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The most common errors made by startup companies: Part 1

At the London Law Collective, we provide entrepreneurs and startups with quality legal advice. As such, we are well aware of the common errors that they make, both legal and non-legal, and which often drive them to seek our support. We've been asked by Maddyness to share our experiences, thoughts and solutions over the next few weeks.

We do not pretend that our list of errors is complete or definitive. We simply hope that it is helpful, and will allow entrepreneurs and startups to avoid pitfalls that have otherwise been experienced by their peers in the past.

1. **The wrong premise**

Generally speaking, a startup begins with a clever idea. Yet, 90% of startups fail within 3 years. Why is this? One reason is that great ideas do not always solve a problem or provide a solution that the market needs or wants, certainly at the price being charged.

In *The Pursuit of Happyness*, Chris Gardner carries a set of portable bone-density scanners around with him. A brilliant piece of technology, they provide significant advantages over x-rays, but he has real difficulties selling them because their cost is prohibitive in comparison to those x-rays and there simply is not the demand for that product at that price.

So, no matter how brilliant your idea, unless there is a market for it, your startup is born to fail.

2. The wrong structure

With any startup, there is risk. An entrepreneur’s first task is to determine how that risk should be balanced against potential reward. A key decision therefore is to consider under what kind of structure the business should be operated.

Often, entrepreneurs begin their businesses as sole traders. This gives them autonomy and an absolute right to the upside if it transpires. However, it also makes them very prone to the downside. If things go wrong, they are open to unlimited personal liability.

As a result, entrepreneurs sometimes utilise a limited liability company. As the name suggests, the liability arising from this is limited to the assets of the company: an immediately attractive proposition.

It is though, to some extent, a mirage. A limited liability company will (in general) require funding. In order to obtain that funding, the entrepreneur will be expected to give a personal guarantee, normally at the same level as the funding. As such, there may not be a considerable difference, in practical terms, between being a sole trader and using a limited liability company.

There are exceptions. Sometimes a funder can be convinced to place a maximum level on the personal guarantee, so that it is possible for the entrepreneur to take a measured level of risk. However, this is the exception rather than the rule.

Having a single limited liability company may also provide other pitfalls. If the same company:

- holds all of the valuable assets of the business (e.g. intellectual property); and
- enters into all of the commercial contracts;

and if that company suffers a commercially damaging event (e.g. litigation with a customer), the valuable assets will be at risk.

Entrepreneurs should think about having one company that holds the valuable assets of the business. This company can then licence the use of those assets to a second company (probably a subsidiary of the holding company), which can then be the main 'trading' company. This is not a bullet proof solution, but given European Courts' reluctance to 'pierce the corporate veil' (i.e. to look outside the assets of the company in relation to recovery following a successful claim against that company), it certainly provides a significant level of insulation.

3. **No founder agreements**

No man is an island. And this is very true of entrepreneurs. Very often they hunt in packs. However, with numbers come difficulties. Early in the development of a business, the cofounders may well have informally discussed and even agreed amongst themselves how the business should operate. However, this does not always translate into a formal agreement.

As such, crucial issues such as:

- how cofounders will be required to invest in the business ;
- how day-to-day decisions in relation to the business will be made;
- how disputes should be remedied if they arise; and
- who should receive any profits that the business makes, and how;

might remain in an undocumented state. If something very bad or very good then happens to the business, there is the risk that disputes can break out like wildfire. If the cofounders are family members (as is often the case), disputes can be long, bitter and expensive.

Formalising the informal agreement at an early stage, is therefore likely to be one of the better business decisions any entrepreneur makes.

Having a founders' agreement also provides an element of future proofing. If an investor comes along later, it will have to negotiate out any key founder protections inserted in the agreement, rather than simply handing out its standard form investment agreement to the founders to sign.

We'll return with part two next month, when we'll look at intellectual property and employment matters.

At the London Law Collective, we believe we do more together than alone. We gather the best people to provide excellent legal advice to accelerate the potential of your rapidly growing business. We will expertly guide you and *create clear solutions to help your business thrive. We will be generous with our time, supportive and helpful, and will collaborate with you along the way, building long-term relationships. As a collective we do more than law. We understand that having a positive impact on the world around us is just as important.*

Tim Herbert, a director at LLC and the author of this article, can be contacted at tim@londonlawcollective.com or on +44 737 562 6184.

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The most common errors made by startup companies: Part 2

Article by TIM HERBERT