

Limited Companies – Do They Really Offer Protection?

There is a common belief that limited companies offer limited liability in the sense that they offer an absolute discharge from liability for their shareholders – the shareholders' liability being limited to losing their investment in their shares. This is essentially correct, but only in so far as it applies to shareholders who are not also directors. This article is concerned with the more common circumstance in which a limited company is incorporated and the shares are owned by the directors, who also manage the company. This is the normal form of organisation in a new or small company.

But first, let us deal with one important circumstance in which a shareholder can have a liability to the company. This can arise where the shares are either not paid for at all or are partly paid for (e.g. 25p is paid towards a £1 share). In this case, the unpaid balance is a debt due to the company. In the event of the company 'going under' it is possible for the liquidator to demand from shareholders any unpaid balance on their shares.

The first and most common situation in which the 'limited' in 'limited liability' gets undermined arises through the normal operation of commerce. It is not uncommon for traders and quite normal for banks and other lenders to require directors of limited companies to give personal guarantees for all or a proportion of the company's indebtedness to them. If the company defaults on its debts, they then look to the directors for the shortfall. This situation can also arise by operation of law. For example, if a supplier's terms of trade mean they own the goods supplied until paid for and a director sells the goods on knowing they cannot be paid for, he may be personally liable for the shortfall. This is particularly common where vehicles are sold which are still the subject of HP agreements. Indeed, directors can become personally liable for their company's debts whenever there is 'wrongful trading' – when they allow the company to incur liabilities which they know (or should know) it will be unable to pay. Where a company cannot pay its debts and goes into liquidation, guarantees may be enforced even some years after trading ceases.

There are also particular rules relating to non-payment of tax liabilities (especially PAYE) that need to be borne in mind.

Another pitfall is when a director trades with his or her own company and makes a profit on that trading. This is a complex area, but is, in principle, unlawful and can lead to the director being sued for the profits.

Where a company suffers loss due to the negligence, neglect or criminal behaviour of a director, the director may be liable to be sued by the company. Most company insurance policies will cover this contingency (except fraud or criminal behaviour) but do check the wording of your 'corporate all risks' or 'D&O' policy.

Another pitfall is when a director improperly incurs liabilities in the company's name – for example, by ordering goods beyond his authority. In such circumstances, the 'long stop' of the company is to sue the director personally, as indeed suppliers may be able to if they remain unpaid.

The last major area in which 'limited' can become 'not limited' is when a director treats the company's assets as his or her own, for example by withdrawing 'dividends' without the proper resolutions and paperwork or which are in excess of the 'available profits'. Directors do not own the assets of their companies. Where directors withdraw from a company assets or cash in excess of their contractual entitlement, a debt to the company results.

If there is a moral, it is that director shareholders who want 'limited liability' to mean what it says need to comply with all the necessary regulations and to get their paperwork right (especially as regards anything they take out of the company) and to make sure they take only such actions on behalf of the company as are permitted by its internal rules and by their contract.