

IALS Legal Entities Study Group Report

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Introduction

A person or a group of persons seeking to engage in an enterprise, whether for profit or otherwise, will generally seek to do so through a legal entity. This will usually come about through the use of the partnership vehicle or corporation, which includes the limited liability partnership, the limited partnership, and the limited liability company.

In general, the distinction is between the partnership vehicle and the corporation. The limited partnership is a vehicle that is essentially a partnership with an important difference being that not all the partners are personally liable for the debts and obligations of the partnership. The limited liability partnership on the other hand, is essentially a corporation,¹ although for some purposes it is treated as a partnership. The limited liability company is a hybrid of the two.

A jurisdiction need not have all of the above but most jurisdictions will at least have both the partnership and the corporation. Most jurisdictions will also allow individuals to engage in enterprise as a sole proprietor but since this is essentially the individual engaging in personal transactions this paper is not concerned with sole proprietorships.

Knowledge

There are a number of core elements that are essential for students to enable them to have a substantive understanding of the field.

Separate Personality/Entity

This is a key element that in turn determines many other areas in this field. It is necessary to determine at the outset whether the legal entity of partnership or corporation (and their variants) constitutes a separate person in the eyes of the law. In essence a partnership is not a separate entity from its partners, while a corporation is a separate entity from its shareholders/members (and its directors).

The major consequence of this is that partners are generally liable to the world at large for the debts of the partnership including wrongful acts by individual partners that took place in the course of the partnership business. On the other hand, shareholders are not liable for a corporation's debts and only stand to lose the amount they invested in the corporation, hence the term "limited liability" in relation to shareholders.

Nevertheless, to the extent that the corporate form can be abused, most jurisdictions have developed exceptions to limited liability such that on occasion personal liability for a corporation's debts can be extended either to shareholders or directors and it is important for students to understand what these exceptions are.

¹ For example, see the UK Limited Liability Partnerships Act 2000 and the Singapore Limited Liability Partnerships Act (Cap 163A) which is based on the UK Act of 2000.

Internal Framework

As partnerships and corporations are intended to facilitate individuals acting collectively through a legal entity, it is necessary for students to understand the framework that governs the internal relations within the partnership and the corporation.

In a partnership structure, the rights and liabilities of partners are usually set out in the partnership agreement and the general law relating to partners. In a corporation, the legislation relating to corporations is important but so is the constitution of the corporation which will often set out specific bye-laws that determine the rights, responsibilities and powers of the shareholders and the directors. In addition, the corporate constitution may also determine the types of activities that the corporation can engage in. Such constitutional limitations on a corporation's capacity have to be understood by students in addition to the extent to which particular jurisdictions have relaxed such a rule.

Transactions with Third Parties

Just as it is important for students to understand the internal framework of the corporation, it is also important for them to understand how a company transacts with third parties. In part, this is connected to the constitutional division of powers between the shareholders and the board of directors, with the latter often the principal body charged with the corporation's management.

As boards and partners are unlikely to be able to act collectively on every transaction, corporations and partnerships depend significantly on the ability to delegate authority to agents to enter into transactions with third parties. Some knowledge of agency law is therefore useful for students.

In addition, there may be procedural lapses within the company that on the face of it can vitiate a transaction entered into. This may, however, be unfair to third parties who have no knowledge of such internal lapses. To what extent are such transactions nevertheless binding on the company?

Principal – Agent Problem

As a result of the corporation being an artificial entity, and shareholders of many corporations not being in a position to effectively monitor the corporation's management, an agency problem can arise where officers (agents) of a company may be tempted to put their interests above those of the corporation. Students ought to understand some of the means by which the agency problem can be ameliorated.

One instrument is through contract, particularly the employment contract which can provide incentives that align the agents' interests with those of the corporation, e.g. share performance plans and share option schemes. Another is through the appointment of independent and non-executive directors whose principal role is to exercise oversight on management.

The law has also developed prophylactic rules the most important of which in the common law world is to impose onerous fiduciary duties on senior officers of a corporation, e.g. a director of a corporation must act in the best interests of the corporation, and cannot put himself/herself in a position where his/her duties to the corporation will conflict with his/her own interests.

This problem is less acute in partnerships where all the partners are generally engaged in the business and are in a better position to monitor each other. Yet to the extent that partners are agents for the partnership, partners at common law also owe each other onerous fiduciary responsibilities.

Minority Oppression

As both partnerships and corporations often involve groups of people coming together,² partnership and corporation law have provisions that seek to restrain majority conduct that go beyond the acceptable limits of majority control which is the default rule at law. Students should know what are the principles and rules that determine when the courts will not sanction acts by the majority even though the majority has abided by the procedural requirements under the legislation, the partnership deed or the corporate constitution.

In corporations law, an added complication is that wrongs committed against a corporation is a matter where the corporation is the proper plaintiff. As such, where the wrongdoers are also the majority within the corporation, it will be practically impossible for the corporation to sue the wrongdoers. Is there any mechanism that allows an individual shareholder or minority shareholders to bring a personal claim or more usually, a claim on behalf of the corporation against such wrongdoers?

Shares

Not all corporations issue shares³ but most corporations do. Students should understand the nature of a share, the rights of shareholders, and some technical matters such as whether there are minimum capital requirements; capital maintenance rules; and exceptions such as share buy-backs and capital reductions.

Skills

In addition to the skills set out in *Outcomes of a Legal Education*, it will be helpful for students to understand some of the policy considerations behind corporations law and to a lesser extent, partnership law.

For example, a fuller understanding of the corporation's separate personality and its exceptions is facilitated by an understanding of the economic considerations behind allowing incorporation as a matter of right through the process of registering a corporation. Such considerations include facilitating the use of surplus capital, and encouraging innovation and risk-taking.

As another example, in many jurisdictions, significant autonomy is retained by incorporators with the legislation providing a default set of rules that can be altered by persons who incorporate corporations. This is usually done through the corporation's constitution and provides businesspeople with a flexible legal entity that can be tailored to their expectations.⁴ It will be useful to understand when this is departed from and the reasons behind such departures.

² Note, however, that certain jurisdictions allow "one-person" companies.

³ For example, the company limited by guarantee does not have a share structure.

⁴ This is also true for partnerships through the partnership agreement.

In seeking to understand corporations law more fully, some comparative analysis is helpful. As many business corporations have to operate across jurisdictions, often through local subsidiaries, corporations have to grapple with the law in other jurisdictions. The need to facilitate business is one reason why there is a reasonably high degree of convergence in the corporate law of many jurisdictions. For example, many jurisdictions allow for incorporation through registration, separate personality, limited liability, transferability of shares, shareholder ownership, and delegated management. Corporations law provides a good platform for some degree of comparative law to be introduced to students.

Values

Courses on partnership law and the law relating to corporations provide good avenues to transmit aspects of business ethics to students.

Conclusion

There are other topics in partnership and corporations law that can be included in any course in these areas but the above are the key core areas. Also, given the usual time constraints in all courses, the above framework has been designed to achieve an optimal balance between breadth and depth. As a result of this, certain areas such as debentures, secured transactions and dissolution have been omitted.