

Company law in context



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Introduction

In this course, we will consider the nature of businesses and the principal forms of business organisation. The themes covered in Part A are company, business and capital; and in Part B, business mediums, sole traders, partnerships or firms, and assets and liabilities.

This OpenLearn course provides a sample of Level 1 study in [Law](#).

Learning Outcomes

After studying this course, you should be able to:

- **Part A:**
 - describe in general terms what a business is
 - demonstrate an appreciation of the concept of capital.
- **Part B:**
 - identify the main types of business medium
 - demonstrate an understanding of the key characteristics of businesses run as sole traders
 - determine what are the assets and liabilities of a business using numeracy skills.

1 General introduction to company law and practice

1.1 ‘Company law’

Before embarking on this course, it is important to take some time to think about the implications of its title: Company law in context. In particular, what constitutes ‘company law’, and what is the context in which we are thinking about it?

At this point, you might like to pause for a moment and contemplate what this phrase means to you. In particular, what do you understand by the concept of a ‘company’?

At first, this may seem like a ludicrously straightforward question. However, try defining ‘company’, and the idea may become harder to pin down than you first thought. For example, what about people who run businesses on their own ('sole traders'), or in partnership with other people? Can these ways of running a business be 'companies'? Does it make a difference to a business's status as a company whether it deals in goods or whether it supplies services? Does it make a difference if the business is involved in manufacturing or designing items rather than selling them?

To help you understand how companies work, and how company law has developed, it is useful to start off by looking at the different ways in which a business can be run, and how forms of business organisations other than companies work. This will give us a background against which to place the study of company law and is why we will be concentrating on how sole traders and partnerships run their businesses.



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1.2 Law and context

The law relating to businesses, which includes company law, is a highly practical subject because of the areas which it covers. You may in fact already have experience of this if you are in business; in addition or alternatively, you may be a shareholder in a company, or have lent money to one.

All students and practitioners of these areas of law therefore need to have a good understanding of how they actually work in practice, as well as the commercial, political, economic and social contexts in which they operate. For example, it is certainly important for a lawyer who advises business clients on their transactions to understand how partnership and company law work, and to have a thorough grounding in the legislation and case law in this area.

However, it is equally important to understand the practical implications of the legal advice which a lawyer might give (e.g. how to draft documentation so that it is correct for the particular way in which the client does business or how a client should structure a transaction for commercial reasons). You will therefore sometimes be asked to consider this law from the point of view of people in business (e.g. a bank manager, a partner in a business or a company director) to help you understand the practical implications. The aim of this course is to help you acquire knowledge, understanding and skills in relation to both law and the practical context in which it operates.

Most, if not all, of the work which you do in this course is designed to help you acquire knowledge of the law. To help you acquire and develop an understanding of the practical aspects of the relevant law, we will ask you at the end of the course to reflect briefly on what you have been studying (in particular, through the activities) and consider some practical points which arise.



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1.3 Wider aspects of business and company law

So far, we have touched on just a few of the many aspects of the law which relates to companies and other businesses. It will be useful at this point to consider how these areas fit into some wider issues raised by the study of law in general. For example:

- The law relating to businesses such as companies and partnerships regulates important areas of daily life, and allows you to see that there is a connection between the law and the way in which people think and behave when running a business.
- It allows you to consider the implications of creating a legal framework which regulates aspects of daily life, for example, questions may arise as to how far the law should regulate the way in which businesses operate, or whether the law in a particular area is adequate (e.g. does the present law on shareholders do enough to protect people who invest their money in companies in this way?).
- It allows a study of how and why law is made, and how and why it changes. It allows an appreciation of some of the pressures which bring about change in and development of law, and (in some areas) what roles individuals may play.
- It promotes an awareness of some of the values underpinning law, such as whether companies have a 'social' role to play.
- It allows you to consider the concept of rights and duties which lies beneath law generally. Duties and rights are usually regarded as inextricably linked; for every right enjoyed by an individual, there is a duty on others to respect that right. Equally, individuals must appreciate that other individuals also have rights. We will consider some of the issues which arise from this in a company law context.
- It allows you to understand the role of the law as a mechanism for solving problems and providing protection, and also to appreciate the law's limitations in these areas.
- It allows you to understand in general terms the need for a system of enforcement of law. Knowledge of the law is of limited use unless you understand how the system works to enforce it and the mechanisms for seeking help and advice.

Where possible, we have tried to encourage you to think through issues on your own and come to conclusions about them. We have used a range of active learning strategies, including problem-solving and decision-making to assist you in this process.



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1.4 Law, skills and learning outcomes

This course has a number of learning outcomes. In relation to a course of study, a learning outcome is simply something which you should be able to do (and to show that you can do) at the end of studying a particular course. The learning outcomes are concerned with ability to demonstrate knowledge and understanding of company law, and also ability to demonstrate a range of skills, including use of IT, research and problem-solving.

In addition to being listed at the beginning of the course, the learning outcomes for Parts A and B are set out at the start of each section. There is an opportunity at the end of each part to review the learning outcomes and reflect on how well you think you achieved them. It should therefore always be clear to you what this course is helping you to achieve.



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2 Introductory concepts

2.1 Key themes and learning outcomes

The key themes of Part A are:

company;
business;
capital.

After studying Part A, you should be able to:

- describe in general terms what a business is;
- demonstrate an appreciation of the concept of capital.



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2.2 What is a ‘company’?

In Part A, we will start by examining some of the basic concepts which will underpin your understanding of the course. We will begin by examining what you think a company is (you do not need to have previous legal knowledge for this).

Activity 1: What does ‘company’ mean?

0 hour(s) 10 minutes(s)

What do you understand by the word ‘company’? What do you think a company is, or does?

Discussion

There is not really any right answer to this activity, for different people have different conceptions of what the word ‘company’ means. Perhaps you came up with some of the following, which are listed under the word ‘company’ in the *New Shorter Oxford English Dictionary*:

- a social party or assembly;
- a number of individuals assembled or associated together; a body of people combined for some common object;
- a legal association formed to carry out some commercial or industrial undertaking;
- a party of actors, entertainers, musicians, etc.

You might have had some idea that most companies are concerned with running businesses; in which case your ideas of a company are closely related to what companies actually do, and not just what they are. This, too, is important, as we will see in due course that much of the law relating to companies arises out of the fact that most of them are business undertakings.

Our studies will be concerned in particular with the third of the ‘definitions’ in the *New Shorter Oxford English Dictionary* in the activity above. (We will not be too concerned with musicians and parties!) We will be exploring how in the eyes of the law persons may ‘combine’ to form companies, and what are the consequences which follow from them doing so. The *New Shorter Oxford English Dictionary* definition will turn out to be only a starting point for the legal concept of what a company is.



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2.3 What is a ‘business’?

The vast majority of companies are, indeed, set up and run with ‘commercial objects’ – in other words, they are business enterprises, or ‘undertakings’, set up to trade and make a profit. It is principally in the context of the company as a form of business organisation (or ‘business medium’) that we will be studying it. So, before we start to look in detail at what companies are, it is a good idea to have a grasp of what companies do, which will lead us on to consider why they exist in the first place.

The next activity will allow you to start to consider what we mean when we talk about ‘a business’ and to develop an appreciation of the range of legal issues which might affect the operation of a business. We will keep things simple at this stage by not looking at a business run by a company, but at one which is simply run by an individual person.

Activity 2: What is a business?

0 hour(s) 20 minutes(s)

Imagine you had decided to open a newsagents. What are the different things you would need to do in order to set up in business and trade? Think of as many ways as you can in which the law would have an impact on your planned activity.



Discussion

Here are some of the things you might have thought about:

You would need premises. If you bought the premises outright, you would own them (you would own what is known as the 'freehold'). You may, however, rent the premises under the terms of a lease, and have a landlord. You would need to comply with any relevant planning permissions.

You would need to buy shop fittings, and you would need to pay someone to fit them. You would need suppliers of newspapers, magazines, sweets, etc. This might involve you in entering into supply contracts. You would also enter into various contracts for the supply of gas, electricity, etc. with utilities companies.

You would be making sales to customers of your products, in respect of which you would need to comply with food safety legislation. You would need to comply with legislation about the disposal of waste; for example, of packaging. If you sold tobacco products, you would need to comply with relevant legislation about warnings and under-age sales. If you wished to sell fireworks, you would need an appropriate licence. You would need to comply with legislation relating to health and safety, and fire safety.

You would need to choose a name for your business, which may become a trademark; potentially a valuable one, in which case you might later register it. You may advertise your business.

You would probably need employees to help you in the business. They would have contracts of employment. On top of your obligations set out in the contracts of employment, you would also have to comply with a multitude of employment laws. You would have to deal with employees' tax and with employer's and employees' national insurance contributions.

You would need to enter into various insurance arrangements; in relation to your liability as an employer, this is a legal obligation.

You would need banking arrangements, which may involve borrowing facilities. You would probably need the services of accountants to deal with the accounts of your business, paying tax (if you make a profit!) and VAT. You may need the services of solicitors in relation to many of the things we are considering here (for example, to draw up contracts of employment).

If you were involved in all of these things, you would certainly be running a business.

What, then, *is* a business? Well, it is not really a ‘thing’ at all. It is perhaps better to think of it in terms of all the different things involved in running a business. A lawyer might think of a business in terms of the *totality* of the legal relationships, rights, obligations, permissions, statuses, etc., which the owner has when they are involved in running a business. It is probably not too difficult to conceive of an individual person having all of these sorts of things. We will see as we go through the course how a company may have them too.



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2.4 What is ‘capital’?

Before we move on to look at the different types of business organisation, we will introduce one more concept. It is the concept of capital. It has, historically, been a very important concept in company law. But it is a concept not limited to company law. The next activity will allow you to reflect on your own ideas of what ‘capital’ means, without you needing to have any prior legal knowledge, or, for that matter, knowledge of any other discipline.

Activity 3: Capital

0 hour(s) 10 minutes(s)

What do you understand by the word ‘capital’? What would someone mean if they said they had some capital to invest? Or if they said they had a lot of capital tied up in a business?

Discussion

Capital is one of those words with all sorts of different shades of meaning in law, accountancy, economics and even politics. After all, Karl Marx had some bad things to say about it; but capitalism is very much based on it. Fortunately, the sense in which we need to understand it for the purposes of this course is comparatively straightforward. One definition of capital in the *New Shorter Oxford English Dictionary* is:

stock with which company or person enters into business; the total sum of shareholders' contributions in a joint-stock company; accumulated wealth especially as used in further production.

These are basically the senses in which we will use the term ‘capital’ in this course.

In our newsagency business in Activity 2, you would probably have had to contribute some capital to get the business up and running. Perhaps you would need, say, a capital sum of £30,000 to buy you the means of setting up in business. (The word ‘capital’ is often used by economists to mean ‘the means of production’ in this wider sense.) You might have this capital yourself, or you might have to borrow to start your business off. If your business did well, you might decide it was worth investing more capital in it.

Sometimes capital is contrasted with profit, though both words represent forms of wealth. Suppose you invested £30,000 in your newsagency business, but traded profitably so that you could afford better premises, etc. As a result, by the end of the first year, the business was worth £40,000. In one sense, we can say that you have contributed £30,000 capital and have made £10,000 profit. Loosely speaking, we would consider capital to be the wealth *invested in* the business, and profit to be the wealth *created by* the business. This is often the sense in which lawyers think of capital: as the investment rather than the profit generated from it.

Sometimes, however, capital is used in a wider sense, to encompass all the wealth ‘tied up’ in a business: so if, in the example above, you did not take any profits out of the business, an economist or an accountant might describe the capital of the business as £40,000. Even a lawyer might describe you as having ‘capitalised’ your profits: in other words, having re-invested *in* the business the wealth created *by* the business. However, for the purposes of this course, you need not be concerned with the different senses in which the word ‘capital’ is used.

Now we have some basic concepts in our minds, we will move on to consider some of the ways in which businesses might be run.



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2.5 Review of learning outcomes

Decide for yourself, by working through the table below, whether you have satisfied the learning outcomes for Part A.

| | | |
|--|--|---|
| I am confident that I have a sufficiently comprehensive understanding to enable me to move on. | I am sufficiently confident in my understanding to enable me to move on, but I am aware that I need to revisit the material later. | I found this difficult to understand and need to look over it again before moving on. |
|--|--|---|

You should be able to:

1 Describe in general terms what a business is.

2 Demonstrate an appreciation of the concept of capital.



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3 Sole traders and partnerships as business mediums

3.1 Key themes and learning outcomes

The key themes of Part B are:

- business mediums;
- sole trader;
- partnership or firm;
- assets and liabilities.

After studying Part B, you should be able to:

- identify the main types of business medium;
- demonstrate an understanding of the key characteristics of businesses run as sole traders;
- demonstrate an understanding of the key characteristics of businesses run in partnership;
- identify in broad terms where the risks of business failure lie;
- determine what are the assets and liabilities of a business using numeracy skills.



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3.2 Forms of business organisation, or ‘business mediums’

If you were to carry on the business described in [Activity 2](#), you would be carrying on business on your own. You would be what is called a ‘sole trader’. We will look at the consequences of being a sole trader in a little bit more detail in this section.

However, not all businesses are run by sole traders. There are several different ways in which businesses may be run. In other words, there are several types of ‘business organisation’ or ‘business medium’. In England and Wales, the most common forms are: the sole trader, the partnership, the private limited company and the public limited company. In 2002, a new business form known as a ‘limited liability partnership’ was created, which is becoming a common form of business organisation in particular business sectors.

In the remainder of this course, we will look briefly at some of the fundamental legal characteristics of running a business: either as a sole trader, or in partnership. It is a good

idea to grasp the nature of sole trading and partnership as business mediums, because companies as business entities owe their very existence to the law's response to some of the problems that trading as a sole trader or in partnership give rise to.



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3.3 Sole traders

3.2.1 What is a sole trader?

If you were to set up a newsagency business on your own as described in [Activity 2](#), you would be a sole trader. Often this is described as being 'self-employed'. You would be the 'owner' of the business. Whilst other people might be involved in your business (for example, as employees or suppliers), it would nevertheless be your business.

But it follows from what we saw in [Activity 2](#) that being the 'owner' of the business involves you in a lot more than owning things. You would be the person who has all of those relevant legal relationships, rights, obligations, statuses, permissions, etc. Some of those are to do with owning things. Many are not. You are owner, buyer, seller, employer, debtor (i.e. you owe someone money), creditor (i.e. someone owes you money), contractor, tenant, taxpayer, licence holder, and perhaps a host of other things too.

3.3.2 Key characteristics of being a sole trader

In general terms, some of the key characteristics of being a sole trader are that:

- you 'own' the business; strictly, you own the property of the business, and have a variety of other legal capacities. In a more general sense, we can say that the wealth represented by the business is yours; in other words, you are entitled to all the capital of the business.
- you make the decisions which affect the nature and running of the business.
- you are entitled to the profits which the business generates.
- you are legally responsible for all of the debts and obligations of the business without limit.

In the next activity, we will consider some of the advantages and disadvantages of being a sole trader.

Activity 4: Advantages and disadvantages of being a sole trader

0 hour(s) 10 minutes(s)

Consider the 'key characteristics' of being a sole trader above. To what advantages and disadvantages do they give rise?

Discussion

The fact that you are entitled to all of the profits from the business (as well as its capital) is the attractive side of being a sole trader. If you run a newsagency as a sole

trader, the profits belong to you, because the sales which generated them were sales to your customers. Whilst your customers may have conceived of themselves as buying their sweets and magazines from 'the newsagents', in the eyes of the law, the seller is not 'the shop', but you. Customers bought their sweets and magazines from you.

On the other hand, you are legally responsible for all of the debts and obligations of the business. Suppliers and others may conceive of themselves as dealing with 'the business'. However, as we have seen, there is no single 'thing' which is the business. In the eyes of the law, they are not dealing with a 'business' at all: they are dealing with you. You are responsible for paying for the sweets and magazines supplied to you, for the gas, for the business rates, etc. If you have not paid for it, you are their debtor, and they are your creditor.

It may be that your business is lawfully run, makes a profit, your customers are happy, and your landlord, suppliers, employees and HM Revenue and Customs all get paid. However, if your business is not successful and 'runs out of money', then the law has much to say about who loses out.

We will examine a simple example, still in the context of a sole trader, in the next activity, where you will be able to consider a basic example of what might happen if a business run by a sole trader should fail.

Activity 5: Liability of a sole trader

0 hour(s) 20 minutes(s)

Imagine you had set up your newsagency investing, say, £10,000 capital into the business at the beginning. You had then run it for a number of years but it had never been a roaring success. At the end of five years, you still rent your shop. You own the fixtures and fittings, worth £5,000, and stocks of sweets and other items, worth £1,000. You also own a delivery van, worth £2,000.

Your only other wealth lies in the small flat you live in on your own. This is worth £50,000. But it is mortgaged to the building society, and you still owe them £40,000.

Now the business has hit hard times. The rent on your shop has gone up and you owe your landlord £10,000 in rent. The price of goods has gone up, and you have suppliers who are owed £7,000. They have refused to supply you with any more goods until your bill is cleared. You have outstanding bills for gas and electricity which total £8,000, and the supply of gas is about to be cut off. Your bank overdraft stands at £15,000, and the bank has refused to extend it. You have just received a tax bill for £10,000 from HM Revenue and Customs. Trade has gone down, and there is no prospect of things improving: if you carry on trading, the bills will just get bigger.

Make a list of all the amounts you own (your 'assets'), and all the amounts you owe (your 'liabilities'). You might want to use the printable PDF table linked below.

Click [here](#) to open the assets and liabilities table

Now please answer the following questions:

1. If all of your assets were sold off, would you be able to pay all of your creditors (i.e. meet all of your liabilities)?
2. What do you think your creditors will do? Do you think your home is safe?

Discussion

Here is a list of your assets and your liabilities:

| Assets | Liabilities | |
|-----------------------|-------------|---------------------------|
| Fixtures and fittings | 5,000 | Bank overdraft 15,000 |
| Stocks | 1,000 | Suppliers 7,000 |
| Van | 2,000 | Gas and electricity 8,000 |
| Flat | 50,000 | HMRC 10,000 |
| | | Rent 10,000 |
| | | Building society 40,000 |
| Total: | £58,000 | Total: £90,000 |

- As you can see, your liabilities exceed your assets by £32,000! If all of your assets were sold off, there would not be sufficient to meet all of your liabilities.
- What will your creditors do? If you do not keep up your mortgage payments, your flat may be repossessed by the building society. In any event, your other creditors will probably sue you, and if you cannot repay them, you may find that eventually they make you bankrupt (in other words, you will be found by the law to be unable to pay your debts, and as a result, your assets will be sold off and distributed amongst the persons to whom you owe money). If the building society has not already repossessed it, your flat may be sold off as part of your bankruptcy.

Perhaps this seems harsh that you should lose the roof over your head just because of your business failure. But on the other hand, your creditors are entitled to be paid, and in the circumstances described above, even if they have your flat sold, they *still* would not get everything to which they are entitled. After all, your liability to your creditors exceeds the value of your assets by some £32,000. This could, of course, have a very bad effect on some of your creditors too. For if you are not able to meet their bills, they may be unable to pay their own bills, and then they may struggle financially, too.

A sole trader may be made bankrupt on account of their business debts. But if that happens, it is not only their *business* assets which are 'up for grabs': all of their assets – including all of their *personal* wealth (with some minor exceptions) – will be realised to meet the claims of their creditors. Creditors may go unpaid in whole or in part, but, in general, they will not lose *anything* until the sole trader has lost *everything*! Being a sole trader can carry a considerable amount of risk if things go wrong; for a sole trader stands to lose much more than just the *capital* which they invested in the business. Such is the potential price of being one's own boss.

Are things any better if you run a business with somebody else? Is a problem shared a problem halved, or not? We will consider this in the next section when we look at running a business in partnership.



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3.4 Partnership

3.4.1 What is a partnership?

Persons who run a business together are said to be in partnership. Partnership is the second form of business organisation at which we shall look, and we will explore what a partnership is, in the eyes of the law, in the next activity.

Activity 6: Nature of a partnership

0 hour(s) 10 minutes(s)

Suppose you had set up a business buying and selling second-hand cars with two friends, and you decided to call it 'Yew, Hymn and Hurr, Car Dealers'. Please read s. 1 (1) of the Partnership Act 1890 as set out below to determine whether you would be 'in partnership' with your two friends.

The Partnership Act 1890, s. 1 (1), provides that:

Partnership is the relationship which subsists between persons carrying on a business in common with a view of profit.

Discussion

This wording means that, were you to run your second-hand car business together, you would indeed be in partnership with your friends: the appropriate relationship would subsist between you. Note that the existence of a partnership would not depend on any agreement to that effect between you and your friends; it would be enough that you carried on the business together with a view to making a profit. Whether or not you thought of yourselves as partners, you would still be partners in the firm of 'Yew, Hymn and Hurr, Car Dealers'. (The word 'firm' is used to refer to the partners collectively.)

You should also note that the word 'firm' is often used in a non-technical way to mean any form of business organisation. Here, however, we are using it in a more technical sense to mean the partners in a partnership, and it is preferable to stick to that sense of the term.

3.4.2 Key characteristics of a partnership

In [Part B, Section 2](#), we noted some of the key characteristics of being a sole trader. You may wish to briefly review that section before proceeding, as in the remaining activities in Part B, we will consider those same characteristics in the context of a partnership. First, we will look at those characteristics which give rise to issues as between the partners themselves.

Activity 7: Relations of partners with each other

0 hour(s) 25 minutes(s)

Suppose you have set up 'Yew, Hymn and Hurr, Car Dealers' with your friends as in [Activity 6](#). Please read s. 24 of the Partnership Act 1890 as set out below, paying particular attention to sub-sections 24(1), 24(5) and 24(8). Please then answer the following questions:

1. Who 'owns' the second-hand car business?
2. Who makes the decisions which affect the nature and running of the business?
3. Who is entitled to the profits which the business makes?



24. Rules as to interests and duties of partners subject to special agreement

The interests of partners in the partnership property and their rights and duties in relation to the partnership shall be determined, subject to any agreement express or implied between the partners, by the following rules:

- (1) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses whether of capital or otherwise sustained by the firm.
- (2) The firm must indemnify every partner in respect of payments made and personal liabilities incurred by him-
 - (a) In the ordinary and proper conduct of the business of the firm; or

- (b) In or about anything necessarily done for the preservation of the business or property of the firm.
- (3) A partner making, for the purpose of the partnership, any actual payment or advance beyond the amount of capital which he has agreed to subscribe, is entitled to interest at the rate of five per cent per annum from the date of the payment or advance.
- (4) A partner is not entitled, before the ascertainment of profits, to interest on the capital subscribed by him.
- (5) Every partner may take part in the management of the partnership business.
- (6) No partner shall be entitled to remuneration for acting in the partnership business.
- (7) No person may be introduced as a partner without the consent of all existing partners.
- (8) Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, but no change may be made in the nature of the partnership business without the consent of all existing partners.
- (9) The partnership books are to be kept at the place of business of the partnership (or the principal place, if there is more than one), and every partner may, when he thinks fit, have access to and inspect and copy any of them.

Discussion

1. Section 24(1) provides that, subject to any agreement express or implied between the partners, 'all of the partners are entitled to share equally in the capital and profits of the business' (our emphasis).
The fact that you are entitled to share in the capital equally means that you will 'own' the wealth invested in the business in equal proportions, unless you have agreed otherwise. If you had contributed different amounts of capital to the business, you probably would 'agree otherwise' – normally, you would agree that you shared in the capital of the business in the proportions that you contributed it. Note that the Partnership Act 1890 is here using the word 'capital' in the sense of 'wealth invested', and the word 'profit' in the sense of 'wealth created'. This is the 'narrower' sense of the word 'capital' which we noted in [Activity 3](#).
2. Section 24(5) provides (again subject to any agreement express or implied between the partners) that 'every partner may take part in the management of the partnership business'. Section 24(8) (again subject to contrary agreement) provides that:

Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of partners, but no change may be made in the nature of the partnership business without the consent of all the existing partners.

So, if, for example, you were to disagree about the price at which to sell a particular car, the matter would be resolved by a majority decision: two of you could 'outvote' the other. For this would be an ordinary matter connected with the partnership business. However, unanimity would be required if you wished to start buying and selling commercial vans, for this concerns the nature of the

partnership business. Even these requirements are 'subject to contrary agreement'. So, for example, you could all agree at the outset that you would not sell any cars without unanimously agreeing the price.

3. As we saw above, s. 24(1) provides that, subject to any agreement express or implied between the partners, 'all of the partners are entitled to share equally in the capital and profitsof the business' (our emphasis).

This means that any profits of the business will be shared equally between you, unless you agreed some other basis for sharing profits. The wealth the business creates (its profit) is very often shared in the same proportions as the wealth which the partners have invested in the business (its capital). This, however, does not have to be the case – it might be that one of the partners works longer hours than the others, and is rewarded with a higher proportion of the profits than their capital contribution alone would entitle them to.

You may have noted that those provisions of the Partnership Act 1890 which deal with the relations of partners *between one another* are, for the most part, subject to contrary agreement between the partners. So, as regards the relations of partners to one another, the Partnership Act 1890 provides what is basically a 'default' position.

It is normally considered good practice for partners to set out any agreement they may wish to make about their business in a formal 'partnership agreement' between them. Obviously, this will be most important where they wish to agree something different from the 'default' position that would otherwise apply under the Partnership Act 1890. A partnership agreement normally sets out the purposes of the partnership, how the partners are to be treated as owning the business, how they share any profit from it, and the rules governing its management and control. A partnership agreement is, in effect, the 'constitutional document' of a partnership. The constitutional documents of a company, in very general terms, cover the same sorts of issue that a partnership agreement would be expected to cover.

As sole traders own the capital and get to keep the profits of their businesses, so do partners – they share in the capital and profits equally, or as otherwise agreed. We will see a short example in the next activity.

Activity 8: Profit sharing between partners

0 hour(s) 15 minutes(s)

When setting up their business, Yew, Hymn and Hurr made capital contributions as follows:

Yew: £10,000

Hymn: £20,000

Hurr: £30,000

Under their partnership agreement, Hymn works six days a week, Hurr works five days a week, and Yew only works when the others are on holiday. As a result, it is agreed that the first £11,000 of profit is to be divided between Hymn and Hurr, who are to be credited with £6,000 and £5,000 respectively. The remaining profit is divided in proportion to the capital contributions of the partners. If this year's profits are £47,000, how much profit will each of the partners be entitled to?

Discussion

After allowing for the £11,000 to be divided between Hymn and Hurr, the remaining profits of the business are £36,000. This is divided between the partners in proportion to their capital contributions.

Hymn will therefore receive £6,000 plus £12,000, i.e. £18,000.

Hurr will therefore receive £5,000 plus £18,000, i.e. £23,000.

Yew will therefore receive £6,000.

We noted before that a sole trader was responsible for all of the debts and obligations of the business they ran; and we saw that one of the consequences of this was that a sole trader potentially put at risk their entire personal wealth. In the next activity, we will look at the relationship between the partners on the one hand, and the persons with whom they deal on the other. This activity will also enable us to explore the consequences of business failure for persons in partnership.

Activity 9: Relations of partners with outsiders

0 hour(s) 25 minutes(s)

Please read the extract from s. 9 of the Partnership Act 1890 as set out below. Please then consider the following circumstances:

The firm of Yew, Hymn and Hurr has hit upon hard times. The bank overdraft stands at £80,000. The firm owes its suppliers £70,000, and owes its landlord £30,000. The only property it has is ten unsold cars, which in total are worth £30,000. There is no prospect of continuing in business.

Hymn and Hurr live in rented accommodation and have no material personal wealth at all. Yew, however, lives in a house worth £80,000, and has scrimped and saved so that the mortgage is completely paid off. Yew also has a personal bank account with £50,000 in it.

1. Who is responsible for all of the debts and obligations of the business?
2. Who will end up meeting them (i.e. paying them)?

Section 9 of the Partnership Act 1890 provides that

Every partner in a firm is liable jointly with the other partners ... for all debts and obligations of the firm incurred while he is a partner; ...

Discussion

This wording means that all three partners would be jointly liable to pay off the overdraft, to pay the suppliers, to pay the rent, and so on. Note that this provision is not subject to any contrary agreement between the partners. It applies whatever the partners may think about it!

All of the partners are jointly liable to meet the claims of the firm's creditors, because the firm's creditors are simply their creditors: for Yew, Hymn and Hurr are the firm.

Only £30,000 of these claims will be able to be met out of the partnership's assets. Perhaps you think that Yew should only have to pay one-third of the remaining £150,000 owed to creditors, and that the other two-thirds is a problem for Hymn and Hurr. But you would be wrong! If Hymn and Hurr are unable to meet their share of any

liability, it is Yew's bad luck that he has money and the other partners do not, not bad luck for the creditors.

The firm's creditors will be able to enforce their claims by making Yew bankrupt, and Yew will in due course lose not only the £50,000 which he had in the bank, but also his house. Even then, £20,000 worth of the creditors' claims will not have been met!

Where a partnership business fails, creditors may go unpaid in whole or in part, but in general, they will not lose *anything* until *all* of the partners have lost *everything*! Running a business as a partnership potentially puts at risk the personal wealth of *all* of the partners. Again, much more is at risk than just the capital invested by the partners in the business. As we noted, s. 9 of the Partnership Act 1890 is not subject to contrary agreement: the law dictates that the partners of a firm are jointly liable for the debts and obligations of the firm. This was the one provision we have looked at which deals with the relations of partners with *persons dealing with the partnership* (i.e. outsiders); and it is true generally, that those provisions of the Partnership Act 1890 which regulate the relationship between the partnership and outsiders are not subject to contrary agreement by the partners.

In English law, using the words 'firm' and 'partnership' is just a convenient way of referring to the persons who are partners involved in running a business and to the relationship between them. The 'firm' is not something 'in addition to' the partners who comprise it; there is no extra entity which the law regards as existing separately from the partners (though the position is different in Scotland). It is for this reason that the assets and rights and debts and liabilities of the firm just *are* the assets and rights and debts and liabilities of the partners.



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3.5 Review of learning outcomes

Decide for yourself, by working through the table below, whether you have satisfied the learning outcomes for Part B.

| | | |
|--|--|---|
| I am confident that I have a sufficiently comprehensive understanding to enable me to move on. | I am sufficiently confident in my understanding to enable me to move on, but I am aware that I need to revisit the material later. | I found this difficult to understand and need to look over it again before moving on. |
|--|--|---|

You should be able to:

- 1 Identify the main types of business medium.**

2 Demonstrate an understanding of the key characteristics of businesses run as sole traders.

3 Demonstrate an understanding of the key characteristics of businesses run in partnership.

4 Identify in broad terms where the risks of business failure lie.

5 Determine what are the assets and liabilities of a business using numeracy skills (Activities 5, 8 and 9).

3.5.1 Review of skills

Activities [5](#), [8](#) and [9](#) allowed you to demonstrate numeracy skills by performing calculations in relation to business finance.



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4 Reflection on this course

To review and consolidate the learning which you have gained from studying this course, you might like to consider the following questions:

- Has studying the course changed your ideas in any way about what a ‘business’ is?
- Why do you think that different ways of running a business have developed under English law (e.g. sole trader, partnership, company)?
- What do you think are the advantages and disadvantages of running a business as a sole trader?
- What do you think are the advantages and disadvantages of running a business in partnership?
- How far do you think that the law set out in the Partnership Act 1890 which you have studied in this course is helpful to people running a partnership business in the 21st century?
- How efficient do you think the sole trader and partnership forms of business are likely to be in practice, considering the commercial, economic and social backgrounds against which they will operate?



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Conclusion

This free course provided an introduction to studying Law. It took you through a series of exercises designed to develop your approach to study and learning at a distance and helped to improve your confidence as an independent learner.

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