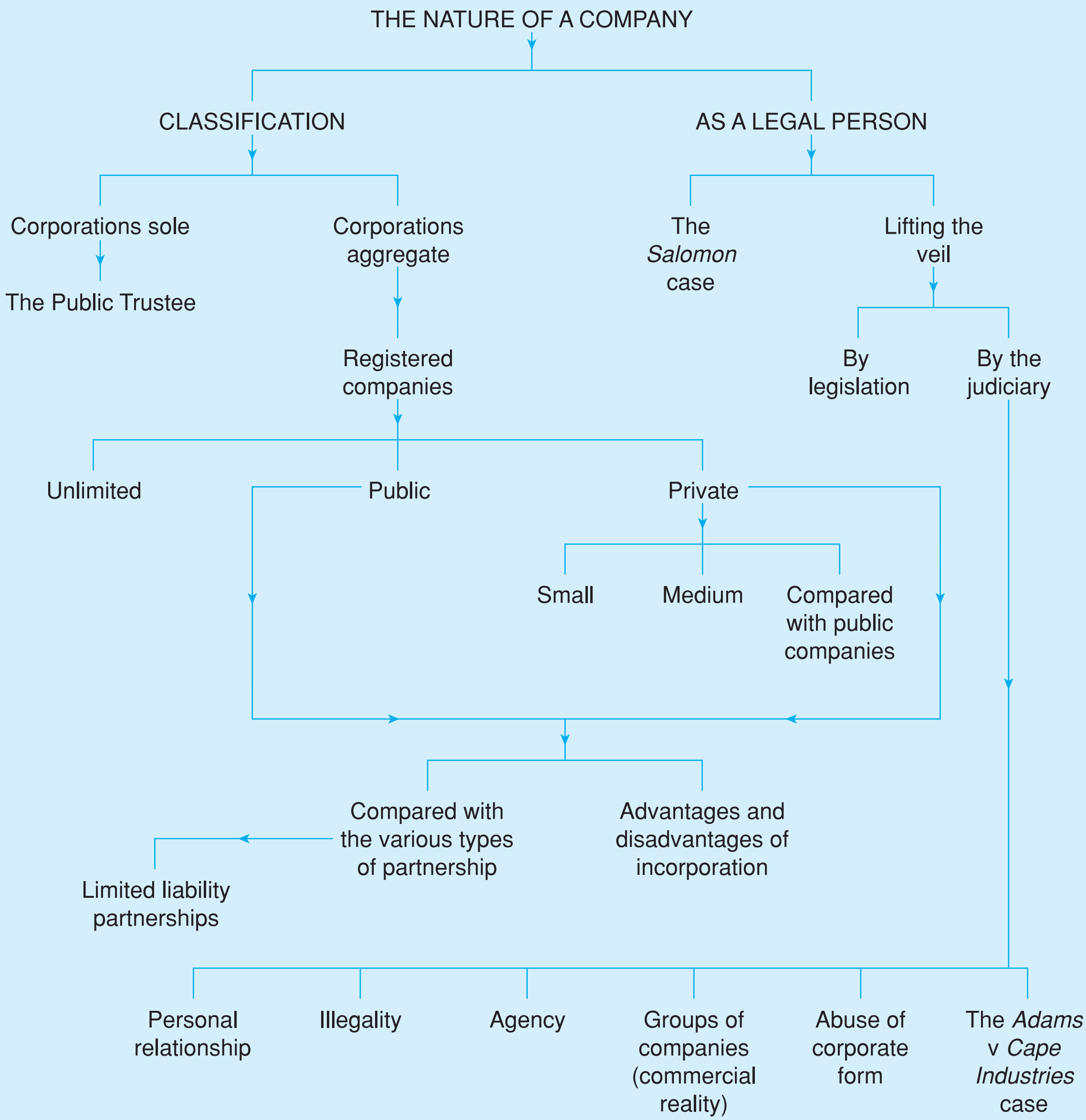
1 The nature of a company



This text is concerned almost entirely with the law relating to registered companies which, in turn, are governed in the main by the Companies Act 2006 and relevant case law. Section references have been cut to a minimum, but those that do appear relate to the Companies Act 2006 unless otherwise indicated.

As regards corporate insolvency, section references are to the Insolvency Act 1986. Here, again, a number of the sections quoted were not in the original Act but have been inserted by subsequent statutory instruments and, in particular, by the Enterprise Act 2002. Furthermore, where a case is quoted and its date is before the company legislation that it illustrates, it was decided on identical (or similar) legislation which is now consolidated into the 2006 Act. This is why a case decided in 1936 can still be used to illustrate a provision in the 2006 Act.

General features

Since a company is a corporation, it is necessary first to examine the nature of a corporation. A corporation is a succession or collection of persons having at law an existence, rights and duties, separate and distinct from those of the persons who are from time to time its members.

The distinguishing features of a corporation are:

(a) It is a persona at law (i.e. an artificial legal entity and not a natural person) which in certain circumstances may prevent it from making a successful claim for harm inflicted upon it. For instance, in ***DPP* v *Dziurzynski*** (2002) *The Times*, 8 July, a prosecution was brought against D, an animal-rights protestor, for harassing a company (B & K Universal Group Ltd) by filming its vehicles going in and out of its premises and making abusive remarks. The company brought a prosecution through the Director of Public Prosecutions under the Protection from Harassment Act 1997. The Divisional Court of the Queen's Bench ruled that the prosecution failed because a company could not be regarded as a 'person' for these purposes. The Act envisaged harassment of a human being.

(b) It has perpetual succession, i.e. its existence is maintained by the constant succession of new persons who replace those who die or are in some other way removed.

This means that even though a member dies, goes bankrupt, or retires from the company by transferring his shares, the company carries on and is not dissolved. By contrast, an ordinary partnership is dissolved when a partner dies or goes bankrupt, or retires. The business will usually continue under the remaining partners but the retiring partner is entitled, subject to what the partnership agreement says, to be paid his share in the firm. The executor of a deceased partner and the trustee in bankruptcy of a bankrupt partner are also entitled to payment of the relevant share.

This results in a return of capital in a partnership and can effect some dislocation of the business, but although this can be reduced by clauses in the articles of partnership, e.g. deferred payment, the problem cannot be totally eliminated, and provision must be made. The same does not happen in companies. A retiring shareholder must find a purchaser for the shares, as must the executors and trustee in bankruptcy. A company can purchase its own shares but is not forced to do so.

A limited liability partnership (LLP) registered under the Limited Liability Partnerships Act 2000 is more like a company than an ordinary partnership in that it has a separate existence at law, i.e. is a persona at law with its own property and liabilities separate from its members (not partners). The retirement of a member, therefore, will not effect a dissolution of the LLP but there may be problems in terms of the repayment of the retiring member's capital. It is important, therefore, that the members of the LLP make an effective and valid agreement between themselves before the LLP is registered and incorporated. That failing, the default provisions of Regs 7 and 8 of the Limited Liability Partnerships Regulations 2001 apply under which all members of an LLP are entitled to share equally in the capital and profits of the firm, and in the absence of a special member agreement would be entitled to the return of it on retirement. The members of an LLP do not hold saleable shares in the LLP and the procedure for the retirement of members and the admission of new members should appear in the pre-registration agreement, otherwise the retirement of a member and the admission of a member take place 'in accordance with any agreement made in a particular case with the other members of the LLP'.

Background to limited liability

Company law in its modern form may be traced back to the mid-nineteenth century and the enactment of the Limited Liability Act and Joint Stock Companies Acts. However, an array of business associations developed long before this time, among which was the common law construct of the partnerships. However, as England sought to expand its international trade activities across the globe, the government sought to create corporations under Royal Charters and Acts of Parliament, granting monopolies over specified territories; the best known example being the East India Company.

A similar chartered company, the South Sea Company, was established in 1711 in order to undertake trade with the Spanish South American colonies. However, it met with far less success than the British East India Company. The South Sea Company's monopoly rights were based on the Treaty of Utrecht which purported to grant the United Kingdom an *assiento* to trade in the region for thirty years. In reality the company was unable to undertake extensive business, though such problems did not permeate back to the UK for quite some time and, in the interim period, investors were encouraged to purchase large quantities of shares based on extravagant promises of profit. Consequently, as it was undertaking little actual business, the South Sea Company became extremely rich on the basis of shareholder investment.

Following the company's agreement to take on a considerable proportion of the UK's public debt in 1717, share prices continued to rise so rapidly that people began buying them merely in order to sell such shares later at a higher price. (This new breed of investors who traded in shares were called the 'stockjobbers' and were based around the coffee houses of Exchange Alley.) Shares were also sold to politicians, enabling the company to publicise a growing list of elite stockholders, further enhancing the legitimacy of its claims of lucrative trade and, in turn, speculative investment. On 21 January 1720, an announcement was made that the company would take over the entire national debt, taking on annuities of around £30 million. (Given the current global financial crisis in 2010, it is worth noting the creative solution that the government sought to use in the 1700s – using the South Sea Company as a means of reducing the cost of servicing the public debt by converting government annuities into lower-yielding shares.)

The 'South Sea bubble' was, in essence, the first speculative bubble that the UK had experienced. However, by late 1720 this bubble had 'burst' resulting in the company's share price falling from around £1,000 to less than £100. Inevitably, this burst led to widespread bankruptcies and, more importantly, impacted directly on members of the government and political classes of the country which, in turn, led to calls for greater control and regulation of companies and their directors. The estates of the company's directors were confiscated and used to offset some of the losses suffered by investors while the South Sea Company's stock was divided between the Bank of England and the East India Company; in essence, the government nationalised the company in order to protect the financial system.

The prohibition on establishing joint-stock companies with a Royal Charter set down in the Bubble Act (also known as the Royal Exchange and London Assurance Corporation Act 1719), remained in force until 1825. By this stage the Industrial Revolution had gathered momentum and, with it, a growing sense that the time was right for legal change to be effected in order to facilitate business activity. Restrictions were gradually lifted on ordinary people being permitted to incorporate businesses. However, little success was enjoyed until 1843 when William Gladstone took chairmanship of a Parliamentary Committee on Joint Stock Companies; the resultant piece of legislation being the Joint Stock Companies Act 1844.

The Joint Stock Companies Act 1844 first introduced the possibility of incorporation of companies via registration. Due to the fact that the concept of 'limited liability' remained rather a contentious issue that ran contrary to the established business practice of the time (i.e. that an individual – e.g. merchant, trader, etc. – should be personally liable for debts incurred in the course of his/her business), the Joint Stock Companies Act 1844 imposed a form of direct and unlimited liability for debts (***Re Sea Fire and Life Assurance Co, Greenwood's Case*** (1854) 3 De G M & G 459).

However, the debate as to whether limited liability ran contrary to accepted business practice designed to maintain certain standards of behaviour in society or that many members in such joint-stock companies were simply passive investors who sought no active involvement in the day-to-day running of the business (and as such should not be held accountable for any resultant debts accrued) continued, fuelled by the needs of the Industrial Revolution. The growing sense was that in order to attract capital from private investors into the hands of industrialists and/or entrepreneurs, and as such fuel the growing economy, a certain level of protection needed to be provided to these people. The Limited Liability Act 1855 marked the pivotal moment in this debate, allowing any registered company with at least 25 members to limit the liability of its members to the amounts unpaid on their shares. However, as a warning to those external to the company seeking to undertake business with it, such companies were required to place 'limited' as the last word of its name.

The Joint Stock Companies Act 1856 subsequently reduced the minimum number of members to seven. The Act also provided for the fact that the liability of members of a registered company should only be to the company and not directly to the creditors of the company. However, the 1856 Act is significant in terms of bringing together the concepts of a simple registration process coupled with limited liability in the form of the world's first modern company law legislation. All subsequent Companies Acts, even the Companies Act 2006, have sought to retain these same fundamental principles.

It is worth noting that while this new concept of limited liability encouraged private investors to invest capital into companies in which they would not undertake any active management roles, the legislation did not specify that such companies were expected to have investors who did not take part in the day-to-day running of the company. As such, the opportunity for groups of investors, who were also the managers of the company, to adopt the limited liability format began to be increasingly pursued by the late 1800s. This, in turn, gave rise to the growth of quasi-partnership companies (discussed in greater depth within Chapters 4 and 5) as well as one of the leading cases in Company Law – ***Salomon*** **v** ***Salomon & Co Ltd*** [1897] AC 22.

The growth of the corporate form and its subsequent dominance as the preferred organisational form have led to ongoing concerns regarding the accountability of managers to shareholders and attempts to reform this area of the law, even up to the present day. For example, following the Great Depression the Companies Act 1948 sought to provide greater 'shareholder democracy' within companies by ensuring that a number of member-authorisations were introduced alongside the ability of shareholders to remove directors via a simple majority vote. However, such procedures have come at the expense of time and money in compliance with such procedures. The UK government's Bullock Report published in 1977 proposed further reform in the shape of allowing employees to participate in the selection process for a company's board of directors, as exemplified by the German Codetermination Act 1976. Under this system there is a two-tier management structure (consisting of a managerial/executive board and a supervisory board), the former being responsible for the day-to-day management of the company and the latter overseeing the executive board – and having the power of appointment and removal of its personnel. (In most German public companies around one-third of the supervisory board's membership is elected by the employees of the company, with the remaining two-thirds being appointed by the shareholders.) However, the UK never implemented these reforms, driven in part by the UK's limited concern for the interests of employees. (It should be noted that the Draft Fifth EU Directive on Company Law would have introduced this two-tier model for all public companies of EU member states. However, this proposal was resisted by a number of governments, with the introduction of the Societas Europaea being the compromise position. See: Regulation (EC) 2157/2001.)

The Cork Report subsequently sought to curtail the actions of directors who negligently ran companies at a loss, resulting in the Insolvency Act 1986 and the Company Directors Disqualification Act 1986. More recently, the focus of reform has been upon internal control mechanisms (e.g. auditing processes, remuneration committees, etc.).

Classification of corporations – the company as a corporation

The main classification is between corporations sole and aggregate.

Corporation sole

A corporation may be a corporation sole (i.e. it may consist of only one member at a time holding a perpetual office). Here the office is personified to distinguish it from the person who is from time to time the holder of it.

The concept has little commercial application but a useful and practical example is provided by the Public Trustee which is a corporation sole created by the Public Trustee Act 1906. The Public Trustee is a civil servant who, while in post, is the sole member of the corporation. The corporation is trustee of much property and it would be inconvenient if all the trusts had to be transferred into the ownership of the new holder of the office every time there was a change. The office of Public Trustee, therefore, was personified as a corporation sole and the trust property is vested in the corporation and is not affected when the human holder of the office changes.

The role of Public Trustee has now been assumed by the Official Solicitor and the Public Trust Office no longer exists. The posts of Official Solicitor and Public Trustee are held by the same person, although some types of work can only be accepted by that person in the role of Public Trustee, and other types of work only in the role of Official Solicitor. The Office of the Official Solicitor and Public Trustee handles relevant business.

Corporation aggregate

A corporation aggregate consists of a number of persons so associated that in law they form a single person, e.g. a registered company. Here the undertaking is personified so that it may be distinguished from its members. A registered company is, like any other corporation, an entity separate from its members as the following cases illustrate.

Salomon* v *Salomon & Co Ltd [1897] AC 22

Salomon carried on business as a leather merchant and boot manufacturer. In 1892 he formed a limited company to take over the business. The memorandum of association was signed by Salomon, his wife, his daughter, and four of his sons. Each subscribed for one share. The subscribers met and appointed Mr Salomon and his two elder sons as directors. The company paid £39,000 to Salomon for the business, and the mode of payment was to give Salomon £10,000 in debentures, secured by a floating charge on the company's assets, and 20,000 shares of £1 each and the balance in cash. Less than one year later the company fell on hard times and a liquidator was appointed. If Salomon's debenture was valid, he was, as a secured creditor, entitled to be paid before the unsecured trade creditors. The assets were sufficient to pay off the debentures but in that event the trade creditors would receive nothing. The unsecured creditors claimed all the remaining assets on the ground that the company was a mere alias or agent for Salomon.

Held – A company is, at law, a distinct and separate person from the people who set the company up. Once an association has incorporated, the company is an independent entity, separate from those who had set it up. Any fully paid-up shareholders could not be required to pay any more. The debentures were perfectly valid, and Salomon was entitled to the remaining assets in payment of the secured debentures held by him. Lord MacNaughten stated:

> When the trial came on before Vaughan Williams J., the validity of Mr Broderip's claim was admitted, and it was not disputed that the 20,000 shares were fully paid up. The case presented by the liquidator broke down completely; but the learned judge suggested that the company had a right of indemnity against Mr Salomon. The signatories of the memorandum of association were, he said, mere nominees of Mr Salomon – mere dummies. The company was Mr Salomon in another form. He used the name of the company as an alias. He employed the company as his agent; so the company, he thought, was entitled to indemnity against its principal. The counter-claim was accordingly amended to raise this point; and on the amendment being made the learned judge pronounced an order in accordance with the view he had expressed.
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> The order of the learned judge appears to me to be founded on a misconception of the scope and effect of the Companies Act 1862. In order to form a company limited by shares, the Act requires that a memorandum of association should be signed by seven persons, who are each to take one share

at least. If those conditions are complied with, what can it matter whether the signatories are relations or strangers? There is nothing in the Act requiring that the subscribers to the memorandum should be independent or unconnected, or that they or any one of them should take a substantial interest in the undertaking, or that they should have a mind and will of their own, as one of the learned Lords Justices seems to think, or that there should be anything like a balance of power in the constitution of the company. In almost every company that is formed the statutory number is eked out by clerks or friends, who sign their names at the request of the promoter or promoters without intending to take any further part or interest in the matter.

When the memorandum is duly signed and registered, though there be only seven shares taken, the subscribers are a body corporate 'capable forthwith', to use the words of the enactment, 'of exercising all the functions of an incorporated company'. Those are strong words. The company attains maturity on its birth. There is no period of minority – no interval of incapacity. I cannot understand how a body corporate thus made 'capable' by statute can lose its individuality by issuing the bulk of its capital to one person, whether he be a subscriber to the memorandum or not. The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act. That is, I think, the declared intention of the enactment. If the view of the learned judge were sound, it would follow that no common law partnership could register as a company limited by shares without remaining subject to unlimited liability.

Mr Salomon appealed; but his appeal was dismissed with costs, though the Appellate Court did not entirely accept the view of the Court below. The decision of the Court of Appeal proceeds on a declaration of opinion embodied in the order which has been already read.

I must say that I, too, have great difficulty in understanding this declaration. If it only means that Mr. Salomon availed himself to the full of the advantages offered by the Act of 1862, what is there wrong in that? . . .

It has become the fashion to call companies of this class 'one man companies'. That is a taking nickname, but it does not help one much in the way of argument. If it is intended to convey the meaning that a company which is under the absolute control of one person is not a company legally incorporated, although the requirements of the Act of 1862 may have been complied with, it is inaccurate and misleading: if it merely means that there is a predominant partner possessing an overwhelming influence and entitled practically to the whole of the profits, there is nothing in that that I can see contrary to the true intention of the Act of 1862, or against public policy, or detrimental to the interests of creditors. If the shares are fully paid up, it cannot matter whether they are in the hands of one or many. If the shares are not fully paid, it is as easy to gauge the solvency of an individual as to estimate the financial ability of a crowd. One argument was addressed to your Lordships which ought perhaps to be noticed, although it was not the ground of decision in either of the Courts below. It was argued that the agreement for the transfer of the business to the company ought to be set aside, because there was no independent board of directors, and the property was transferred at an overvalue. There are, it seems to me, two answers to that argument. In the first place, the directors did just what they were authorised to do by the memorandum of association. There was no fraud or misrepresentation, and there was nobody deceived. In the second place, the company have put it out of their power to restore the property which was transferred to them. It was said that the assets were sold by an order made in the presence of Mr Salomon, though not with his consent, which declared that the sale was to be without prejudice to the rights claimed by the company by their counter-claim. I cannot see what difference that makes. The reservation in the order seems to me to be simply nugatory.

I am of opinion that the appeal ought to be allowed, and the counter-claim of the company dismissed with costs, both here and below.

Furthermore, Lord Halsbury stated:

My Lords, the important question in this case, I am not certain it is not the only question, is whether the respondent company was a company at all – whether in truth that artificial creation of the

Legislature had been validly constituted in this instance; and in order to determine that question it is necessary to look at what the statute itself has determined in that respect. I have no right to add to the requirements of the statute, nor to take from the requirements thus enacted. The sole guide must be the statute itself.

Now, that there were seven actual living persons who held shares in the company has not been doubted. As to the proportionate amounts held by each I will deal presently; but it is important to observe that this first condition of the statute is satisfied, and it follows as a consequence that it would not be competent to any one – and certainly not to these persons themselves – to deny that they were shareholders.

I must pause here to point out that the statute enacts nothing as to the extent or degree of interest which may be held by each of the seven, or as to the proportion of interest or influence possessed by one or the majority of the shareholders over the others. One share is enough. Still less is it possible to contend that the motive of becoming shareholders or of making them shareholders is a field of inquiry which the statute itself recognises as legitimate. If they are shareholders, they are shareholders for all purposes; and even if the statute was silent as to the recognition of trusts, I should be prepared to hold that if six of them were the *cestuis que* trust of the seventh, whatever might be their rights inter se, the statute would have made them shareholders to all intents and purposes with their respective rights and liabilities, and, dealing with them in their relation to the company, the only relations which I believe the law would sanction would be that they were corporators of the corporate body.

I am simply here dealing with the provisions of the statute, and it seems to me to be essential to the artificial creation that the law should recognise only that artificial existence – quite apart from the motives or conduct of individual corporators. In saying this, I do not at all mean to suggest that if it could be established that this provision of the statute to which I am adverting had not been complied with, you could not go behind the certificate of incorporation to show that a fraud had been committed upon the officer entrusted with the duty of giving the certificate, and that by some proceeding in the nature of *scire facias* you could not prove the fact that the company had no real legal existence. But short of such proof it seems to me impossible to dispute that once the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself, and that the motives of those who took part in the promotion of the company are absolutely irrelevant in discussing what those rights and liabilities are.

I will for the sake of argument assume the proposition that the Court of Appeal lays down – that the formation of the company was a mere scheme to enable Aron Salomon to carry on business in the name of the company. I am wholly unable to follow the proposition that this was contrary to the true intent and meaning of the Companies Act. I can only find the true intent and meaning of the Act from the Act itself; and the Act appears to me to give a company a legal existence with, as I have said, rights and liabilities of its own, whatever may have been the ideas or schemes of those who brought it into existence.

I observe that the learned judge (Vaughan Williams J) held that the business was Mr Salomon's business, and no one else's, and that he chose to employ as agent a limited company; and he proceeded to argue that he was employing that limited company as agent, and that he was bound to indemnify that agent (the company). I confess it seems to me that that very learned judge becomes involved by this argument in a very singular contradiction. Either the limited company was a legal entity or it was not. If it was, the business belonged to it and not to Mr Salomon. If it was not, there was no person and no thing to be an agent at all; and it is impossible to say at the same time that there is a company and there is not.

Comment

(i) There was no fraud upon creditors or shareholders. The creditors of the old business had been paid off. The unsecured creditors concerned in this case were creditors of the new company. The House of Lords took the view that they must be deemed to know the risk they were taking if the company went into liquidation with insufficient funds. The members who had fully paid shares could not be required to pay more. Any profit which Mr Salomon might have made as a promoter selling his business to the company, and in fact the price of some of the assets was fixed prior to sale at figures exceeding their balance sheet value by some £8,000, was fully disclosed and approved by the shareholders, i.e. his family.

(ii) The decision in ***Salomon*** was of vital importance at the time. Shortly after the industrial revolution, commerce and capitalism were on the increase and this decision encouraged individuals to provide money for businesses, without the threat of liability if the company became insolvent. This in turn increased the country's economic prosperity as more people were willing to take risks with their money within the safety buffer of limited liability.

Judicial pronouncement has also been firm in support of the principle that if people choose to conduct their affairs through the medium of corporations, they are taking advantage of the fact that in law those corporations are separate legal entities, whose property and actions are in law not the property or actions of their incorporators or shareholders.

Macaura* v *Northern Assurance Co Ltd [1925] AC 619

Macaura was the owner of a timber estate in County Tyrone and he formed an estate company and sold the timber to it for £42,000. The purchase money was paid by the issue to Macaura and his nominees of 42,000 fully paid shares of £1 each. No other shares were issued. He also financed the company and was an unsecured creditor for £19,000, its other debts being trifling. Macaura effected an insurance policy on the timber in his own name, and not in that of the company or as agent for the company, and on 23 February 1922 most of the timber was destroyed by fire. Macaura claimed under his policies, but he was held not to have an insurable interest. He could only be insuring either as a creditor or as a shareholder of the company, and neither a simple creditor nor a shareholder has an insurable interest in a particular asset which the company holds, since the company is an independent entity. Lord Sumner stated:

> My Lords, this appeal relates to an insurance on goods against loss by fire. It is clear that the appellant had no insurable interest in the timber described. It was not his. It belonged to the Irish Canadian Sawmills Ltd, of Skibbereen, Co Cork. He had no lien or security over it and, though it lay on his land by his permission, he had no responsibility to its owner for its safety, nor was it there under any contract that enabled him to hold it for his debt. He owned almost all the shares in the company, and the company owed him a good deal of money, but, neither as creditor nor as shareholder, could he insure the company's assets. The debt was not exposed to fire nor were the shares, and the fact that he was virtually the company's only creditor, while the timber was its only asset, seems to me to make no difference. He stood in no 'legal or equitable relation to' the timber at all. He had no 'concern in' the subject insured. His relation was to the company, not to its goods, and after the fire he was directly prejudiced by the paucity of the company's assets, not by the fire . . .

Lord Wrenbury also noted:

> My Lords, this appeal may be disposed of by saying that the corporator even if he holds all the shares is not the corporation, and that neither he nor any creditor of the company has any property legal or equitable in the assets of the corporation.

Comment

Unlike a shareholder, a debenture holder can insure the property of the company on which his debenture is secured (***Westminster Fire Office* v *Glasgow Provident Investment Society*** (1888) 13 App Cas 699). The difference in the debenture holder's position is justifiable since as a secured creditor he has an interest by way of a charge on the company's property which, of course, the shareholder does not have.

Lee (Catherine) v Lee's Air Farming Ltd [1960] 3 All ER 420

In 1954 the appellant's husband formed the respondent company which carried on the business of crop spraying from the air. In March 1956, Mr Lee was killed while piloting an aircraft during the course of top-soil dressing, and Mrs Lee claimed compensation from the company, as the employer of her husband, under the New Zealand Workers' Compensation Act 1922. Since Mr Lee owned 2,999 of the company's 3,000 £1 shares and since he was its governing director, the question arose as to whether the relationship of employer and employee could exist between the company and him. One of his first acts as governing director had been to appoint himself the only pilot of the company at a salary arranged by himself. The judgment of their Lordships was delivered by Lord Morris of Borth-Y-Gest, who stated:

> The Court of Appeal recognised that a director of a company may properly enter into a service agreement with his company, but they considered that, in the present case, inasmuch as the deceased was the governing director in whom was vested the full government and control of the company he could not also be a servant of the company. After referring in his judgment to the delegation to the deceased of substantially all the powers of the company, North J said: 'These powers were moreover delegated to him for life and there remained with the company no power of management whatsoever. One of his first acts was to appoint himself the only pilot of the company, for, although article 33 foreshadowed this appointment, a contract could only spring into existence after the company had been incorporated. Therefore, he became in effect both employer and worker. True, the contract of employment was between himself and the company . . . but on him lay the duty both of giving orders and obeying them. In our view, the two offices are clearly incompatible. There could exist no power of control and therefore the relationship of master–servant was not created.'
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> The substantial question which arises is, as their Lordships think, whether the deceased was a 'worker' within the meaning of the Workers' Compensation Act, 1922, and its amendments. Was he a person who had entered into or worked under a contract of service with an employer? The Court of Appeal thought that his special position as governing director precluded him from being a servant of the company. On this view it is difficult to know what his status and position was when he was performing the arduous and skilful duties of piloting an aeroplane which belonged to the company and when he was carrying out the operation of top-dressing farm lands from the air. He was paid wages for so doing. The company kept a wages book in which these were recorded. The work that was being done was being done at the request of farmers whose contractual rights and obligations were with the company alone. It cannot be suggested that when engaged in the activities above referred to the deceased was discharging his duties as governing director. Their Lordships find it impossible to resist the conclusion that the active aerial operations were performed because the deceased was in some contractual relationship with the company. That relationship came about because the deceased as one legal person was willing to work for and to make a contract with the company which was another legal entity. A contractual relationship could only exist on the basis that there was consensus between two contracting parties. It was never suggested (nor in their Lordships' view could it reasonably have been suggested) that the company was a sham or a mere simulacrum. It is well established that the mere fact that someone is a director of a company is no impediment to his entering into a contract to serve the company. If, then, it be accepted that the respondent company was a legal entity their Lordships see no reason to challenge the validity of any contractual obligations which were created between the company and the deceased . . .
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> Nor in their Lordships' view were any contractual obligations invalidated by the circumstance that the deceased was sole governing director in whom was vested the full government and control of the company. Always assuming that the company was not a sham then the capacity of the company to make a contract with the deceased could not be impugned merely because the deceased was the agent of the company in its negotiation. The deceased might have made a firm contract to serve the company for a fixed period of years. If within such period he had retired from the office of governing director and other directors had been appointed his contract would not have been affected. The circumstance that in his capacity as a shareholder he could control the course of events would not in

> itself affect the validity of his contractual relationship with the company. When, therefore, it is said that 'one of his first acts was to appoint himself the only pilot of the company', it must be recognised that the appointment was made by the company, and that it was none the less a valid appointment because it was the deceased himself who acted as the agent of the company in arranging it. In their Lordships' view it is a logical consequence of the decision in ***Salomon's*** case that one person may function in dual capacities. There is no reason, therefore, to deny the possibility of a contractual relationship being created as between the deceased and the company. If this stage is reached then their lordships see no reason why the range of possible contractual relationships should not include a contract for services, and if the deceased as agent for the company could negotiate a contract for services as between the company and himself there is no reason why a contract of service could not also be negotiated. It is said that therein lies the difficulty, because it is said that the deceased could not both be under the duty of giving orders and also be under the duty of obeying them. But this approach does not give effect to the circumstance that it would be the company and not the deceased that would be giving the orders. Control would remain with the company whoever might be the agent of the company to exercise it. The fact that so long as the deceased continued to be governing director, with amplitude of powers, it would be for him to act as the agent of the company to give the orders, does not alter the fact that the company and the deceased were two separate and distinct legal persons. If the deceased had a contract of service with the company then the company had a right of control. The manner of its exercise would not affect or diminish the right to its exercise. But the existence of a right to control cannot be denied if once the reality of the legal existence of the company is recognised. Just as the company and the deceased were separate legal entities so as to permit of contractual relations being established between them, so also were they separate legal entities so as to enable the company to give an order to the deceased . . .
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> *Ex facie* there was a contract of service. Their Lordships conclude, therefore, that the real issue in the case is whether the position of the deceased as sole governing director made it impossible for him to be the servant of the company in the capacity of chief pilot of the company. In their Lordships' view, for the reasons which have been indicated, there was no such impossibility. There appears to be no greater difficulty in holding that a man acting in one capacity can give orders to himself in another capacity than there is in holding that a man acting in one capacity can make a contract with himself in another capacity. The company and the deceased were separate legal entities. The company had the right to decide what contracts for aerial top-dressing it would enter into. The deceased was the agent of the company in making the necessary decisions. Any profits earned would belong to the company and not to the deceased. If the company entered into a contract with a farmer, then it lay within its right and power to direct its chief pilot to perform certain operations. The right to control existed even though it would be for the deceased in his capacity as agent for the company to decide what orders to give. The right to control existed in the company, and an application of the principles of ***Salomon's*** case demonstrates that the company was distinct from the deceased. As pointed out above, there might have come a time when the deceased would remain bound contractually to serve the company as chief pilot though he had retired from the office of sole governing director. Their Lordships consider, therefore, that the deceased was a worker and that the question posed in the case stated should be answered in the affirmative.

Held – Mrs Lee was entitled to compensation because her husband was employed by the company in the sense required by the Act of 1922, and the decision in ***Salomon* v *Salomon & Co*** was applied.

Comment

(i) In ***AG's Reference (No 2 of 1982)*** [1984] 2 All ER 216 the Court of Appeal held that two directors who were also shareholders of several companies were capable of stealing from those companies. Money from the companies, which had raised large loans from various institutions, had been used, it was alleged, to support the extravagant lifestyle of the directors and their wives. There had, it was alleged, been a spending of the company's money in hotels and restaurants and on cars, yachts, and house improvements, silver and antiques. The effect on creditors was obviously uppermost in the mind of the court, which felt that a criminal sanction was needed. By applying the rule of corporate personality the directors could, as a matter of law, be liable for stealing from a company which they owned.

(ii) This case has been distinguished in employment/insolvency law. When a company becomes insolvent, directors, who are regarded for many purposes as employees, i.e. the executive directors such as the finance director, are preferential creditors for salary due up to defined limits. These will be discussed in later chapters on company charges and insolvency. If the insolvent company cannot meet these payments, there may be a claim through the government's Business, Enterprise & Regulatory Reform Department (BERR), which in turn will try to recoup any payments made from the company. However, where the director concerned is also a controlling shareholder, the Employment Appeal Tribunal has refused to support claims on the BERR. Lee's case has been distinguished because claims on the BERR are met from public funds whereas in Lee's case the funds were supplied by the company's insurers (see ***Buchan* v *Secretary of State for Trade and Employment*** (1997) 565 IRLB 2). The tribunal approach is based upon the fact that the definition of an employee still requires an element of employer control which is not present where the worker in effect controls himself. However, in ***Fleming* v *Secretary of State for Trade and Industry*** (1998) 588 IRLB 10 the Scottish Court of Session rejected the view expressed in Buchan that a controlling shareholder/director could never as a matter of law be an employee. However, the director's claim in ***Fleming*** was turned down on the facts. He worked alongside the employees but was a majority shareholder and had guaranteed the company's debts. The ***Fleming*** approach was also approved by the Employment Appeal Tribunal in ***Secretary of State for Trade and Industry* v *Bottrill*** [1998] IRLR 120 where Morison J said that the reasoning in Buchan was 'unsound'. The decision of the EAT was affirmed by the Court of Appeal in ***Secretary of State for Trade and Industry* v *Bottrill*** (1999) 615 IRLB 12. In ***Connolly* v *Sellers Arenascene Ltd*** (2000) 633 IRLB 15 the EAT ruled that the controlling shareholder of a company could be an employee. He had a contract of employment with the company. The contract was not a sham and he had been treated and rewarded as an employee.

It seems then from the case law that a director/controlling shareholder will be regarded as an employee where there is a written contract of employment and all the usual hallmarks of employment are present. Certainly the original, almost blanket, ban on controlling shareholder/directors as employees has been much eroded.

(iii) The courts continue to be willing to draw aside the corporate veil where the circumstances warrant it. Thus, in ***Secretary of State for Trade and Industry* v *Backhouse*** (2001) *The Times*, 23 February, Mr Backhouse was ordered to pay the costs of the Secretary of State in connection with a winding-up petition presented by him against North West Holdings plc, a company controlled by Mr Backhouse. It appeared that Mr Backhouse had caused the company to defend the petition not in the interests of the company but in order to protect his own personal reputation. His personal business affairs were bound up with those of the company and money the company earned had been treated as if it belonged to Mr Backhouse. The court drew aside the corporate veil so as to make the company's liability to pay costs that of Mr Backhouse personally. The court would obviously bear in mind that if the company was required to pay the costs, they would in effect be paid by the company's creditors who would be denied access to the funds required to pay them.

Again, in ***Trustor AB* v *Smallbone*** (2001) *The Times*, 30 March, Mr Smallbone, a director of Trustor AB, opened a bank account in London for the company and without the approval of the board paid money belonging to Trustor AB from its account in Sweden to the London account. Mr Smallbone then paid £38 million from Trustor AB's account in London to the account of a company called Introcom (International) Ltd that he controlled. When this was discovered by the members of the board of Trustor AB, they caused the company to claim the funds back from Introcom and also claimed that Mr Smallbone should be regarded as having received the money personally so that he was liable to repay the money personally if Introcom did not. The High Court ruled that the corporate veil could be drawn aside in this case to make Mr Smallbone personally liable.

On the other hand, the Court of Appeal refused to draw aside the veil in ***Ord* v *Belhaven Pubs Ltd*** [1998] 2 BCLC 447. The Ords purchased a 20-year lease of a pub, the Fox Inn. Belhaven Pubs Ltd owned the freehold and was the landlord. The Ords later alleged misrepresentation by Belhaven as to the turnover and profitability of the Fox Inn. They wished to make a claim. However, the holding company of the group in which Belhaven was a subsidiary carried out a reconstruction of the group, leaving Belhaven with only the Fox Inn as an asset. Belhaven ceased trading. The Ords wanted to claim against Ascot Holdings as the true owner (they said) of the Belhaven business. The Court of Appeal refused to draw aside the Belhaven veil and the Ords were unable to make Ascot a defendant. The reconstruction was genuine, ruled the Court of Appeal. There was no justification for ignoring the ***Salomon*** principle.

See p. 94

As a separate legal entity, the courts to a very large degree will allow companies to operate as they see fit within the boundaries of the law. (This will be explored further in Chapter 4.) The courts are very protective of the ***Salomon*** decision and the corporate form. Without it, company law would virtually collapse as limited liability would no longer act as an incentive for investors to be able to restrict the risks associated with their 'passive' investment; the consequence being the grinding to a halt of the corporate-capitalist machine.

However, on some occasions the courts and the legislature have found it necessary to lift the corporate veil, or to remove the protection (in the form of limited liability) that is afforded shareholders. This means that the courts or statutes will lift the veil of incorporation to reveal the people who stand behind the company. They will look to make those people responsible for the actions of the company. This will be examined further later in this chapter. However, it is worth reading some of the academic opinion in the area. (See Ottolenghi (1990) 'From Peeping behind the Corporate Veil, to Ignoring It Completely', 53 MLR 338. Note: this article provides a useful overview of cases, but does not take into account ***Adams* v *Cape Industries***.)

Classification of registered companies

Public companies

Section 4 defines a public company as a company limited by shares or by guarantee with a share capital whose certificate of incorporation states that the company is a public company. The name of a public company must end with the words 'public limited company', or the Welsh equivalent if the registered office is situated in Wales. The abbreviation plc may be used and the equivalent in Welsh may be given where the registered office is to be in Wales.

If the company is to be a public company, the minimum capital must be at least £50,000, or such other sum as the Secretary of State, in the future by statutory instrument, specifies instead. As we have seen, the certificate of incorporation of a public company states that it is (a public company) and is conclusive evidence that the Act has been complied with and that the company is a public company (s 15).

Under s 761 a public company formed as such cannot commence business or borrow money unless the Registrar has issued a s 761 certificate, which private companies do not require. The certificate is issued if the nominal value of the company's allotted share capital is at least £50,000 and not less than one-quarter of the nominal value of each issued share and the whole of any premium has been received by the company whether in cash or otherwise. A share allotted under an employees' share scheme cannot be taken into account in determining the company's allotted share capital unless it is paid up as to one-quarter of the nominal value and the whole of any premium on the share.

In order to show the extent to which the company's starting capital might be watered down, the obtaining of a s 761 certificate requires disclosure to the Registrar of the amount of preliminary expenses (including the cost of allotting shares) and by whom these were paid or are payable because if not by the company such persons will normally require reimbursement and the benefits given or intended to be given to the company's promoters.

The s 761 certificate is conclusive evidence that the company is entitled to do business and exercise any borrowing powers. It is unusual for a company to incorporate as a public company. It is more common to incorporate as a private company and go public at a later stage (e.g. when the business has expanded sufficiently to benefit from going to the market so that the public can subscribe for its shares). This obviates the need for a s 761 certificate in most cases.

Private companies: generally

These are intended for the smaller business. Chapter 1 of Part 20 of the Companies Act 2006 (ss 755–760) prohibits public offers by private companies. A private purchaser must be found.

The single-member private limited company

Section 7 of the Companies Act 2006 permits the formation of single-member limited liability companies. It is now no longer necessary to have an 'artificial' member, who exists in many private companies which in fact have a sole proprietor but where, for example, a spouse holds a nominee share to fulfil the previous two-member requirement.

The same is true of subsidiaries whether trading or dormant where someone such as the group secretary or a separate nominee company has in the past had to hold a share or shares in the subsidiary, normally under a declaration of trust and a blank transfer form in favour of the parent company so that the shareholding can be recalled from the nominee at any time.

A further useful application is that where one shareholder in a two-member company dies, the remaining shareholder can seek to acquire the deceased's shares from the personal representatives and convert the company into a single-member private company.

Gramophone and Typewriter Co Ltd* v *Stanley [1908] 2 KB 89 (Court of Appeal)

In this case the appellant company (resident in England) held all of the shares in a German company (Deutsche Grammophon Aktiengesellschaft). The appellant had then been assessed, for income tax purposes, on the monies retained by the German company (and subsequently transferred to a depreciation fund) as well as the actual profits which had been remitted to it in England. The case was dependent upon whether the unremitted funds were the gains of a business 'carried on' by the English company as opposed to a separate entity.

Held – the Court of Appeal rejected this view. The fact that all of the shares in a company are held by one person does not, without additional factors, make the company's business the business of that person. Buckley LJ stated:

The question is, I think, one of fact, and one upon which we are not concluded by any findings of fact on the part of the Commissioners. The question of fact is whether the business in Germany is carried on by the appellant company. If it is, the respondents do not dispute that the Attorney-General is right. If, on the contrary, the German business is not carried on by the English company, then equally the Attorney-General cannot dispute but that the English company is assessable only upon the dividends which it may receive upon its shares in the German company.

In order to succeed the Attorney-General must, I think, make out either, first, that the German company is a fiction, a sham, a simulacrum, and that in reality the English company, and not the German company, is carrying on the business; or, secondly, that the German company, if it is a real thing, is the agent of the English company. As regards the former of these, there are no facts at all to show that the German company is a pretence. It was formed in January 1900 by the union of three other companies, each of which brought in substantial properties, and of two individuals. It is duly constituted and governed according to German law, and there is no ground whatever for saying that it is other than a real German corporation carrying on business in Germany under circumstances in which the company and its officers are amenable to German law and with a view to the acquisition of profit. The only remaining question, therefore, is whether the German company is agent of the English company, whether the English company is really carrying on the business and is employing the German company to do so on its behalf. Upon this point the Attorney-General relies principally upon the fact that, as stated in paragraph 17 of the case, the appellant company now holds all the shares of the German company. In my opinion this fact does not establish the relation of principal and agent between the English company and the German company. It is so familiar that it would be waste of time to dwell upon the difference between the corporation and the aggregate of all the corporators. But I may point out the following considerations as bearing upon the question whether the possession of all the shares is evidence of agency. Suppose that during the year whose accounts are under review the appellant company had held no shares at all in the first six months and had held all the shares in the last six months, or suppose that, having held all the shares but ten today, it became the holder of all tomorrow and again parted with ten the next day, it cannot seriously be suggested that each time one person becomes the holder of all the shares an agency comes into existence which dies again when he parts with some of them.

Further it is urged that the English company, as owning all the shares, can control the German company in the sense that the German company must do all that the English company directs. In my opinion this again is a misapprehension. This Court decided not long since, in ***Automatic Self-Cleansing Filter Syndicate Co Ld*** **v** ***Cunninghame***, that even a resolution of a numerical majority at a general meeting of the company cannot impose its will upon the directors when the articles have confided to them the control of the company's affairs. The directors are not servants to obey directions given by the shareholders as individuals; they are not agents appointed by and bound to serve the shareholders as their principals. They are persons who may by the regulations be entrusted with the control of the business, and if so entrusted they can be dispossessed from that control only by the statutory majority which can alter the articles. Directors are not, I think, bound to comply with the directions even of all the corporators acting as individuals. Of course the corporators have it in their power by proper resolutions, which would generally be special resolutions, to remove directors who do not act as they desire, but this in no way answers the question here to be considered, which is whether the corporators are engaged in carrying on the business of the corporation. In my opinion they are not. To say that they are involves a complete confusion of ideas.

Registration of single-member companies

See p. 56

The documents which are sent to Companies House are the same as those required for multi-member companies which are considered in Chapter 2. The necessary amendments to company legislation are considered below but it should be noted at this stage that a public single-member company requires two directors and a secretary so such companies can have one member but need three officers (i.e. two directors and a secretary). In a private single member company the sole member can be the sole director and a secretary is not a legal requirement. Such companies need only one member and one officer (i.e. the sole member) though if a secretary was appointed that individual would be regarded as an officer of the company which would then have one member and two officers (ss 154, 270, 271 and 274 apply).

Conversion to single-member status

There are no re-registration requirements. Conversion is achieved by transferring the nominee holding to the then sole proprietor. No resolutions of the company are required and there are no filing requirements at Companies House. Under s 123, when the number of members falls to one, or if an unlimited company with only one member becomes a limited company on re-registration, a statement that this is the case must be entered on the Register of Members at the side of the name and address of the sole member, together with the date on which this occurred. No special form of words is given but a statement saying 'The company became a single-member company on . . . (date–month–year)' would appear to suffice. If the membership increases to two or more, then when that happens, a statement that the company has ceased to have only one member must be entered in the Register of Members alongside the name and address of the person who was formerly the sole member. The date when this occurred is also required. A statement saying 'The company ceased to be a single-member company on . . . (date–month–year)' would suffice. A default fine is imposed on the company and its officers in default if the relevant statement is not made.

Accounts and audit

The requirements are no different from those applying to other companies.

Meetings of the single-member company

Section 318 provides that notwithstanding any provision to the contrary in the articles (so that no changes in the articles are required) one member present in person or by proxy shall be a quorum. Section 357 provides that if the sole member takes any decision which could have been taken in general meeting he shall (unless it is a written resolution) provide the company with a written record of it and although it would seem desirable for the sole member to sign it in case of dispute there is no requirement of signature in the regulations. Section 318 is not a significant change since all the formalities of calling and holding a meeting will have to be gone through. However, s 357 is significant in that it allows the sole member to conduct business informally without notice or formal minutes.

Filing requirements still apply when, for example, the articles are altered informally, and an annual general meeting must still be held unless the company is a private company. The Companies Act 2006 does not require a private company to hold an Annual General Meeting (AGM) nor need it lay its accounts and reports before a general meeting, thus there need not be any member meetings. However, board meetings and board resolutions are required although even here the written resolution procedure for directors provided for by Reg 7 of the Model Articles for private companies may be used.

Single-member companies may conduct business by written resolution. There is no provision in the Companies Act 2006 for a public company to conduct business by written resolution. However, in multi-member companies written resolutions cannot be used to remove a director or auditor from office. In single-member companies the s 357 procedure would seem to be available. Removal of a non-member director or the auditor without a meeting and without receiving representations from them could be achieved in that way, although the regulations are silent on this.

Contracts with a sole member who is also a director

Section 231 provides that the terms of a contract with a sole member/director must either be set out in a written memorandum or be made the subject of a report to the next available board meeting and be recorded in the minutes.

This provision does not apply if the contract is in writing or if it is entered into in the ordinary course of business, as where the company buys raw materials from the sole member/director.

Death of the sole member: private companies

If a sole member/director of a private company dies, there is no board to approve the transfer of his or her shares under the terms of the will or on intestacy. The company is then in effect paralysed, being without a board or shareholders. The articles should therefore be altered so as to allow, for example, the company secretary, if one has been appointed, to authorise a transfer or allow the personal representatives of the deceased member to appoint a director if the company has none. The director could then approve the transfer and the business of the company could proceed.

There is also a common law rule that the directors must actively refuse a transfer within a reasonable time. Under s 771 any power of veto vested in the directors must be exercised within two months after the lodging of the transfer and after that time the court can compel the registration of the transfer, as is further described in Chapter 12. Nevertheless, it is better that the articles address this matter. In fact, a power of refusal is not given by s 771 and must be in the articles. A power of refusal is given in the Model Articles in Reg 26(5) – private limited companies model – and Reg 62 – public limited companies model.

See p. 243

Small and medium-sized companies

Private companies are further subdivided by ss 381–384 (small companies including parent companies and groups), which introduce the accounting exemptions. They give the benefit of confidentiality of information but involve the preparation of two sets of accounts – one for members and one for the Registrar of Companies. These exemptions then draw a distinction between the reporting requirements in regard to the accounts which small or medium-sized companies prepare for their members and those which they file with the Registrar of Companies. They are allowed to file what the Act refers to as 'abbreviated' and 'modified' accounts with the Registrar.

The 2006 Act permits (but does not require) a small company to dispense with the filing of its directors' report and profit and loss account and allows the filing of an abbreviated balance sheet only. Fuller particulars of the exemptions are given below, but the major result is that members of the public examining these abbreviated accounts at Companies Registration Office will have no trading information and will know nothing about directors' emoluments or the company's dividends.

If a small company files accounts made up in accordance with International Accounting Standards (IAS accounts) or Companies Act accounts that are not abbreviated accounts but the directors wish to exercise the option of not providing a copy of the director's report and/or profit and loss account, then s 444(5) states that the balance sheet shall include in a prominent place a statement that the accounts have been delivered in accordance with the provisions relating to small companies.

Sections 465–467 set out which companies, parent companies and groups qualify as medium sized. A medium-sized company may modify only its profit and loss account. Apart from this, full accounts and reports must be filed.

The modifications to the profit and loss account of a medium-sized company are as follows:

- Instead of showing turnover, cost of sales, gross profit or loss and other operating income as separate figures they can be combined into one figure under the heading Gross Profit or Loss.
- In addition, the analysis of turnover and profit among different classes of business and different markets need not be given in the notes to the profit and loss account.

The reason for this is that the details of turnover profits and markets were sometimes used to the unreasonable disadvantage of medium-sized companies by their larger competitors. It should be noted, however, that this requirement is now removed for all companies where, in the opinion of the directors, the disclosure of such information would seriously prejudice the company's interests and the fact that it has not been disclosed is stated.

In the case of medium-sized companies, a full and unmodified set of accounts must be prepared for members. The full accounts and reports will be sent to the members, though any member, or the company's auditor, is given the right to require the accounts and reports to be laid before a general meeting of members.

It may be taken as a general view that there is in many cases little benefit in filing abbreviated accounts for medium-sized companies. Unless there are special reasons for not disclosing details of turnover and cost of sales, the cost of preparing such accounts may outweigh the benefits.

Summary of abbreviations applicable

The abbreviations in Table 1.1 are applicable where the accounts of small and medium-sized companies are filed at Companies House.

Financial reporting standard for smaller entities

The Accounting Standards Board (see now the Financial Reporting Council) decided to free small companies from the burden of complying with many of the accounting standards. By conforming to the Financial Reporting Standard for Smaller Entities (FRSSE) such companies are able to ignore other accounting standards. They may choose not to adopt it, in which case they remain subject to the full range of standards and abstracts.

Table 1.1

	Directors' report	*Profit and loss a/c*	*Balance sheet*	*Cash flow statement*	*Notes to the accounts*	*Auditors' report*
Small	Not required	Not required	Required with special directors' statement	Not required	Limited information only	Special report (unless audit exempt)
Medium-sized	Required in full	Required but may start at 'Gross Profit'	Required with special directors' statement	Required	All except analysis of turnover and profit	Special report

Note: Companies that are audit exempt do not need any form of audit or accountants' report, although exempt charitable companies must file a copy of the statutory accountants' report.

Small and medium-sized companies: definitions

(a) Small companies

A small company is one which has been within the limits of two of the following thresholds since incorporation or, if not within the limits at incorporation, then for the current financial year and the one before:

Turnover £5.6 million or less
Balance sheet total (i.e. total assets) £2.8 million or less
Employees 50 (average) or less.

(b) Medium-sized companies

A medium-sized company is one which has been within the limits of two of the following thresholds since incorporation or, if not within the limits at incorporation, then for the current financial year and the one before:

Turnover £22.8 million or less
Balance sheet total (i.e. total assets) £11.4 million or less
Employees 250 (average) or less.

As regards both small and medium-sized companies, the employee average is to be ascertained on a monthly basis and not a weekly basis as it was initially. The average is derived by dividing the sum of the number of employees employed under contracts of service in each month by the number of months in the financial year.

The authority for the above thresholds is the Companies Act 2006: s 382 for small companies and s 465 for medium-sized companies.

Subsequent failure to qualify

If a company ceases to satisfy the exemption requirements for two successive years, it must file full accounts for the second year.

Exemptions inapplicable: small and medium-sized companies

The exemptions do not apply if the company concerned is or at any time during its financial year was:

(a) A public company (whether listed or unlisted).
(b) A banking or insurance company.
(c) An organisation authorised to conduct investment business under the Financial Services and Markets Act 2000. (However, small authorised firms and appointed representatives whose only regulated activities are mortgage and insurance activities may take the Companies Act 2006 exemption. An appointed representative is a person in a contractual relationship with an authorised person to carry out authorised activities with the principal having proper control and for whose activities the authorised principal has accepted responsibility in writing.)
(d) A member of an 'ineligible group', i.e. a group containing any of the companies in (a) to (c) above.

A company which has subsidiaries, i.e. it is a holding or parent company, although it satisfies the definition of a small or medium-sized company, cannot be treated as one unless the group as a whole is small or medium-sized within the definitions given below. Thus if the parent company qualifies as a small company but the group is medium-sized, the parent would only be entitled to the exemptions available to a medium-sized company when preparing individual accounts.

Small and medium-sized groups

This is a further division into small and medium-sized groups of private companies. Normally, where a company, say A Ltd, is the holding (or parent) company of B Ltd, e.g. because A Ltd owns more than half of the voting share capital of B Ltd – generally more than half of B Ltd's ordinary shares – then A Ltd and B Ltd have to prepare individual accounts. However, A Ltd has an extra duty which is to prepare group accounts (or consolidated accounts) showing, for the benefit of outsiders who might invest in or do business with either company, the financial position of A Ltd and B Ltd together in one set of financial statements.

However, a parent company, such as A Ltd, need not prepare group accounts for a financial year in relation to which the group headed by that company qualifies as a small or medium-sized group and is not an ineligible group. This is a further example of the deregulation of private companies running the smaller business.

The qualifying conditions are met by a group which satisfies two or more of the following thresholds: (a) in the parent company's first financial year as a parent company; and (b) in its second or subsequent financial year as a parent company in that year and the preceding year. If it fails to satisfy the exemption requirements for two successive years, it must prepare group accounts in the second year. The thresholds under s 383 (small) and s 465 (medium-sized) are given in Table 1.2.

A group can choose to meet the gross or net formula for any item; thus, say, turnover may be gross and balance sheet total net. The net formula is calculated after adjustments are made in the consolidation of the accounts, e.g. elimination of inter-company balances. Thus, if B Ltd owes A Ltd £20,000, this £20,000 will be shown as an asset in A Ltd's individual balance sheet and as a liability in the individual balance sheet of B Ltd but not at all in the group balance sheet. The transaction is cancelled out on consolidation because it is of no interest to outsiders. Where there are extensive inter-company balances, it may be difficult for the group to meet the gross formula but the exemptions apply if the net formula is complied with.

Table 1.2

	Small	*Medium-sized*
Aggregate turnover	£5.6 m (net) or less *or* £6.72 m (gross) or less	£22.8 m (net) or less *or* £27.36 m (gross) or less
Aggregate balance sheet total	£2.8 m (net) or less *or* £3.36 m (gross) or less	£11.4 m (net) or less *or* £13.68 m (gross) or less
Number of employees	50 (average) or less	250 (average) or less

In the case of a small or medium-sized group, the average number of persons that the company employs can now be calculated on a monthly average basis instead of a weekly average as before.

Where a parent company is not exempt and, therefore, is required to prepare group accounts, it is not required to file a profit and loss account with the annual accounts. However, where a small or medium-sized company is exempt but chooses voluntarily to prepare group accounts, it must file a profit and loss account. It is not able to take advantage of the exemption because it is not 'required' to prepare group accounts.

Exemptions inapplicable

A group is ineligible if any of the companies in it is a plc (listed or unlisted) or a company carrying on an insurance market activity or an authorised person under the Financial Services and Markets Act 2000 (though see earlier comment on this point for small groups). A special auditors' report is required for accounts delivered to the Registrar when small and medium-sized companies and groups take advantage of the exemptions referred to above. The purpose of the report is to say that the company concerned is entitled to them. This report is not required where the company has taken advantage of the audit exemption referred to below.

Criteria for exemption

Under s 477, the following conditions must apply in respect of the financial year:

- The company must qualify as a small company though even where it does it need not take advantage of the exemption and can have an audit.
- For these companies:
  (a) turnover must not be more than £5.6 million, and
  (b) the balance sheet total (assets) must not be more than £2.8 million.
- The company must not at any time during the financial year have been an ineligible company, for example:
  (a) a public company (listed or unlisted);
  (b) a parent or a subsidiary undertaking unless a member of a small group (see below) or where the subsidiary is dormant (s 249A(1A), (1B) and (1C));
  (c) a company carrying on an insurance market activity;
  (d) an authorised person or appointed representative under the Financial Services and Markets Act 2000 (subject to exceptions considered above in regard to accounting exemptions);