**The importance of limited liability**

Sole Traders – Fill in The Gaps

Owners have to decide on the best legal structure for their business - opting to run as sole traders, partnerships or private limited companies. As the business expands and starts to employ hundreds of staff in many locations, it may decide to become a public limited company or to offer franchises.

Sole traders

A sole trader describes any .................... that is owned and controlled by one person - although they may employ ..................... Individuals who provide a specialist service like plumbers, hairdressers or photographers are often sole traders.

Sole traders do not have a separate .................... existence from the business. In the eyes of the law, the business and the .................... are the same. As a result, the owner is .................... liable for the firm's debts and may have to pay for losses made by the business out of their own ..................... This is called unlimited liability.

Advantages

* It is easy to set up as no .................... legal paperwork is required.
* Generally, only a small amount of .................... needs to be invested, which reduces the initial start-up cost.
* As the only owner, the entrepreneur can make decisions without consulting anyone else.

Disadvantages

* The sole trader has no one to share the .................... of running the business with. A good hairdresser, for example, may not be very good at handling the accounts.
* Sole traders often work long hours. They may find it difficult to take holidays or time off if they are ill.
* They face unlimited liability if the business .....................

Personally

Workers

Legal

Pocket

Owner

Formal

Capital

Business

Responsibility

Fails

**Private Limited companies**

A company is a form of business that is created when individuals complete two documents. These are the Memorandum of Association and the Articles of Association.

The Memorandum sets out:

* The name of the company
* The overall purpose of the business
* Where the company is registered
* A general statement of the firm’s activities

The Articles of Association set out:

* The voting rights of the shareholders
* How profits are distributed
* How directors are elected
* The duties and powers of the director

These documents are sent to Companies House and the firm receives a Certificate of Incorporation. This means a new company has been created.

A **limited company** has special status in the eyes of the law. These types of company are **incorporated**, which means they have their own legal identity and can sue or own assets in their own right. The ownership of a limited company is divided up into equal parts called **shares**. Whoever owns one or more of these is called a **shareholder**.

When a business is starting up, its shareholders tend to be the business founders, although they may bring in outside investors if they need more funding. The shareholders of Ltd’s are family members. It cannot advertise these shares to the public.

Because limited companies have their own legal identity, their owners are not personally liable for the firm's debts. The shareholders have **limited liability**, which is the major advantage of this type of business legal structure.

1. What do you think are the advantages of being an LTD over a sole trader or partnership?
2. What do you think are the disadvantages of being an LTD over a sole trader or partnership?

LIMITED LIABILITY



**Case Study:** Greg Pallow, a self-employed painter and decorator was delighted to win a £20,000 contract to decorate a big hotel. The work came just in time, as he was at the limit of his bank overdraft. He picked up £8,000’s worth of decorating materials, using his credit account at the local DIY merchants. He would not have to pay for three months. ials on three months credit from the local builders’ merchant.

Although Greg didn’t have the money at the moment to pay for these materials, when the hotel paid him he could settle his account and make a tidy profit. Greg completed the work, but before the hotel sent him the cheque, disaster struck. There was a fire, the hotel burned down, and was not fully insured. The company that owned the hotel went bankrupt and it was announced that Greg was just one of a long line of creditors. He would not get paid, but the shop that provided Greg with the paint and wallpaper still wanted its money – and was determined Greg would pay up, even if doing so forced him out of business.

Greg cannot pay the builders’ merchants the money he owes for the materials. He does not have £8,000. All he has is a car worth £2,000 and a share in a flat, which would be worth £10,000.

# Situation 1

Greg is a **sole trader**. This means he has **unlimited liability**, and is responsible for all the debts of his business.

**Situation 2**

Greg had formed a **limited company** called Pallow Decoration Limited. This gives him the protection of **limited liability**, should his firm go bankrupt.

**2.** What would happen to Greg if he were a sole trader as in situation 1?

**3.** What would happen to Greg if he were a limited company as in situation 2?

**4.** Why is it easier for a sole trader to obtain a bank loan than a limited company? Use the word *risk*.

1. **What does it mean by the term ‘Sole Trader’?**
2. **What does it mean by the term ‘Company’**
3. **What is the difference between ‘Limited Liability’ and ‘Unlimited Liability’?**
4. **The owners of a company are called ‘Shareholders’. What does it mean by the term ‘Shareholders’?**
5. **Give TWO advantages and TWO disadvantages of having shareholders instead of ONE owner.**

|  |  |  |  |
| --- | --- | --- | --- |
| **Variables** |  | **Sole Trader** | **Private Limited Company** |
| **Risk: Which business ownership has more risk? Explain why.** | Limited liability means that owning a company is less risky than being a sole trader. A shareholder can only lose what they have put into the company. Sole traders can lose everything. |  |  |
| **Control – Which business ownership has more control? Explain why.** | A sole trader has complete control over their business, whereas a shareholder in a company has as much control as their shareholding dictates e.g. 80% or 20%. |  |  |
| **Profits – Which business gets to keep their profits? Which makes more? Explain why.** | In an LTD, the shareholder gets the share of profits that equals their shareholding in the company. A sole trader gets all the profits. |  |  |
| **Privacy – Which business has to publish their accounts? Explain why.** | LTDs must, by law, file their accounts each year with Companies House. Their accounts are a record of the value of their sales, their costs and their profits for a 12 month period. These can be seen by anybody who pays a small feel to Companies House to see them. In comparison, no private individual or business has a right to see the accounts of a sole trader. Being a sole trader gives you more privacy. |  |  |