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Chapter 1 The nature of a company

This text is concerned almost entirely with the law relating to registered companies. These 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. Later statutory instruments may add new sections to the 2006 Act.

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 the date of it is before the company legislation which 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 Dzurynski [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. This can result in some dislocation of the business, and although this can be reduced by clauses in the articles of partnership, e.g. deferred payment, the problem cannot be totally eliminated: 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 will not therefore effect a dissolution of the LLP but there may be problems in terms of the repayment of the retiring member’s capital. It is therefore important 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 a 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 a 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’.

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 was therefore 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 the Public Trustee are held by the same person though 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 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 was an independent entity, separate from those who had set it up. Any fully paid-up shareholders could not be required to pay anymore. 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:

The company attains maturity on its birth. There is no period of minority – no interval of incapacity . . . 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 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.

Furthermore, Lord Halsbury stated:

... 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 liability 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.

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 was 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. In Tate Access Floors Inc. v Boswell [1991] Ch 512, Browne-Wilkinson VC stated:

If people choose to conduct their affair 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 controlling 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 Wrenbury stated:

*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.

*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 obvi-
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.

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 companies
A medium 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 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 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 authorized 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 company, cannot be treated as one unless the group as a whole is small or medium 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 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 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) are:

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<th>Small</th>
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<td>Aggregate turnover</td>
<td>£5.6 m (net) or less</td>
<td>£22.8 m (net) or less</td>
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<td>or</td>
<td>£6.72 m (gross) or less</td>
<td>£27.36 m (gross) or less</td>
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<tr>
<td>Aggregate balance sheet total</td>
<td>£2.8 m (net) or less</td>
<td>£11.4 m (net) or less</td>
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<td>or</td>
<td>£3.36 m (gross) or less</td>
<td>£13.68 m (gross) or less</td>
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<td>Number of employees</td>
<td>50 (average) or less</td>
<td>250 (average) or less</td>
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A group can choose to meet the gross or net formula for any item; thus, say, turn-over 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
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2 Administrative expenses in terms, e.g. of filing fees for documents.
3 Cost of compulsory annual audit (unless the company is a dormant company or in a position to opt out).

Companies and human rights

The Human Rights Act 1998 came into force on 2 October 2000. It implements the European Convention on Human Rights into UK law. The Convention is available to companies in terms of their dealings with emanations of the state, e.g. government and local authorities. This is because the initial effect of the Act is vertical. Whether the Convention will be extended by the courts horizontally into areas of private business remains to be seen, though s 6 of the 1998 Act provides that the courts and tribunals of the UK must not act contrary to the Convention. Problems have arisen in connection with the lack of independence in UK courts and tribunals in that Crown Court recorders were appointed part time and paid by the state and removable by the state with no security of tenure. The same was true of appointments to employment tribunals in cases involving the state as an employer or an emanation of the state, such as a local authority. The solution here has been to give these part-time judicial officers fixed-term contracts of, say, five years during which time they are not dismissable except for misconduct, and this gives some security of tenure. That a company can complain about the infringements of its human rights in this context (and others no doubt) is illustrated by County Properties Ltd v Scottish Ministers [2000] The Times, 19 September, which, although a Scottish case, is applicable in the rest of the UK. The company, in effect, had been refused permission by the Crown to obtain the release of the listed building restrictions on one of its properties and the matter was referred for decision to an inspector appointed by the Crown. The company objected to this procedure because it infringed Art 6 of the Convention that provides: ‘In the determination of his civil rights and obligations [. . .] everyone is entitled to a [. . .] hearing [. . .] by an independent and impartial tribunal.’ The Court of Session held that this was an infringement of the company’s rights. That part of the procedure was invalid and the matter would have to be dealt with by appeal to the courts as the relevant legislation allowed. The case was overturned on appeal (County Properties Ltd v Scottish Ministers 2002 SC 79) the court following the same line as in the Barnes case (see below).

The House of Lords took a different view in an appeal from the Divisional Court of Queen’s Bench in England. Their Lordships felt that the hearing of planning matters by a government-appointed inspector did not flout Art 6 of the Convention because the inspector’s decision could always be brought before the ordinary courts by means of a procedure called judicial review (see R v Secretary of State for the Environment, etc., ex parte Holding and Barnes plc [2001] The Times, 10 May). Nevertheless, the cases show that companies can argue human rights matters before our courts.

Action against companies based on human rights

Implementation of the Human Rights Act 1998 on 2 October 2000 raised the spectre of the litigation floodgates opening since it made the European Convention on Human Rights available to litigants in UK courts, thus avoiding the need to take the matter to the European Court of Human Rights at Strasbourg, previously the only option. It has already been noted that the
initial effect is against public authorities with the possibility of some expansion into the private sector through s 6 of the 1998 Act. In this connection, a statement by the Lord Chief Justice in Daniels v Walker [2000] 1 WLR 1382, CA is of interest. He expressed the hope that judges would be robust in resisting attempts to allow inappropriate arguments on human rights. These he defined as arguments that lead the court down blind alleys. There has also been the suggestion that adverse costs may be awarded against those who raise spurious questions and points on human rights. Furthermore, the Court of Appeal observed in Barclays Bank plc v Ellis [2000] The Times, 24 October that legal representatives seeking to rely on the Human Rights Act 1998 should supply the court with any decisions of the European Court of Human Rights on which they intend to rely or which might assist the court. This should operate as a deterrent to those lawyers who may think of raising human rights issues unless, where possible, supported by authority.

The specific effect of the Convention on directors is considered, in terms of their functions as individuals and managers, in Chapter 17.

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**Essay questions**

1. (a) In the celebrated case of *Salomon v Salomon & Co Ltd* [1897] AC 22, Lord Halsbury LC observed: ‘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.

(b) Tiedeman was the owner of a large bulk-carrier called Ocean-Star. The ship was valued at £1 million and was insured for that sum with Lloyd’s in Tiedeman’s name. Subsequently Tiedeman incorporated Tiedeman Ltd in which he held all the shares but one which was held by his wife as his nominee. Ocean-Star was then sold to Tiedeman Ltd and the purchase price was secured by a debenture issued in favour of Tiedeman giving as a security a fixed charge on the only asset of the company Ocean-Star. While carrying a valuable cargo on charter to a Kuwait company the Ocean-Star was attacked by Iranian gun-boats and sunk.

   Consider whether Tiedeman or in the alternative Tiedeman Ltd could claim to be indemnified by Lloyd’s for the loss of the bulk-carrier. (University of Plymouth)

2. The principle of law set out in *Salomon v Salomon & Co Ltd* is not always applied. Give the facts of this case and give its principle of law, and discuss when the judiciary or statutory provisions will not take account of that principle. (University of Paisley)

3. ‘... a fundamental attribute of corporate personality ... is that the corporation is a legal entity distinct from its members’ – Gower.

   Which do you consider are the two outstanding advantages of incorporation? Give reasons for your choice and explain their dependence upon this fundamental attribute.

   (The Institute of Chartered Accountants in England and Wales)

4. Explain by reference to statutory and common law examples what is meant by the term ‘lifting the veil of incorporation’. (The Chartered Institute of Management Accountants)
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5 John, who runs Trent Ltd, a small manufacturing company, has heard that he may not have to appoint auditors in regard to future accounts and is keen to save the audit fees. Advise John as to the relevant law.  

(Author’s question)

6 Thomas Taylor-Wright is a sole trader, based in Saville Row in London, where he has a very lucrative business making men’s exclusive formal suits. Thomas has decided that he would like to expand his business and is having discussions with a fellow tailor, Terry Thimble, about possibly going into business together and renting larger premises in Saville Row. Thomas comes to you for advice as he cannot decide whether he and Terry should set up as a partnership or a limited company.

Answer ALL PARTS.

(a) Advise Thomas and Terry which type of business medium you would recommend and why;  
(b) Thomas and Terry have decided to set up as a limited company, but they have no idea how they should go about doing so. Advise them of the procedure for incorporating as a limited company.  
(c) They would like to use the name Saville Row Tailors Ltd. Advise them on their suggested choice of name.  

(University of Hertfordshire)

Test your knowledge

Four alternative answers are given. Select ONE only. Circle the letter beside the answer which you consider to be correct. Check your answers by referring back to the information given in the chapter and against the answers at the back of the book.

1 The members of a social club wish to form a legal entity. There is no commercial risk but they do not want too much disclosure of their affairs to the public. What type of company should they form?

A A company limited by guarantee.  
B An unincorporated association.  
C A private company limited by shares.  
D A private unlimited company.

2 Fred has been allotted 200 £1 ordinary shares in Ark Ltd with a nominal value of £1 and a premium of 0.40 pence. Fred has paid 0.85 pence. What is Fred’s maximum liability if the company is wound up?

A £30.  
B £110.  
C £2,000.  
D £280.

3 To what extent is a member of a company which is limited by guarantee personally liable for the company’s debts?

A He is personally liable for all the company’s debts at any time.  
B He is personally liable for all the company’s debts if the company is wound up.  
C His personal liability is limited to the amount set out in the memorandum on a winding-up.  
D His personal liability is limited to the amount set out in the memorandum at any time.
Three friends own and are also directors of a limited company carrying on the family business. They have it in mind to change the organisation to an ordinary partnership. What aspect of the business would be affected if this change were carried out?

A The right to sue in the business name.
B The right to mortgage the business assets.
C The right of the partners to examine the firm’s accounts.
D The ability to create a floating charge over the business assets.

The answers to Test your knowledge questions appear on p 576.

Further reading

Acton, ‘Just and equitable winding up; the strange case of the disappearing jurisdiction’ (2001) 22 Co Law 134.
Prentice, ‘Winding up on the just and equitable ground: the partnership analogy’ (1973) 89 LQR 107.

Visit www.mylawchamber.co.uk/keenancompany to access selected answers to self-test questions in the book to test yourself on this chapter.
### Answers to test your knowledge questions

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UK Company Law. This page covers selected developments in UK companies legislation, prospective legislation and related matters of professional concern to accountants in practice, industry or commerce. Information on this page is open to the public but may include links to material where access is limited to members or certain members of ICAEW. Current issues. Dividends and distributable profits. ICAEW Introduction to the Law on Dividends. Company law: company formation and management. 1. Reading A: Introduction to company law. Law firms often publish informative articles on their websites which they believe will be of interest to their clients. Typically, these articles deal with areas of the law in which the firm has particular expertise. The text on the next page, which appeared on the website of a US law firm, deals with entity formation in Russia, and contrasts a Wholly Foreign-Owned Entity (WFOE) with a representative office. 8.1 Read the first paragraph. UK Company Law. Topic Gateway Series No. 14. Prepared by Louise Ross and Technical Information Service. Company Law (known as Corporate Law in some countries) refers to the formation and governance of corporate entities. In the UK, the responsible body is the Corporate Law and Governance Directorate of the Department for Business, Enterprise and Regulatory Reform (BERR), formerly the Department of Trade and Industry (DTI). This directorate also represents UK interests in the development of EU company law.
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