



COMPANY FORMATION



SCINAPSE

Geldards
law firm



COMPANY FORMATION & STRUCTURE

Setting up the right legal structure for your business is very important. Although other legal structures are available, the one chosen most often for commercial ventures is a private company limited by shares.

The major benefits of a company include:

Limited liability for its shareholders

This means that once they have paid the company in full for their shares, the shareholders do not have any further liability and so cannot, for example, be called upon to contribute towards the company's debts. However, the benefits of limited liability are lost to some extent if shareholders agree to provide a bank or other lender with personal guarantees as security for the company's debts.

Favourable tax regime for companies

The Enterprise Investment Scheme and the Seed Enterprise Investment Scheme are available for investments in companies (subject to conditions). Potential investors in your business may be unwilling to invest unless they can take advantage of one of these tax reliefs.

Funding and sale

The limited liability company is a widely used, and universally understood, structure. Running your business within a company can make it easier to attract funding and investment and to find a buyer for your business.

Setting up a company is a very easy, quick process. It involves filling in a few forms and sending them to Companies House together with a small incorporation fee. However, creating the right constitution for your company requires more thought.

Your company will be governed by the rules of company law, which are mostly set out in the Companies Act 2006. In addition, your company will have its own internal rules known as its articles of association. There are a set of default articles, known as the Model Articles, which will apply unless you use your own tailored articles. It is common to adopt articles based on the Model Articles but tailored to suit the needs of the company and its shareholders.

If your company will have two or more shareholders, it is usually advisable for them to supplement the articles of association with a separate agreement, known as a shareholders' agreement.

Unlike the articles, there is no requirement to file a shareholders' agreement on the public register at Companies House, so it can be used to deal with matters the shareholders wish to keep confidential.

ARTICLES OF ASSOCIATION AND SHAREHOLDERS' AGREEMENT

When preparing your articles of association and shareholders' agreement, you need to think about the following issues:

SHAREHOLDERS

Who will be the shareholders of the company? The shareholders invest money in the company in return for shares entitling them to share in the company's profits. In a start-up company, this investment from shareholders may provide a large proportion, or even all, of the company's finances during the early years. The company therefore benefits financially when new shares are issued. By contrast, when existing shares are sold by one shareholder to another, this doesn't involve the investment of any new funds in the company.

DIRECTORS

Who will be the directors of the company? There must be at least one director, and at least one director must be a human being (as opposed to a company). A change in the law is anticipated which will require all the directors of a company to be human (subject to exceptions) in future. The directors will be responsible for the day to day management of the company. A directorship is a position of responsibility.

Directors are subject to a range of duties, such as the duty always to act in the best interests of their company. Directors can incur personal liability if they fail in their duties. You can choose whether or not to appoint a company secretary if your company is a private company. The secretary normally fulfils a range of administrative functions, but these can be performed by the directors of a private company in the absence of a secretary.

Benefits of Audit

Reducing Risk

Accounting Assurance

Exit Planning

Acquisition

Strategic P

BALANCE OF POWER IN YOUR COMPANY

The balance of power in your company will depend on where the voting rights lie. The default rule is one vote per share. Company law reserves certain important decisions, such as amending the articles, to the shareholders, but generally allows the board of directors to take most decisions concerning the company. You will have considerable flexibility to change rules which are not fixed by law to suit your purposes. You'll need to think about:

Voting power amongst the shareholders

You may want to protect minority shareholders by giving them a veto over certain key decisions where they could otherwise be outvoted by the majority. You may want to give a particular shareholder enhanced voting rights in relation to certain decisions.

How the board of directors is appointed and voting power amongst directors

You will need to think about whether any shareholders will be entitled to nominate their own director to the board. Generally, directors get one vote each at board meetings. You can alter the

balance of power by excluding the right of particular directors to vote on certain decisions, and by creating veto rights or enhanced voting rights. Sometimes this is done to ensure that the balance of voting power enjoyed by the shareholders is mirrored at board level.

How decisions are divided between the board of directors and the shareholders

Is it usually more convenient to allow the directors to take most day to day decisions. However, if the balance of voting control at board level differs from the balance of voting control between the shareholders, you will need to consider whether particular matters ought to be reserved as a matter for decision by the shareholders.

FUTURE CHANGES IN SHAREHOLDING

It is prudent to put in place a framework for dealing with changes in share ownership later on. You'll need to think about:

Shareholders who leave the company

It is common to require them to sell their shares to the remaining shareholders. The value they receive will depend on whether they are a "good leaver"

(retiring perhaps) or a "bad leaver" (dismissed for misconduct perhaps).

If a shareholder dies

Cross-options backed with life policies can be used to give the surviving shareholders the right to purchase shares from the deceased's estate using the proceeds of the life policy. This realises value for the deceased's estate and allows the surviving shareholders to retain control of the company.

An eventual sale of the company

It is common for the majority shareholders to be given "drag-along" rights so that if they want to sell the company they can force the minority shareholders to sell their shares too. Minority shareholders can be given matching "tag-along" rights which allow them to block a sale of the company unless their shares are bought on the same terms.

EXTRACTING PROFITS

You may want to agree a policy on profit retention and level of dividends. It will also be necessary to consider the profit shares of shareholders. The default rule is that they share in proportion to their shareholdings but there is complete flexibility to change this. Differing rights are achieved by creating different classes of shares:

Preference shares

These typically entitle their holders to a fixed rate dividend which must be paid before any profits are shared amongst the ordinary shareholders. Preference shares do not usually carry voting rights.

Preferred ordinary shares

These are relatively uncommon, but give their holders enhanced rights to a profit compared to ordinary shareholders.

Ordinary shares

These shareholders can't be paid a dividend unless any preference shareholders have been paid in full and any preferred ordinary shareholders have received the preferred element of their dividend entitlement.

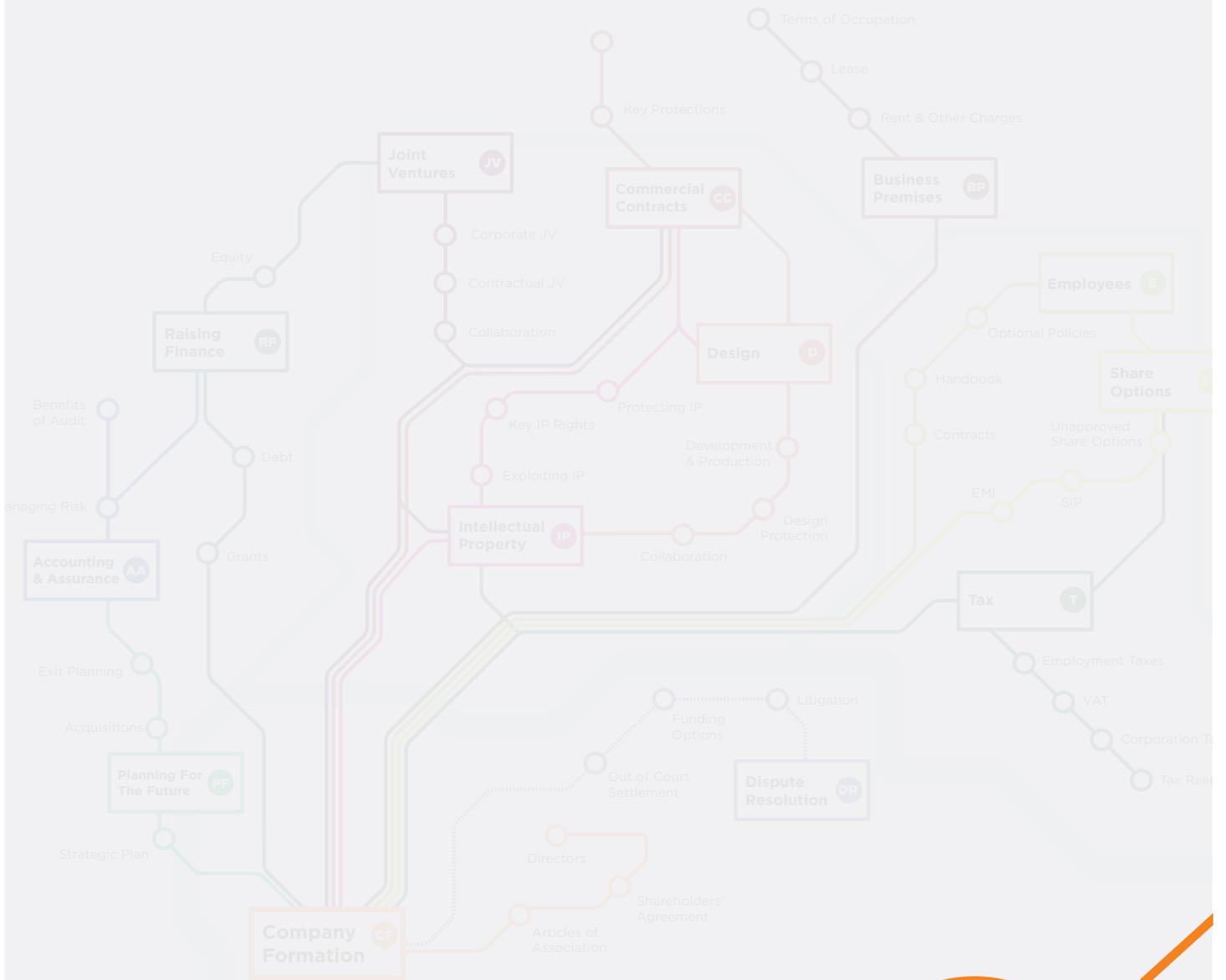
CHECKLIST

- Consider who the shareholders are to be.
- Consider who the directors are to be.
- Consider how the balance of power (including voting rights) is to be divided.
- Consider whether a shareholders' agreement is required.
- Consider how changes in share ownership are to be dealt with. This will impact on your articles of association and shareholders' agreement (if you have one).

Directors

Shareholders' Agreement

Articles of Association



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