

GUIDANCE NOTE

Know Your Debtor – Types of Debtor Under English Law

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Background

This Guidance Note is aimed at overseas lawyers and their clients. Its purpose is to set out the types of debtor that can be encountered under English law.¹ For the avoidance of doubt a debtor is someone who owes money and a creditor is a person to whom a debt is owed. The type of debtor is relevant to both debt recovery and litigation, but also insolvency proceedings. To conclude there are also some suggestions on various safeguards for creditors.

In essence there are four main types of debtor under English law.² First and oldest, there is the sole trader. Secondly there is the partnership. Thirdly there is the limited liability company, which has a number of different forms. Fourthly and most recently there is the Limited Liability Partnership. Each will be discussed in turn.

Sole Traders

This is simply an individual who trades. They can trade under their own name or a trading style i.e. “John Smith” or “John Smith trading as JS Motors”, or more likely just “JS Motors”. All documentation should make it clear who the sole trader behind the trading style actually is.

The sole trader remains personally liable for any liabilities of the trading business, up to the extent of their personal wealth.

A sole trader is sued in their own name, together with their trading style if applicable (i.e. “John Smith trading as JS Motors”) at their residential or business address.

For a sole trader whose business encounters financial difficulty there are two main insolvency options³, namely bankruptcy or an Individual Voluntary Arrangement (“IVA”) under the provisions of the Insolvency Act 1986. A detailed discussion of those two insolvency regimes is beyond the scope of this Guidance Note. Suffice it to say that both are formal insolvency processes which result in debt relief. An IVA is a contract with creditors whereby

¹ For the avoidance of doubt English law is used as shorthand for the laws of England and Wales.

² Certain other types of more unusual legal entities known to English law, such as unincorporated associations, are beyond the scope of this Guidance Note.

³ A few other options are available, all of which result debt forgiveness one way or another.

a sufficient majority of creditors⁴ agree to a certain amount of debt forgiveness in exchange for a better return than they would expect to get with the debtor's bankruptcy. In an IVA or a bankruptcy each unsecured creditor will expect to receive a dividend being a proportion of their debt expressed as X cents in the Euro.

An IVA will typically last for 3 or 5 years, but some are much shorter. They can include existing property, future income or third party contributions. By contrast in most cases a debtor is discharged from bankruptcy after only 1 year. An IVA avoids a number of the legal consequences of bankruptcy and does not have the same stigma attached to it. However many IVAs fail because they rely upon what will happen in the future.

Other than for specialised professions or industries there is no prescribed register of sole trader businesses beyond the telephone book and on-line directories. There are no filing or reporting requirements. The individual is likely to have to file a tax return with HM Revenue & Customs but that is not publically available. As such it is very difficult to assess credit risk when dealing with a sole trader.

Partnerships

The primary legislation dealing with partnerships under English law is the Partnership Act 1890. Section 1 provides a definition as follows:-

“[A] partnership is the relation which subsists between persons carrying on a business in common with a view of profit.”

As such it is possible for partnerships to be very informal. Two sole traders working together can constitute a partnership under the Act of 1890 i.e. John Smith and Simon Jones trading together as JS Motors.

A partnership will often (but not always) have a partnership agreement regulating the arrangements between the partners, dealing with, for instance, how they share profits and what happens if a partner joins or leaves. That is a private document.

Where individuals trade as a partnership then they can adopt a trading style (e.g. JS Motors) but all documentation and correspondence must list who the individual partners are or, alternatively, where a list of their names can be inspected. Until quite recently most professional services firms (for instance accountants and lawyers) traded as partnerships.

The liability of the individual partners is unlimited. So any creditor owed money by the partnership business can claim everything they are owed from each partner, up to the extent of their personal wealth. Any partners who are pursued personally are usually entitled to an indemnity from their other partners by way of a contribution to what they have paid out.

⁴ More than 75% by value voting in favour and also more than 50% by value voting in favour excluding associated or connected creditors.

While the partnership is not a distinct legal entity, it is nevertheless permissible for a creditor to pursue the partnership (usually written in court papers as “JS Motors (a firm)”). But they can if they wish name all of the individual partners as co-defendants to the court proceedings.

Upon insolvency the position becomes quite complicated. The partnership is effectively treated like a distinct legal entity for insolvency purposes. That is because the partnership will have assets that underpin the business of the partnership, for instance trading premises, equipment or goodwill. Those assets are distinct from the assets belonging to the individual members of the partnership (the partners). But they still have their own assets which are nothing to do with the business of the partnership, such as their homes. As such, when a partnership becomes insolvent it is often the case that there will be one set of insolvency proceedings for the partnership itself and also related insolvency proceedings for the individual partners. The partnership’s insolvency can then claim in the insolvencies of each of the individual partners; and the individual partners can claim in the insolvency of the partnership and in the insolvencies of each other partner!

There is no register of partnerships beyond the telephone book and on-line directories. There are no filing or other reporting requirements. The individual partners are likely to have to file tax returns with HM Revenue & Customs but they are not publically available. As such it is very difficult to assess credit risk when dealing with a partnership.

Companies

Companies (or limited liability companies to give them their full title⁵) have been around since at least the Joint Stock Companies Act 1844. A company is a distinct legal entity having separate legal personality. It can therefore hold property in its own name and can be sued in its own name.

A significant proportion of English businesses trade as limited liability companies. That includes larger companies (public limited companies or PLCs) and companies listed on the various stock exchanges. The same basic legal and practical considerations apply to all companies.

A company is owned by its shareholders. Their liability is limited (hence the name) to whatever sum they are obliged to pay for their shares(s) and no more. They are effectively investors in the company. In return for their investment their share gives them certain rights in relation to the running of the company. Those rights include an entitlement to receive a share of any profits that the company makes and to vote upon certain significant matters provided for by statute or in the company’s constitution. Some matters require a higher percentage of shareholder approval than others, such as changing the company’s name or constitution.⁶

⁵ It is possible to have a company limited by guarantee or even an unlimited liability company, where the liability of shareholders is unlimited.

⁶ Sections 77 to 78 and 21 of the Companies Act 2006 respectively.

It is possible to have a company with only one shareholder who has received and paid for a share worth only £1.00. If that is so then the worth of that company, being its paid up share capital, is £1.00 only.

The day to day running and business decisions of the company are dealt with by the directors. There need only be one director.

A register of all companies is maintained by Companies House. That register is available online, enabling the details of the directors⁷ and shareholders and their recent filings to be viewed by third parties.

A limited liability company will have the word Limited or Ltd as part of its name e.g. JS Motors Limited. It can adopt a trading style which does not include either Limited or Ltd but must state on its documentation and headed paper the name of the underlying limited company, together with its company number and the location of its registered office. It can also trade as a completely unrelated name e.g. “123 Limited trading as JS Motors”. This is apt to cause confusion especially if the requirement to identify the underlying limited company is not observed. Certain names or words in company names are prohibited by law.⁸

It is even possible for more than one limited liability company to trade under the same style to maintain a brand e.g. 123 North Limited trading as JS Motors; 123 South Limited trading as JS Motors and 123 Midlands Limited trading as JS Motors. None of those three companies are responsible for the liabilities of the others; they are distinct legal entities.

Occasionally unscrupulous company directors deliberately operate a number of companies with similar names, all of which trade as the same trading style, to try to avoid honouring contractual obligations or paying debts. It is therefore very important when extending credit that the identity of the underlying company in question is very clear in the contractual documentation.

For litigation it would be necessary to issue court proceedings against “123 Limited trading as JS Motors”. It would be incorrect to simply sue JS Motors or even JS Motors Limited because that is not the correct name of the underlying company. A company’s registered office (or “seat” in European parlance) is the only correct place for service of legal documents upon it; trading addresses will not do in the eyes of the court.

Perhaps unsurprisingly, there is a larger range of insolvency procedures for limited liability companies and other forms of trading. A detailed explanation of those insolvency procedures is beyond the scope of this Guidance Note. Nevertheless, there are various options for insolvent companies to seek protection from their creditors for the purposes of restructuring, as well as proposing arrangements with creditors⁹ leading to partial debt forgiveness. There

⁷ Directors can now give their registered address at the company’s address, rather than their home address.

⁸ Business Names Act 1985.

⁹ For instance a Company Voluntary Arrangement, the company equivalent of an IVA (described above) but also Schemes of Arrangement which are not dissimilar but are more sophisticated.

are also various options for liquidating insolvent companies, after which they are dissolved and cease to exist as a legal entity.

All trading companies are required to file annual returns and accounts at Companies House. There are fines for the directors personally if they do not do so. In extreme cases, where annual returns and/or accounts have not been filed then the Registrar of Companies can cause the company to be struck off and dissolved, at which point it no longer exists as a legal entity; any property it owned then vests in Her Majesty Queen Elizabeth II. Those filings (which are of course retrospective) are analysed by credit reference agencies and can be used to assess creditworthiness.

Limited Liability Partnerships

These are effectively a hybrid between a company and a partnership. Many professional services firms that were once partnerships under the Partnership Act 1890 are now limited liability partnerships or LLPs.

LLPs combine the benefits of a limited liability company with the structure of a partnership. An LLP is a distinct legal entity in the way that a company is. The liability of the members of the partnership is, as the name suggests, limited. A list of the members of the LLP is required to be displayed at each of its trading addresses.

It is usual for an LLP to have a Members' Agreement which regulates the relationships between the members of the LLP.

In many other respects LLPs are similar to limited liability companies insofar as they are obliged to file documents at Companies House and they can have trading styles e.g. John Smith Accountants LLP trading as JSA.

An LLP is sued in its full name e.g. "John Smith Accountants LLP trading as JSA". It has a registered office or "seat" at which legal proceeding must be served. Unlike a partnership under the Partnership Act 1890, the partners of the LLP are not parties to the litigation because they do not have liability; only the LLP itself does (if proved).

LLPs also have available to them the same range of insolvency procedures to companies in the event that they get into financial difficulty.

Like companies LLPs are also obliged to file accounts at Companies House, which enter the public domain. They are picked up and analysed by credit reference agencies.

Practical Guidance

As can be seen, there are a variety of trading options available under English law. That variety has the potential to cause confusion in terms of the legal entity being dealt with. Occasionally unscrupulous traders will exploit that potential for confusion by hiding behind one or more very similar trading styles to try to avoid liabilities, mislead creditors or to keep assets beyond their reach.

Consequently in all cases, when trading with an English counter-party, it is important to be clear as to the nature of the entity that is being dealt with. Are they a sole trader? Which sort of partnership are they? Are they using a trading style, which is possibly very different from the name of the underlying individual, partnership, company or LLP that is actually liable?

These considerations are important for a number of reasons. First, the type of legal entity will determine the extent to which it is possible to find out information about them and whether they are worth the amount of credit being extended, either in terms of money or goods supplied. The sole trader only has his personal wealth. A partnership has the potential combined wealth of all of its partners. A company may have assets of only £1.00. A company or LLP with filed accounts showing net assets of £1 million may have filed those accounts many months ago and could be insolvent now.

Secondly, the type of legal entity will also affect any court proceedings that need to be commenced in the event that the contractual arrangements do not go as planned. Any legal proceedings which do not identify the debtor in correct form will either not succeed or will result in a judgment against the entity which does not exist.

Lastly, it is also very important that any underlying contractual paperwork, including order confirmations, delivery notes and invoices are all properly addressed to the correct debtor. Otherwise an unscrupulous debtor will potentially be able to argue that it is not the right party to be sued and does not owe the money.

The comments in this Guidance Note are of a general nature only. Full advice should be sought on any specific problems or issues.

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