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The 9 most common errors made by startup companies

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

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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.

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 bonedensity 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.

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.

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.

Incomplete founder agreement

Previously we highlighted the difficulties a failure to have any *Founder Agreement can cause*. But even if that agreement exists, unless it is comprehensive, it will not be worth the paper it is written on.

Without a Founder Agreement, the following problems can arise (explained in the context of a company, but equally applicable in relation to other structures):

If an entrepreneur has been appointed a Director of the company but owns less than 50% of its share capital:

they can be removed from office by the other shareholders at any time;

the other shareholders can collectively take actions, without the entrepreneur's consent, such as: creating charges over the company's assets, moving the company's registered office, appointing other Directors or engaging senior employees, changing the focus of the business, selling the company's assets.

If an entrepreneur owns 25% or less of the share capital, the other shareholders can vote to create more shares and issue them to whoever they want, including themselves (dilution)

A shareholder can sell their shares to whoever they wish.

Whilst having an unencumbered right to sell shares is good news for the seller it is not necessarily good news for the entrepreneur or, for that matter, the company. It is very possible for the company to be saddled with annoying or disruptive new shareholders, potentially with significant influence because of the percentage of shares they now hold.

All of the difficulties referred to above can be dealt with in a Founder Agreement. For example, a provision can be included that if any shareholder wishes to sell their shares, they have to offer them to the other shareholders first or to the company for repurchase (which is also called a pre-emption right or a right of first refusal).

Insufficient protection of intellectual property

The lifeblood of a startup is normally its idea. Subsequently, that business will develop a brand, based on that idea. Both (which are normally included under the umbrella term of "intellectual property") are crucial to the success of the business.

The law offers various protections both of ideas (through concepts such as patents and copyrights) and brands (through concepts such as trademarks, design rights and domain names). It is incumbent on the entrepreneur to ensure that those protections are put in place and are put in place quickly. The entrepreneur must, if at all possible, become the “first mover”, in relation to the idea, and then secure the brand.

By putting in place these protections, they will be able to maximise their competitive position. Other businesses will not, legitimately, have access to the idea or brand. If, however, those protections are not put in place (as often occurs), then the idea is potentially likely to be exploited by another business, including through a similar brand, and sometimes more successfully than by the person who came up with the idea.

Employment matters disregarded

Many startups will begin with just an entrepreneur. However, almost all expand to include employees. In the excitement of such expansion, key issues with employees are sometimes forgotten, for example:

> It is crucial that any employment arrangement is recorded in a formal, full contract. There is an old adage of “hire slowly, fire quickly”, but hiring mistakes are not uncommon. Entrepreneurs should consider including a probation period in any employment contract, to allow for an assessment of performance in the first few months and a short termination period if that performance is unsatisfactory. Allied to that, the contract should include a comprehensive role description, so that there is something tangible against which to assess performance.
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> Any arrangement should include adequate protections (known as restrictive covenants), such as preventing the employee exiting with any ideas or confidential information of the business, or being able to poach the business’ clients or his or her former colleagues.
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> Employment law is different all over the world. As such, there is no “one size fits all” arrangement for employees. Entrepreneurs need to consider local laws and their effect on employee relations.
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> If an employee’s role changes, so might their tax status. A part-time, flexible worker may become a full time employee, or vice versa, and this may affect the business’ responsibilities to the relevant tax authority. If a business fails to properly monitor the status of an employee, it could face an expensive investigation, which, if it is found to be in default, might lead to retrospective charges, interest and penalties. A word of warning – in a world

of shrinking tax revenues, authorities are increasingly unafraid to pursue potential non-payment.

Employment issues are important and disputes can take-up valuable time and energy from a startup business. As with many areas in relation to fledgling businesses, the small cost of specialist advice at the outset may avoid significant costs further down the line.

Proper regard not paid to commercial contracts

When a big client is interested in product, in the excitement, an entrepreneur rushes to get that client signed up. In so doing, the entrepreneur causes their business to enter into a contract that it subsequently transpires is not in its best interests. The business is left with an albatross around its neck.

Before a business signs on the dotted line, whether it be for a contract with a customer or a supplier, an entrepreneur should check exactly what the business is signing up to.

The following types of terms are often overlooked:

> *Limitation of liability*. The business should limit its liability under the contract to a sensible amount (for example, correlating to its insurance cover). On the flip side, it should prevent the other party limiting its liability under the contract to all but nil.
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> *Protection of intellectual property*. The importance of intellectual property was discussed in our previous article. When it comes to allowing any third party usage of that property, a business should make sure it is as limited as possible. It does not want the other party to the contract running away with its ideas and developing them on its own.
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> *Non-circumvention.* Most entrepreneurs have spent many years building up their networks of useful contacts, including suppliers and potential customers for their business' product. It is valuable information. The other party to the contract should not have the right to approach these sources directly.
>
> *Non-solicitation.* The business may have employees, upon which it may have expended considerable amounts in training. The other party should not be able to poach them
>
> *Probation periods and targets.* Not all business relationships work. With a new relationship, a business should consider having an initial term to see

how things progress and/or potentially targets for the parties to reach. The business should have a mechanism by which it can terminate quickly or make alternative arrangements if things do not go according to plan. If the business is going to make a considerable capital expenditure on the basis of the contract, the opposite applies: it should make sure that the contract will endure for long enough that the business can recoup that expenditure and more.

Ignoring data protection

Very few businesses do not use personal data. Those that do not, probably should: a considerable amount can be learnt about a business' brand from information provided by its customers or potential customers. This is why such information has genuine value.

Protection of personal data is a hot topic. Unless the correct rules are followed, significant penalties can be imposed by regulators. This is obviously bad news for the business.

The possibility of such penalties does not play well with investors. Neither will they be happy to see potentially valuable information received from third parties frittered away. They will want to see that at least the basics of a data protection regime has been instigated. Often they will wish to see considerably more.

Very often, any sort of regime is conspicuously absent.

As initial steps, a business should:

- register with the Information Commissioner's Office (the presiding data authority in the UK): *https://ico.org.uk/*.

- If it is processing data of non UK citizens (which, of course, now includes those in the EU), register with the relevant local data protection authorities.

From then on, the golden rule is to remember that the personal data provided belongs to the individual that provided it and not to the business.

Other than that, some basic rules:

- If the business has a website, it should include in terms and conditions for use of that site, including what it will do with any visitor's data;

- If the business is going to share a person's personal data with any third party (including, for example, to allow a third party to send marketing emails to that person) the business should be explicit with that person that this is intended and should obtain his or her express consent;

On any emails to any person who has provided personal data, a business should ensure it includes an "unsubscribe" option, so that he or she can choose not to receive any further emails.

These really are only a beginning as to what is a very complex topic. If the business is dealing with personal data, it should get specific advice on the levels of protection that it needs to apply, which will vary depending on the particular situation. These levels should be regularly reviewed as the business grows.

Not keeping proper and organised records

It is too easy in the hubbub of running a business to forget to keep proper and organised records.

There are many downsides to this (for example in terms of keeping up with accountancy and taxation issues), but it is a particular issue when it comes to investors.

Imagine that you are an investor that can potentially put money into hundreds or thousands of potential startups. Would you invest in the startup with no or horribly disorganised records, or would you look to the startup whose paperwork is in place and well organised for a quick review?

Obviously, to an extent, it will depend on the product being offered, but there is still a lot to be said for the maxim that you never get a second chance to make a first impression.

When that investor does come along, the entrepreneur often finds himself too busy with the business to undertake the, by then, substantial task of putting together the records (often in a data room). He or she has to pay professional advisers to collate everything, which can be a significant and unnecessary expense.

> *It is far better that an entrepreneur keeps organised records from the outset of the business and then*

updates them as it goes.

That concludes our series of articles. As we have said before, 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. If you have any queries or comments arising from the series, please do not hesitate to contact us!

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.

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