UNSW College

UNSW College Foundation Studies

Business Environments

Choice of Business Structure

Part 2: The Australian Legal Environment for Business

Unit 3: Week 4 Tutorial

Learning Objectives

At the end of this tutorial, you should be able to:

- Distinguish between incorporated and unincorporated business structures.
- Understand the doctrine of separate legal entity.
- Understand the concept of the corporate veil and how it can be lifted.
- Apply the IPAC method to solve a legal problem.
- Develop critical thinking and collaboration skills through group work and presentations.

Before this tutorial, you should have:

- Attended Unit 3 lecture
- Read the assigned *Readings*
- Completed the *Tutorial Questions*
- Read the *In-Class Collaboration and Presentations* questions

During this tutorial, you will:

- Demonstrate an understanding of the topic in the unit
- Participate in tutorial activities by:
    - Contributing to group discussions
    - Asking questions
    - Listening actively
    - Working collaboratively with other students
- Complete the *In-Class Collaboration and Presentations* activity

After this tutorial, you should:

- Consider attending one of the scheduled consultations and attempt to resolve any questions that you have as soon as possible.

Readings

Choice of Business Structure

Before commencing a business, there are many questions to consider — such as which business structure to use:

- sole proprietorship?
- partnership?
- company?
- others?

The choice of the right structure is important as this will be relevant to liability and the capacity to expand the operations of the business.

A number of factors have to be taken into account when selecting an appropriate business structure. These include:

- the purpose, objective and nature of the business
- how long it will run for
- the cost of formation
- availability of capital at both the start-up and later stages
- whether the sources of capital can be relied upon for both the working capital and any additional capital that may be needed if the business expands
- management and control
- the taxation advantages and disadvantages of the various business structures
- the provision for expansion of the business

Often, a simpler form of association may be more suitable, particularly in the early stages. As the business grows and expands, transitioning through various forms of association may become beneficial. For example, it is possible for the organisation to have started life as a sole tradership and later developed or expanded into a large public company.

Sole Trader

Setting up as a sole trader involves minimal formalities. The business is not separate from the owner, meaning the owner is fully responsible for all liabilities and entitled to all profits. The term "sole" refers to the fact that the business has only one owner, with no partners or shareholders.

However, there are several limitations to a sole proprietorship:

- Limited lifespan: The business may cease to exist upon the owner's death.
- Limited access to finance: As the business grows, a sole trader may face difficulties raising capital, as they cannot issue shares or partner with others. Funding options are typically restricted to traditional sources such as banks and mortgages, including personal property securities.

- Unlimited liability: If the business incurs debt, creditors can claim against the sole trader's personal assets, such as their house or any other personal property.

There is no specific legislation regulating sole traders. However, they must comply with general business regulations, just like any other business structure. A sole trader must be familiar with various areas of law, including competition and consumer law, contract law, tax law, health and safety regulations, and environmental rules.

Establishing a sole proprietorship does not involve the same formalities required by other business structures, making it relatively easy to start.

One key disadvantage of a sole proprietorship is the lack of continuity if the owner dies. Without proper succession planning, the business may end, or it may not remain the same if sold to someone else. The risk of death or illness can jeopardise the future of the business.

A sole trader's liability is unlimited. This means that creditors can claim against all the sole trader's assets, including both personal and business assets, in the event of debt. Public liability or professional indemnity insurance may provide some protection, but the risk remains significant.

Sole traders have complete control over their businesses, making quick decisions without consulting partners or shareholders. However, this also means that the sole trader bears all responsibility for business decisions, and may lack the expertise or resources that partners or external advisors could provide.

Partnership

A partnership is a common type of business ownership. Partnerships can be found in many parts of the Australian economy and are very common in family businesses. Individuals may, for example, enter into a partnership with their husband or wife and children. A partnership arrangement provides an inexpensive means of income splitting for family enterprises.

Unlike a company, a partnership can be established without formalities, simply by conducting business together. The key criterion is whether the parties are 'carrying on a business in common with a view to profit.'

A partnership is not a separate legal entity, unlike a company. Each partner is jointly liable with the other partners for all debts incurred by the firm. Consequently, when a legal action is brought against the firm, the partners are sued collectively rather than individually. If some partners are not included in the lawsuit, the partners who are sued can request that the others be added as co-defendants. Alternatively, they can seek to recover a proportional share of any amounts they pay from the other partners.

In all states (excluding territories), there are laws governing limited partnerships, providing an additional business structure alternative to operating as a company or association. These partnership laws permit the establishment of a partnership that includes at least one general partner who bears unlimited personal liability for all partnership debts, alongside one or more limited partners whose liability for the partnership's debts and obligations is restricted.

Limited partnerships offer considerable flexibility, enabling investment in capital-intensive ventures while allowing investors to participate without exposing themselves to unlimited liability. If the limited partnership legislation does not apply, the relevant state Partnership Act will govern the partnership.

Advantages of forming a partnership

- Easy and inexpensive to establish.
- Minimal formalities involved.
- Flexibility in changing the nature of the business through partner agreement.
- Improved management due to individual partners having different areas of expertise.
- Maintenance of confidentiality and privacy.
- Opportunity for partners to pool capital and experience.
- Partnerships are not subject to income tax; instead, each partner is taxed individually on their share of the profits in their personal tax returns.

Disadvantages of forming a partnership

- Partners face unlimited liability.
- The number of partners is limited to 20, except in professional partnerships.
- Lack of permanence, as a partnership does not exist independently of its members.
- Difficulty in transferring a partner's interest.
- Limited capacity to contract with the firm.

Partnerships are a common business structure due to their simplicity and flexibility. Partners can easily modify aspects of the business, such as the nature of the operations or the distribution of profits, as long as all parties agree.

Compared to sole proprietorship, partnerships offer the benefit of combining the financial resources of multiple partners, along with the added advantage of shared experience and expertise.

Incorporated Company

A 'company' is an association of people set up for a common object (objects) to carry on a business or other activity like manufacturing widgets. The process of becoming a company is called registration (formerly known as incorporation). Once registered, the company becomes a separate legal entity, meaning it is considered a 'person' under the law, distinct from its members.

Advantages of being a company

As a separate legal entity, a company enjoys several benefits:

- The liability of the members is limited to any unpaid amounts on their shares.
- A company is responsible for its own debts and legal obligations, not its members or management. It can enter into contracts and incur liabilities independently.

- The company owns its assets, not the members, who do not have any proprietary or insurable interest in the company's property.
- A company can initiate or defend legal actions in its own name, without involving its members personally.
- A company can continue indefinitely, regardless of changes in membership or management.
- Shares in the company can be easily transferred between investors.
- A company can operate both domestically and internationally.

Disadvantages of being a company

- Establishing a company involves costs, including ongoing expenses for accounting, auditing, and taxation services, as well as annual fees payable to the Australian Securities and Investments Commission (ASIC).
- Companies must comply with various legal formalities, including disclosure, reporting, and auditing requirements, which can add complexity and attract public scrutiny.

Classification by The Liability of Members

Companies Limited by Shares

The most common type of company is one limited by shares. This can either be a proprietary (private) company or a public company limited by shares.

The liability of the members of a company limited by shares is limited to any unpaid amount on their shares. Shares are considered the personal property of the members and are generally freely transferable.

Companies Limited by Guarantee

In a company limited by guarantee, members' liability is limited to the amount they have agreed to contribute if the company is wound up, typically a small sum (e.g., $10). Members do not incur liability upon joining, and they are only responsible for their guaranteed amount if the company is wound up and cannot meet its liabilities.

These companies do not have shares or share capital. Common examples include welfare organisations, incorporated clubs, and non-profit entities like independent schools.

A company limited by guarantee shares the same general advantages and disadvantages as any other company.

Unlimited Companies

An unlimited proprietary company is a distinct legal entity with share capital. However, unlike companies limited by shares or guarantee, there is no restriction on the liability of members to cover the company's debts if it is wound up.

In the event of liquidation, creditors can only claim from a member's assets by winding up the company.

No Liability Companies

Members of a no liability company have no limit placed on their liability for the debts and obligations of the company. The company has no right to recover from members any amounts unpaid on their investment. No liability companies are restricted to the mining industry.

The *Corporations Act 2001* (Cth) contains numerous provisions to protect members of no liability companies, who are often inexperienced investors. For instance, these companies must include the term 'No Liability' or the abbreviation 'NL' in their names to alert those interacting with them about the potential risks.

Classification by Membership

The four types of company discussed above can be categorised into two main types based on membership:

- **Proprietary companies**, or
- **Public companies**, which may or may not be listed on the stock exchange.

This distinction separates public companies, where the public has or is invited to have an interest, from smaller private companies that are exempt from many of the obligations imposed on public companies.

Proprietary Companies

A company (excluding no liability companies) can be classified as a proprietary company if it has a share capital and no more than 50 non-employee members.

Advantages

Proprietary companies benefit from fewer obligations compared to public companies:

- They are not required to hold an Annual General Meeting (AGM).
- They only need a minimum of one director.

Disadvantages

However, proprietary companies are subject to certain limitations:

- They have restrictions on the number of members.
- They cannot raise capital from the public using a prospectus.

Public Companies

Public companies are owned by the public and are not subject to the restrictions that apply to proprietary companies. A public company may be limited by shares, unlimited, or a no liability company.

A public company limited by shares may choose to be listed on the stock exchange to access capital from investors.

Company: Limitation of Liability

Upon incorporation a business becomes a separate legal entity. The incorporation of a company as a separate entity means that the debts of the company are the company's debts, and not the debts of its members or officers. In contrast, a partnership's debts are the debts of the partners.

The decision in *Salomon v Salomon & Co Ltd* recognised that a 'one-person' enterprise can incorporate as a limited liability company and be protected from liability to the creditors of the enterprise. The case is the foundation of modern company law — that the company has an existence distinct from that of its shareholders.

***Salomon v Salomon & Co Ltd* [1896] UKHL 1**

Facts

Salomon operated a boot manufacturing business as a sole trader under the name A Salomon & Co for approximately 30 years. He later incorporated this business as a limited liability company called A Salomon & Co Ltd.

Salomon sold his business to the newly formed company for around £39,000. In return, the company issued seven shares: one to Mr Salomon, one to Mrs Salomon, and five to their five adult children. Part of the purchase price was paid immediately with the shares, but the company still owed Salomon £10,000, which it agreed to pay in instalments. To secure this debt, the company granted Salomon a charge over its assets. This meant Salomon had to be fully paid before any other shareholders received funds.

Salomon had significant control over the company as its managing director, majority shareholder, and largest creditor. He also had a voting majority through his family.

Due to a market downturn, the company failed, and its assets were insufficient to pay both Salomon and the company's other creditors.

Because of the charge, Salomon had priority over the company's other creditors, meaning he had to be paid in full before any unsecured creditors were paid (secured creditors take precedence over unsecured creditors).

Decision

The court upheld the separate legal identity of the company, confirming that Salomon was entitled to the protections and benefits of limited liability.

Limitation of liability is a major advantage because it allows setting up a business without risk to the private assets of the owner and controller of the business.

Lifting of the Corporate Veil – Exceptions to Limited Liability

The limited liability company is the main business structure used in business. However, management of a limited liability company should not incur liabilities to creditors if the company cannot repay them.

The "corporate veil" can be lifted (pierced) and company members may be liable in some circumstances. This has been referred to as looking behind the "veil" of incorporation and the courts will effectively disregard a corporation's separate legal personality.

Sometimes a company is incorporated to avoid an existing legal obligation. The court may, in these circumstances, ignore the corporation's separate legal personality.

***Gilford Motor Co Ltd v Horne* [1933] Ch 935**

Facts

Horne, when he was employed by the Gilford Motor Co Ltd ("Gilford Motor"), made a contract with the company by which he promised not to solicit its customers in the event of the cessation of his employment. Horne subsequently left Gilford Motor and formed a company to carry on a similar business. Horne solicited Gilford Motor's customers for his new company. Gilford Motor sought an injunction to restrain Horne and his company from continuing to solicit customers.

Horne argued that he was not in breach of his contract since it was his company which was soliciting the plaintiff's customers.

Decision

The court rejected Horne's argument and granted an injunction against both Horne and his company, even though the latter was not a party to the original contract.

The court held that his new company was a "mere cloak or sham" which allows him to breach his contract with Gilford Motor.

References

Chew, C 2014, *Business Law Guidebook,* OUP, Melbourne, Australia.

Latimer, P 2016, *Australian Business Law 2016*, CCH Australia, Sydney, NSW, Australia.

Tutorial Questions

Students must complete the following questions before coming to class

Terms and Concepts

The following terms and concepts must be understood in the context of the tutorial.

Provide written explanations of these terms and concepts in the space provided.

Terms/Concepts	Explanation
Sole trader	
Partnership	
Incorporation	
Separate legal entity	
Corporate veil	
Unlimited liability	
Limited liability	

Separate Legal Entity and the Corporation Veil

1. Explain the doctrine of separate legal entity and the concept of the 'corporate veil'. Explain one circumstance under which the corporate veil could be lifted.

   In your answer, discuss *Salomon v Salomon & Co. Ltd* [1897] AC 22 and *Gilford Motors v Horne* [1933] Ch 93.

Separate Legal Entity and the Corporation Veil

2. Read the given facts below. Use the IPAC method to analyse the case.

> David is an employee of Lowa Pty Ltd and signs an employment contract agreeing to maintain confidentiality of Lowa Pty Ltd's trade secrets for five years after leaving the company. Six months after resigning, David incorporates a new company, FCC Ptd Ltd, and starts using Lowa Pty Ltd's trade secrets to gain a competitive advantage. Lowa Pty Ltd has found out about David's actions and has taken legal action against him.
>
> **Advise David on his legal rights.**

Issue/s:

	What is the main legal question or problem that needs to be resolved? Identify the specific issue in dispute.

Principle/s and Application:

	What are the relevant laws or legal principles that apply to this issue? State the rules or legal principles that govern the issue. This includes relevant statutes and/or case law. How do the legal principles apply to the facts of the case? Analyse how the legal principles interact with the specific facts. Clearly explain how each fact relates to the legal principles you have identified. *Integrating Principles and Applications: Immediately follow the principle with an application. For each new principle, repeat the process.*

Conclusion:

	What is the outcome based on your analysis? Summarise your analysis and state the final decision. Conclude whether the issue is resolved in favour of one party or another based on the application.

In-Class Collaboration and Presentation

Students must read the following questions before coming to class.

Choosing the Appropriate Business Structure

In this activity, you are required to evaluate different business structures (sole trader, partnership and company) and determine the most suitable one for a given business scenario, and present your answer to the class in small groups.

Instructions:

1. **Form small groups:**
    - Your tutor will divide the class into 3 groups of students.
2. **Understand the business scenario:**
    - Carefully read the provided scenario.
3. **Apply course concepts and discuss:**
    - Consider Sarah's business scenario and her priorities. Each group will look into the different business structures: sole trader, partnership and company.
    - Discuss the advantages and disadvantages of each structure in the context of Sarah's needs.
    - Each group will decide on the most suitable business structure for Sarah.
4. **Prepare your presentation:**
    - Prepare a brief presentation explaining your choice and the reasoning behind it.
    - Assign roles within your group (e.g., who will present which part of the answer).
    - Create a clear and concise presentation.
5. **Presentation:**
    - Each group will have 5-10 minutes to present their analysis and decision to the class.
    - Ensure that each member of the group participates in the presentation.
    - Be prepared to answer questions from your classmates and your tutor.

Scenario

> Sarah is planning to start a new business selling handmade jewellery. She is considering different business structures and wants to choose the one that best suits her needs. Sarah is concerned about liability, taxation, control, and future growth. She has some initial capital but may need more funding as the business grows. Sarah also wants to ensure that the business can continue smoothly if she decides to bring in partners or eventually sell it. Sarah is thinking of future growth and limited liability is something she prioritises.
>
> **Advise Sarah on which business structure would be the most suitable for her.**
>
> **<u>In your answer discuss the advantages and disadvantages of the different business structures.</u>**