value of the shares to which they have subscribed at the point they are being issued by the company. If a shareholder agrees to purchase 1,000 shares being issued by the company with a nominal value of £1, then the liability is for £1,000. Once that £1,000 has been paid to the company, the shareholder has no further liability for any of the company's debts.

This concept of limited liability is activated when a shareholder is acquiring shares from a company either at the point of incorporation or during any further and additional share issue by the company; it has no relevance when shares are being sold from one shareholder to another, unless the shares have only been partly issued and a proportion of the nominal value has yet to be paid.

Types of company

A limited company can be formed either directly through Companies House or through the services of a company formation agent. Before incorporation, it is important to have determined the type of limited company that is required to fulfil the purpose, objectives, and ethos of those forming the company.

Directors' considerations

Are you, as a director, clear on the formal legal structure of your company?

There are five types of standard company:

Private company limited by shares

- This company has a share capital and the liability of each member is limited to the amount, if any, unpaid on their shares.
- A private company cannot offer its shares for sale to the general public.

Private company limited by guarantee

- This company does not have a share capital and its members are guarantors rather than shareholders.
- The members' liability is limited to the amount they agree to contribute to the company's assets if it is wound up.

Private unlimited company

- An unlimited company may or may not have a share capital but there is no limit to the members' liability.

Public limited company

- A public company has a share capital and limits the liability of each member to the amount unpaid on their shares.
- It may offer its shares for sale to the general public and may be quoted on the stock exchange.

Community Interest Company

- A Community Interest Company (CIC) is a limited company designed for people who want to carry out activities that are intended to benefit the community.
- CICs are registered as companies under the Companies Act after the CIC Regulator has approved the application to form a CIC.
- The regulator also has a continuing monitoring and enforcement role.

Articles of association

The articles of association of a company are decided upon by the members of the company (the shareholders). Every company is required to have articles: these are legally binding on the company and all of its members, and help to ensure that the company's business runs as smoothly and efficiently as possible.

The articles set out how directors are appointed, how decisions are taken by the members and directors and a range of matters connected with shares and shareholding. The articles provide the rules of engagement from the shareholders for the directors, establishing the parameters of operation, the decision-making ability of directors and when and how further agreement or permission needs to be obtained from the shareholders.

Directors' considerations
Have you read the articles for your company? If not, why not? They contain your parameters of operation and expectation.

Provided that the articles do not contain rules that are against the law, the members have complete freedom to choose which rules are included in the company's articles. Members have the freedom to decide to draw up their own rules as bespoke articles; if choosing this route, it is advisable to obtain professional advice before proceeding.

Alternatively, members may use the Model Articles issued by Companies House as a default position. On incorporation, a company can adopt the Model Articles in their entirety or make amendments to the Model Articles to create bespoke articles. The Model Articles are suitable for most standard companies, provide useful guidance and in some cases provide a safety net. They are available for private companies limited by shares, private companies limited by guarantee and public companies. The Model Articles are available from Companies House.

If there is no indication which articles are to be adopted on formation of a company, Companies House will automatically apply the Model Articles most appropriate to the type of company being formed.

The articles can be amended at any time during the life of a company. Any amendments must be confirmed by a special resolution of the members and confirmed to Companies House within 15 days of the date the amendment takes effect.

A company can include or adopt articles which include restricted provisions and can only be repealed or amended if certain conditions are met. These are referred to as 'entrenched or restricted articles' and the requirements are detailed in s. 22 of the Companies Act 2006 (CA2006). The articles themselves must make clear the conditions that need to be satisfied in order to change any such entrenched provision. Sections 23 and 24 of CA2006 require directors to specifically notify Companies House of any changes to a previously included entrenchment.

An example of such an entrenchment could be a provision restricting the borrowing limits of directors, which members decide can only be changed with the agreement of 100% of shareholders rather than the 75% that would normally be required under Model Articles to pass a special resolution.

Directors' considerations

Do your articles contain any entrenchment clause?

Might this be a useful addition or protection for the future?

Remember that the articles are a public document, filed at Companies House and available for public inspection. This document is often not the place where a private company will place confidential information (e.g. a pre-agreed dividend policy, detailed voting arrangements, reserved rights or authority amongst family shareholders, etc.). Such agreements will generally be held in separate, private legal agreements and documents which sit alongside the articles, and often referred to as a shareholders' agreement. The articles might not always tell the full story, so sometimes it is necessary to dig deeper.

Why a company needs one or more directors

A company cannot act on its own: it is merely a legal entity formed through the operation of law. Directors are needed to satisfy the requirements of incorporation. Through the articles (and the initial Memorandum of Association), the subscribers who came together to form the company give the directors responsibility for the governance and management of the company's business.

Following incorporation and under the remit of the articles, the directors will be able to take such actions and do such things as they consider necessary to achieve the objectives and purpose of the company. This might, for example, be the immediate appointment of other officers to whom they are able to delegate certain powers to take actions on behalf of the company.

The Companies Act 2006 requires a private company to have at least one director from the point of incorporation. A private company cannot be incorporated unless it has at least one director who is a natural person (i.e. a human being rather than another company). The articles can impose a minimum and/or maximum number of directors. A private company does not need to have a company secretary unless the articles require such appointment.

Directors' considerations

Are you certain who is registered at Companies House as a director of any company in which you are involved?

The Companies Act 2006 requires a public company to have at least two directors and a suitably qualified company secretary. At least one of the directors must be a natural person. Both private companies and public companies can be formed with a single member at the point of incorporation.

Appointing and removing officers

In accordance with the articles and CA2006, the directors have a duty to shareholders and others who have dealings with the company to ensure that the required officers are appointed. These include the following.

Directors

Chapters 3 and 5 cover the appointment, expectations, resignation and removal of directors in detail.

When any such appointment or change is required or is being considered, the directors must ensure that requirements for any minimum or maximum number of directors contained in the articles are observed or risk the validity of their acts being called into question. Where the number of directors falls below the minimum required by the articles, the remaining directors do not have a right to continue to act unless this is specifically provided for in the articles. Most articles contain such a right, but in most instances, this is limited to allowing the directors to either fill the vacancy themselves or to convene a general meeting for this purpose.

Auditors

Chapter 11 in Section 3 covers in detail the appointment, expectations, resignation and removal of auditors.

A company must appoint an auditor for each financial year unless the shareholders and directors of a private company decide otherwise, on the grounds that audited accounts are not required under the prevailing small company *de minimis* rules of CA2006.

The directors of private and public companies generally have authority under the articles to appoint the first auditor and to fill any casual vacancies. When doing so, they must ensure the person or firm is properly qualified and eligible for appointment.

The directors of a public company must ensure that the auditors' reappointment and remuneration are approved each year at the general meeting at which accounts are laid before the members.

Directors' considerations

When were your auditors last reviewed before annual reappointment? As a public company this should happen on a regular timed basis, but in a private company, auditors are often just reappointed through ritual without ever challenging the real value they add.

A private company is only required to reappoint an auditor each year if this is required by provisions in the articles. The auditor's appointment for a private company will therefore be deemed to continue until such time as determined by the members, usually on the advice of the directors. Directors need to be aware that auditors of a private company cannot be deemed to be reappointed where the company has received notice from holders of at least 5% of the company's total voting rights that they should not be reappointed (CA2006, s. 488(1)).

Should this happen, the directors would need to arrange for members to vote on the matter by ordinary resolution, noting that a special notice and a general meeting would still be required should dismissal of the auditor be proposed.

Any change of auditor needs to be notified to Companies House by submitting the auditor's resignation letter and any statement from them of relevant circumstances connected with their resignation which, if received, needs also to be circulated to the members (CA2006, ss. 517 and 521).

In addition, where a new auditor is appointed during the year, special notice must be given to members of the resolution proposing such reappointment. Copies of the special notice must also be sent to the outgoing and incoming auditors (CA2006, s. 511).

Directors of listed companies should also be aware that the UK Corporate Governance Code recommends that a company's audit committee should oversee and manage the relationship with the external auditors, as well as monitor and review their performance and the extent of their independence (discussed further in Chapter 20 in Section 5).