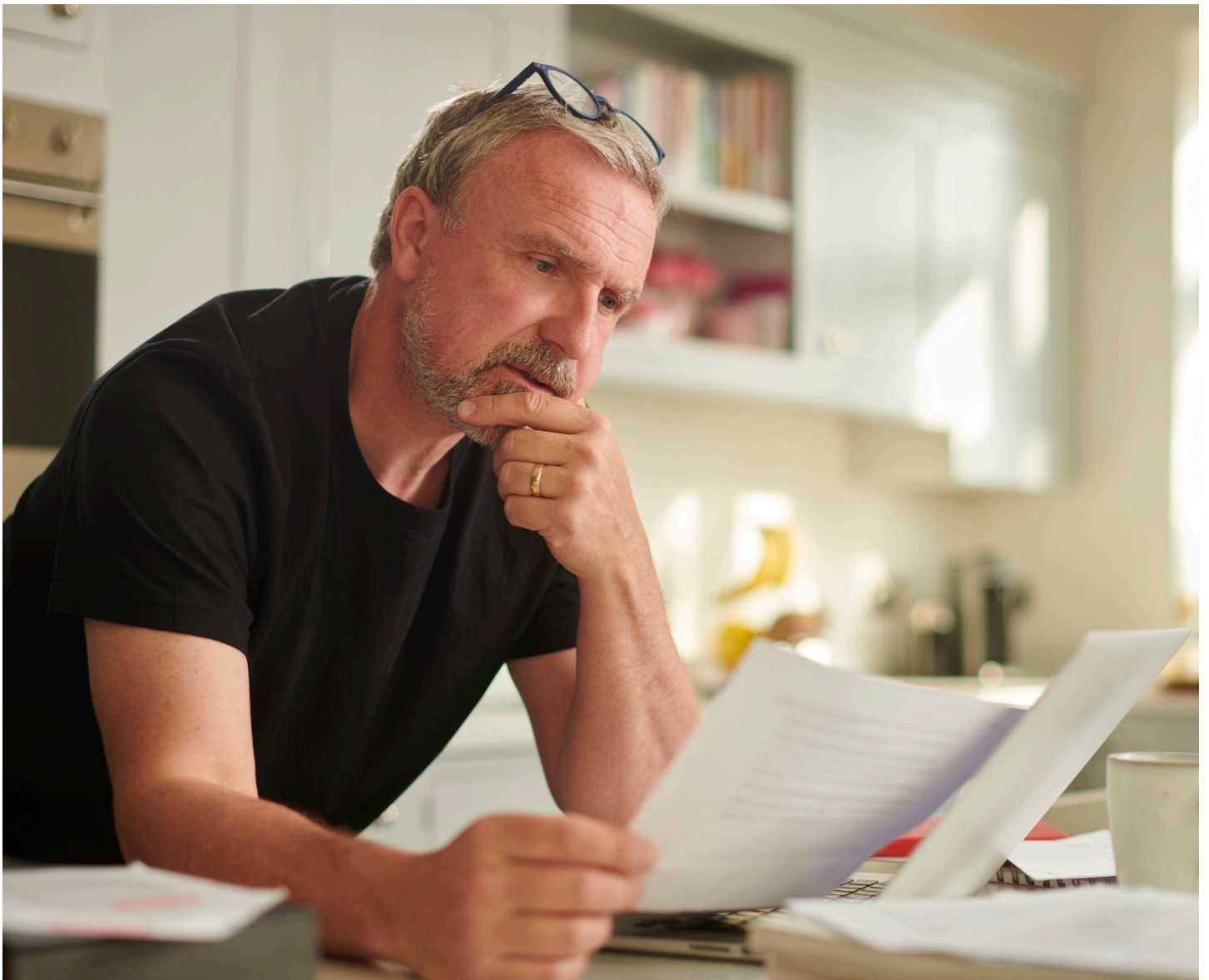


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Business ownership: managing common legal risks



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Here we present an overview of common issues affecting business owners that we have seen in practice and some suggestions on how to start mitigating these. It's not an exhaustive list and it focuses on the legal aspects, rather than more strictly financial risk (which we would recommend that you separately consider with your accountant).

1. Key people

Business continuity

In an owner managed or family business, the key decision makers are most likely material owners of the business as well – and their death or incapacity can create a void that is not only emotionally very difficult but also hugely disruptive to the ongoing business.

The business continuity aspect of this can be addressed ahead of time to mitigate disruption. Any key person in such a business really needs to have a will to clarify their wishes on death and it would also be very sensible to have a business power of attorney in place to allow the exercise of shareholding rights in a situation of incapacity. These documents should be properly lined up with the company's articles and shareholders' agreement (or the partnership deed, as applicable), so that ownership can efficiently pass on and so that business can continue as intended.

Sole director shareholders

A particular risk arises where a company has a sole director and shareholder and that figurehead dies or is incapacitated. This is a topic that is already well covered in online articles, but the essential point is that a catch 22 situation can arise where a new director cannot be appointed without the new shareholder/s being registered, but the new shareholder/s cannot be registered without a new director. This can easily lead to temporary paralysis in the business, whilst relevant court orders are sought, that can be immensely damaging. It's a particular risk if your company was incorporated before 1 October 2009 (when the new model articles of association became the default).

This situation can be most easily mitigated by having at least two directors appointed. Behind this, a combination of a will, business power of attorney and fit-for-purpose governing documents can avoid such complications altogether.

Acting in the best interests

Scenarios can easily develop where a key person essentially treats the business as an extension of themselves. Perhaps this individual used to be the sole director shareholder but now other minority shareholders have joined, or perhaps this individual has taken on the lead role as others have faded into the background. We have seen this kind of situation leading to damaging shareholder dispute in various circumstances.

The lesson here is that, even where there would be no business without them, an owner manager should not lose sight of their obligations to other stakeholders.

A useful guiding principle is that owner managers should act in the best interests of the business and for the good of its members as a whole. More practically, giving due attention to proper process within the business (particularly around taking money out) and involving other stakeholders in, and keeping a record of, material decisions and approvals can avoid issues down the line. What can be an easy discussion at the time can become a cause of legal action against you at a later date if relationships sour.

2. Governing documents

Fit for purpose?

It is not uncommon for the core governing documents of a business to fall down the list of priorities. Business goes on, after all, with the same key people amicably making the necessary decisions. It may not be until something happens to disrupt this, either unexpectedly or by design, that the governance provisions come into the spotlight. In the interim period, it can be the case that the nature of the business has changed considerably, perhaps operating in different areas and with more complex internal organisation and ownership structures that bear little resemblance to what is set out on paper.



As the business develops it can often benefit from a review of its main governing documents to bring them up to date. This can for example include introducing more flexibility to outdated and onerous statutory process and adding more robust controls around decision making, dispute resolution, responsibility, reward and transfer of ownership. Such an update can put in an organisational framework that aids operational efficiency and more harmonious stakeholder relations, as well as demonstrating to third parties (including banks and buyers) that the business is well regulated. It's worth also simply checking that all relevant parties have signed the documents that they should have.

In the absence of such update, the business can leave itself open to commercial risk that should never have existed and, left unaddressed, stakeholder expectations can wildly diverge. Where we have seen relationships break down in this scenario it can often lead to an uncomfortable resolution process hampered by inflexible process and the lack of prior agreement of how things should work.

Specific issues

As well as bringing the governing documents generally up to date, there can be a lot of value in reviewing these documents in order to address specific business concerns.

A common consideration here is succession planning. As noted above, the sudden absence of key people can cause major problems, but there are of course many other circumstances in which key stakeholders will want to transition out of the business – to retire perhaps, to focus their efforts on a different venture, or to bring in the next generation of managers. Amending the governing documents here can be used to effect an orderly handover, either gradually or more directly. Ownership and control of the business can be usefully separated, to provide a greater role and buy-in for those stepping up whilst retaining key controls over major decisions. There are also various measures that can be taken to keep new managers focused and to protect the business if the transition does not go as expected, such as compulsory transfer events and 'bad-leaver' provisions to claw back ownership if there is a negative turn of events and non-compete provisions to protect the business. It's also an opportunity to formally set out the parameters of new roles to align expectations.

If a business exit or sale might be on the horizon, a governance update can assist to smooth the process and avoid transactional risk that might otherwise arise. A company can introduce robust 'drag along rights' so that the majority shareholders can compel an unwilling minority to sell, with a quid pro quo for minority shareholders being the addition of 'tag along rights' – so that they have the right to participate in a sale by the majority. It's also wise to change any onerous process requirements, or outdated provisions that might block likely transactional structures (such as a prohibition on financial assistance).

It is always best to do this well in advance though, rather than leaving it to when an offer is on the table – at which point minorities may have additional leverage to hold up a transaction and negotiate more than their fair share, or else you run an increased risk of a claim for minority prejudice if you just push the changes through.

The governing documents can also be used to reflect the core values of a business and the expected behaviours of its people, which can go a long way towards preventing at source the risk of relationship breakdown. In a family business this is particularly useful and a family charter can enshrine the guiding principles and values to better align behaviours. Typically, such a document would not be legally binding itself (though it can be tied-in with the other governing documents to give it effect) and provides a framework for how the family and the business should interact, as well as presenting an opportunity to represent the views of all family members.

3. Structure

Structuring can be used to contain risk and protect assets.

Using a limited liability company, for example, will generally limit the financial liability of its shareholders to the amount unpaid on the nominal value of their shares (which typically means just a few pounds). Such a company will usually have more options for risk containment in an insolvency situation than an individual or partnership and, furthermore, any legal claims against the business would ordinarily be made against the entity itself rather than its owners. None of this removes the need for owners and managers to act in accordance with their duties and legal responsibilities, but it can fundamentally shift the risk position for the individuals involved. This is relevant even where the business is performing well in the case of prosecution. We have seen individuals in partnerships getting personal criminal records as a result of business-related prosecutions that might otherwise have fallen on the separate business entity.

Despite the name, limited partnerships do not provide all of the same protections as a limited company or LLP and they notably leave the general partner/s with unlimited liability. They can however provide advantage over general partnerships and make it easier for junior parties to formally join the business without too much exposure.



As well as considering the best choice of business entity, it can be advantageous to develop a group structure - perhaps with different entities dealing with different aspects of the overall business. This is often seen in property-heavy businesses (with a different entity for each site) or in businesses operating internationally (with different entities for different territories), but the principals are generally applicable. By splitting out certain activities and assets like this, operational risks can be limited to one part of the wider business - so that unexpected setbacks are contained and assets held elsewhere in the group are protected. A group structure can also provide certain accounting and tax planning benefits, facilitate future disposal plans and allow for parts of the wider business to be run differently.

4. Looking after the value of your assets

Informal arrangements

It makes sense to protect the value of the key assets in your business, yet the tendency to keep the business going on the basis of 'that's how we've always done it' can sometimes get in the way of this. As with the governance matters, it's not uncommon for us to see a disconnect between how a business actually informally operates and what is on paper -and in that gap there can be material risk. If unaddressed, this issue can come home to roost when key stakeholders in the business or in the commercial counterparty change, or when considering an exit or funding. It can be the case that what would have been a conversation at an early stage can become a problem if its only dealt with when the situation is already pressured.

Where you have material commercial arrangements that are not properly documented, or where the existing contract is likely not reflective of the current arrangement, then taking the time to formalise it is a sensible move to protect the ongoing relationship and your business. Where there is negotiation needed, it is better to have this between familiar contacts whilst they are still in role and without the pressure of an external event that may well prejudice your bargaining position.

Third party rights

Situations can arise where third parties acquire rights over your assets. Being conscious of this and taking steps to avoid it can prevent issues arising.

This is a common issue where intellectual property is created within a business, as individual creators or developers can acquire rights both by default and intentionally. A good start to addressing this is to ensure that all employment contracts in the business specify that all IP developed for the business becomes the property of that business. Be careful to read the terms of third-party developers and marketers and negotiate attempts to retain ownership or the right to use IP created for the business. It may also be that one or more key stakeholders in the business developed the IP themselves and if so, it may be owned personally by them and therefore not technically an asset of the business. These matters can be rectified, but it will be easier to do so if addressed early.

Registrable IP should also be registered and maintained in the name of the correct owner.

Where land or buildings are a material part of your business, it is worth ensuring that you are familiar with the title deeds and any rights or restrictions affecting the property. Being aware of such things and building them into your business plans in advance is the first step in managing any issues they might generate. Where there is a relevant landlord it may also be possible to address issues directly through contract renegotiation.

The workforce

Your people are perhaps the key asset of your business. To manage a workforce naturally requires far more than the right legal framework, but not having this in place certainly increases the risk of things going wrong. The starting point in managing legal risk here is to have appropriately drawn and up to date employment contracts in place alongside a staff handbook and sensible HR policies. Ashtons previously published [A 6-point health-check for the employer](#) which provides further reference points on this.

Digital

The significance of digital risk will naturally vary with the nature of the business, but it is relevant to all. It is always worth ensuring that you have robust policies and solutions in place to cover continuity in your IT system (including disaster recovery), data use and retention (particularly personal data, which is subject to the GDPR) and cyber security.



“I had a great experience using Ashtons Legal, they were very friendly and helpful. Everything was explained to me very clearly and the case dealt with efficiently with good communication from the team throughout, making my life a whole lot easier! Would definitely use Ashtons Legal again/highly recommend to others!”

5. Record the ownership!

The legal requirement to maintain the statutory registers of a company can sometimes be overlooked, particularly where the company is older and there has not been significant change over time.

The significance of these books is often underestimated though and they are in fact the ultimate legal reference point for ownership of a company, ahead of anything on Companies House or any issued share certificates.

Aside from the directors being in breach of the Companies Act by not keeping an updated record, inaccuracy in a company's books can become a material problem when looking to make shareholding changes or where relationships break down – especially where the gaps go back far enough in time that it's difficult to ascertain actually what was done. We have seen several internal disputes arise from or be exacerbated by this – and this is a risk that can easily be avoided by keeping the record up to date (either in house or with low-cost company secretarial support from your advisers).

In a sale or investment scenario, any sensible third party would be carefully reviewing the company books and issues with those books will, at the least, lead to the shareholders personally taking on the risk involved (if it doesn't end discussion entirely).

There are obviously no company books in the case of a partnership, but similar issues can arise where the partnership deed is not sufficiently clear and up to date on ownership.

We can help you

We recognise the challenges that are presented to committed business owners and will help you overcome them by understanding your values and vision, helping you to reach your desired outcomes. Our multi-disciplinary team's expertise covers the several relevant areas of law that apply and its insights span many sectors, with particular experience in the tech, construction, agricultural, distribution, manufacturing and engineering sectors.

This means we can help you identify and capitalise on opportunities early on, coordinate parallel legal workstreams involved in progressing your business plans and provide dynamic, practical support.

What drives you, equally drives us. Our team is here to make sure you receive the right support and advice to take that next step forward.

More information

To discuss how we can help you, please contact us:

E: enquiry@ashtonslegal.co.uk

T: 0800 915 6037

