

# Introduction

## Me

- ex-computer scientist
- freelance startup lawyer
- based in the ODI (Shoreditch)

Obligatory statements about me. Read these only if you are interested. Skip to the next section for the real content.

### *Ex-computer scientist*

I received a post-graduate diploma in computer science from Cambridge University in 1990. I did academic research in formal methods and theoretical computing for nearly 6 years and then worked as a system administrator for another 4. I then retrained as a lawyer. During that time I was senior system administrator for a rapid growth startup, which is what made me interested in the field.

### *Freelance startup lawyer*

I am a practising barrister. I qualified as a barrister in 2003. As a young barrister I experienced a lot of varied law (including employment, immigration and property). Since 2008, I have been building my own legal advice business.

## Scope

- focus: the equity startup
- sorry: social enterprises
- most common/important points
- 
- (notes available by week end)

This talk is primarily directed at the classic growth startup - a business that aims to attract outside investors, grow fast and return its founders' investment either in money (e.g. through an "exit") or in valuable publicly tradeable shares (e.g. through some forms of Initial Public Offering or IPO). If this is not you, do not despair -

most of what I say will be relevant to a small but growing business, but I will spend a little time on funding and corporate structures.

Some of what I say will be relevant to social enterprises, but there are quite a few significant points of difference.

These notes are not meant to be a complete introduction to law for startups. If there is enthusiasm for such a thing then do please contact me and suggest it. Instead these notes are intended to supplement some of the things I say in the talk.

## **The Business**

### **Corporate structure**

- company limited by shares
- but: social enterprises
- setup: google

### *Companies Limited by Shares*

The only sensible corporate form for a conventional startup in the UK is a company limited by shares. For almost all startups this will be a private (“Ltd”) rather than public (“plc”) company. Social enterprises have many more choices, for which see the appendix on corporate structures for social enterprises at the end.

### *Creation*

Creating a company is fairly straightforward by hand, but there are numerous online registrars that will create a company for a very modest fee. The online deals are sufficiently competitive that it is worth just googling for something like “Limited Company Creation” and comparing the top hits against each other.

### **Company constitution**

- articles of association
- model articles
- no longer: memorandum
- shareholders’ agreement

## *Model articles*

There are a number of example articles of association online, in particular:

- Companies House model articles available from  
<http://www.companieshouse.gov.uk/about/modelArticles/modelArticles.shtml>  
[http://www.companieshouse.gov.uk/about/modelArticles/model\\_articles\\_private\\_ltd\\_by\\_shares\\_after28April2013.doc](http://www.companieshouse.gov.uk/about/modelArticles/model_articles_private_ltd_by_shares_after28April2013.doc) - the “official” model articles for a private limited company. If your company has no articles, these will be the default.
- British Venture Capital Association (BVCA) model articles, available from  
<http://www.bvca.co.uk/ResearchPublications/StandardIndustryDocuments/Modeldocumentsforearlystageinvestments.aspx> - still in draft form. The BVCA is trying to produce standard documents to be used in the investment industry. These articles are very complicated, but give you an example of the kind of thing you might need at angel or venture capital stage.

## **Agree vesting structure early**

- what if a founder leaves?
- vesting - 4 years
- cliff - one year

## **Shares are flexible**

- can subdivide ( $100 \times £1 = 1,000,000 \times 0.001p$ )
- split into classes
- voting rights
- preferential rights to a dividend
- liquidation
- appointment of directors

## *Dividing shares*

When raising funds or bringing in new people into the business you may want a larger number of shares to allow smaller fractions to be owned. A company may (by resolution) subdivide its shares into more shares of a small face value.

Example: a company with 100 shares of face value £1 could divide its shares into 1,000,000 shares of face value 0.001p

This is a paper exercise. Nobody's shareholding changes in value.

## **Share schemes**

- EIS, SEIS
- no preferences
- tax rebate, loss relief, CGT rollover, CGT exemption
- SITR includes debt investment

These schemes allow an investor to recover a large chunk of their investment one way or another in tax breaks. In particular

- tax rebate - the investor can recover their tax rate from the investment.  
Example: a higher rate (40% in 2014-2015) tax payer invests £10,000, they receive £4,000 tax rebate in that year
- loss relief - if the investment does not work out
- capital gains tax is not payable on any gain in value of the shares and

They apply only to investment in shares and not other kinds of investment, eg through loans to a company.

### *Seed Enterprise Investment Scheme (SEIS)*

Is for seed stage investment and may only be used to raise up to £150,000

### *Social Investment Tax Relief (SITR)*

This has many similarities to SEIS and EIS, but its significant differences include: - investment must be in a social enterprise - Community Interest Company - Community Benefit Society - Charity - debt investment can be used

## **Contracts**

### **Overview**

- understand what a contract is for

- use plain English
- what, where, when, who (and how)
- use heads of terms

## **Contracts you will meet**

- their (big, long, turgid...) contracts
- contracts of adhesion
- your contracts
- your “standard” contracts
- your contracts of adhesion (eg website terms)

## **What is a contract for?**

- pedantry: is a contract a bit of paper?
- suing the other party if things go wrong
- crystallising the agreement
- evidence for others

## **Use plain English**

- no magic words
- objective observer (with knowledge of the parties)
- yuck: hereinafter, aforesaid, hereby,...
- unambiguous
- grammatical
- proof readers are cheaper than lawyers

## **What, where, when, who (and how)**

Ahasuerus Inc shall pay £120,000 into coolCo’s bank account (no. 01234567 at HSBC Bank plc, sort code 11-22-44) on 13 August 2014

- introduce the parties
- use company numbers
- give them friendly names

## **Heads of terms**

- get deal-specific items agreed
- give heads of terms to lawyers to fill out
- *do not* make legally binding
- except: confidentiality, non-compete
- also: term sheet

## **Agreements to agree**

- no
- negotiate [in good faith]
- mechanism for resolving differences

## **Employment**

A lot of useful information can be found on the ACAS website. The most useful pages include:

- Useful templates for letters, forms and checklists
- Help for small firms

## **Employment status (employee v worker v contractor)**

The law makes a broad distinction between people who work for you under an employment contract (employees) and those who do not – often called “contractors. In some situations (particularly for employment rights) there is a third class of individual the “worker“, someone who works for you personally but is not an employee. This means we end up with three categories.

- employees
- workers who are not employees
- other self-employed contractors

The law cares most about what the person is *doing* rather than what you call them. In other words if your relationship with someone quacks like an employment relationship it probably is. This means that simply labelling one of your employees a self-employed contractor won’t automatically turn them into one. Although that

label might be one small factor that could push the relationship over the line if it was doubtful which side of the line it fell.

For tax purposes there is a Useful Employment Status Indicator, the result for which may be something you can rely on for tax/NICs/VAT purposes, assuming you answer the questions it asks correctly.

### *Why employment status matters*

Status matters for three main reasons:

- *tax* (income tax and national insurance)
- *immigration*: someone may be entitled to work in the UK as a self-employed individual but not as an employee
- *employment rights*: there are different employment rights for employees, workers and self-employed who are not workers

### *Employees*

Unfortunately there is no conclusive test for which category someone falls into. Instead the courts have developed a series of “tests”.

- The ESM (HMRC’s employment status manual has more detail than most people could possibly want.

For an employee you will almost certainly have to organise that their tax is paid (via Paye as You Earn) and also employer’s national insurance. A full run-down of rates is available on the HMRC website.

### *Workers*

‘an individual who has entered into or works under (or, where the employment has ceased) worked under (a) a contract of employment, or (b) any other contract, whether express or implied, and (if it is express) whether oral or in writing, whereby the individual undertakes to do or perform personally any work or services for another party to the contract whose status is not by virtue of the contract that of a client or customer of any profession or business undertaking carried on by the individual’.

## *Employment rights*

Right	Status
Unfair dismissal	Employee
Fixed-term worker rights	Employee
Unlawful deduction from wages	Worker
Part-time worker rights	Worker
National minimum wage	Worker
Working time regulations	Worker

## *Directors*

A company's directors are not necessarily employees of the company. The technical term is "officeholder" since they hold the "office" of director. However a director may be, and often is, an employee. Company secretaries will usually be treated as employees.

A company director's employment contract is known as a "service agreement". A company must keep a copy of every written service agreement (and a written memorandum - i.e. summary of - every service agreement that is not in writing).

## *Employee shareholders*

The idea was to reduce employment rights in return for giving employees shares in the company. Employees may be given shares under other schemes (see below). Introduced by section 31 of the Growth and Infrastructure Act 2013. Various rights are lost:

- right to request flexible working (other than one made within 14 days of return from parental leave)
- right not to be unfairly dismissed
- right to claim a redundancy payment
- right to request to undertake study or training (s63D of the Employment Rights Act 1996)

Also a longer notice period of a return to work from maternity/paternity leave. Can't dismiss someone because they refuse to become an employee shareholder. It is



meant to be voluntary.

Requirements:

- the parties agree
- shares with value of at least £2,000
- written statement of particulars of the status of employee shareholder
- employee advised by a “relevant independent adviser” (see under settlement agreements)
- the employee gives nothing back (eg money) in return except for entering the agreement to become an employee shareholder

Advantages to the employee:

- no income tax or NICs on the first £2,000 of shares
- no capital gains tax on disposal of the shares (up to £50,000)

## **Eligibility to work**

- only employee people eligible to work in the UK
- use statutory eligibility check
- knowledge => prison

Employing someone who is not eligible to work in the UK may be a criminal offence. One way to avoid liability is to make sure you check your employee's relevant documents (e.g. their passport) before you employ them. There is official guidance on this:

- <https://www.gov.uk/check-an-employees-right-to-work-documents> - is a useful summary of what you need to do, along with office contact numbers
- Summary guide for employers on preventing illegal working in the UK 22 page PDF
- Full guide for employers on preventing illegal working in the UK 84 page PDF

## **Contract of employment**

- statement of particulars of employment
- staff handbook
- policies

## Discrimination

- Equality Act 2010
- victimisation
- pregnancy

Example: at an interview an Irish girl wearing green was being interviewed by a panel. One interviewer made notes about each interviewee and gave them memorable labels. About this interviewee she wrote “green leprachaun”. This proved very unfortunate when the notes were disclosed as part of a discrimination claim.

## Working Time

Right		opt-out?
Hours per week	48	yes
Consecutive hours in any 24-hour period	11	
Rest break (working day longer than 6 hours)	20 minutes	
Days off per week	1	
Weeks leave per year	5.6	no

## Employment Rights

- redundancy pay
- right not to be unfairly dismissed

## Employee Share options

Problem. There will almost never be a convenient market for small quantities of a startup’s shares, but they will still be treated as having a taxable value. An employee who is given shares by their employer will have to pay income tax on them but won’t be able to realise the value of their shares at that time (if ever).

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Share Investment Plan (SIP)	£3,600 free shares per year
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	£1,800 “partnership” shares per year
Save as You Earn (SAYE)	£500 / month
Company Share Option Plan (CSOP)	
Enterprise Management Investment Scheme (EMIS)	

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See: <http://www.hmrc.gov.uk/shareschemes/> for reference.

### *EMIS*

An EMIS is likely to be the most interesting to most fast equity startups. It is a share option scheme (rather than a share scheme).

- company has assets of up to £30,000,000
- employees may purchase up to £250,000 shares
- no tax or NI at the time the option is granted
- if the option is exercised within 10 years (and there is no “disqualifying event” before that) the employee will only pay tax or NI on any discount on the shares

### *CSOP*

Works very similarly to EMIS but:

- employees may only buy up to £30,000 worth of shares
- less favourable capital gains tax treatment

### *SIP*

A SIP is a “plan” in which shares may be kept. An employee will have to keep them in the plan for up to 5 years in order to avoid paying any tax or NI. There are four kinds of shares under SIP:

- free shares - up to £3,600 worth of shares for which the employee does not have to pay
- partnership shares - bought by the employee out of their salary before tax and NI are deducted, up to 10% of salary or £1,800 whichever is the smaller sum
- matching shares - up to 2 shares per partnership share bought

- dividend shares - taken instead of dividends on free, partnership and matching shares, up to £1,500 per year.

## *SAYE*

The employee saves money and, after a period of time (3 - 5 years), may use the savings to buy shares.

## **Intellectual Property**

There's a lot of useful information at the OWN-IT site, including a rather colourful glossary of terms.

The Intellectual Property Office has a great deal of information and some useful tools, but it is not always easy to find what you want. Some particularly useful documents can be found on their publications page.

The phrase "intellectual property" does not have a single precise meaning. In fact some people strongly object to the term for that reason.

(perhaps something about non-ownership of ideas etc)

The rights a startup is most likely to be concerned with are:

- copyright
- trademarks
- design rights
- database right
- patents

All these rights are either national or in some cases cover multi-national regions (eg there is a Community Trade Mark that covers the EU). This means that startups operating internationally will have to think carefully about the countries in which they register. Unfortunately since each jurisdiction will charge its own fees, international protection can become very expensive.

## **Registering rights**

Some rights only exist if you register them. This will almost always mean fees (to the registry) and legal or administrative costs. Registerable rights tend to be a little stronger than unregistered rights because, as a rule of thumb, a registered right can

be infringed without unwittingly (you are assumed to have read the registers) whereas an unregistered right may only be infringed deliberately.

Example: if you happen to write a poem that is the same as or very similar to someone else's poem protected by copyright (an unregistered right) but the similarities are accidental and you are not infringing, although you may have to do some work to convince the judge that you didn't in fact copy. On the other hand if you build a product using someone else's patented invention of which you were unaware you do infringe.

Registered	Unregistered
Patents	Copyright <sup>1</sup>
Trademarks	Database right
Registered designs	Unregistered designs
Plant breeders' rights	

## Copyright

### Trademarks

Trademarks are a registered right used to protect particular words or signs that identify a product.

You can search for existing trademarks :

A typical trademark application for the UK might cost ???? and for the EU \*????.

### Patents

Patents protect inventions. To be protected an invention must be:[^patent-euonly]  
[^patent-euonly]: These definitions apply to most European countries (those that are part of the European Patent Convention) but not to others and in particular not to the US which has very similar but different rules.

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<sup>1</sup>In the United States you may register copyright works. You do not have to do so to obtain protection, but if someone infringes a registered work they may have to pay much higher damages to the copyright owner in compensation.

- new (no-one must have published or used it before)
- not obvious: someone “skilled in the art” (that is someone with knowledge of and experience in the particular field of the invention) must not think it is obvious
- capable of industrial application: it must be possible either to use it in industry or to manufacture it industrially
- not excluded

Excluded inventions include:

- scientific and mathematical discoveries, theories and methods
- literary, dramatic, musical or artistic works<sup>2</sup>
- business methods and ways of playing games or performing mental acts
- computer programs *as such* (although in practice computer programs are patented, for example by claiming that a computer running the program is not a computer program *as such*<sup>3</sup>)

Patents are a national right. In other words you would need to apply for a different patent in each country where you wanted to protect your invention. There are various ways to simplify the process. In particular it is possible to apply through the European Patent Office for a set of patents covering multiple European countries simultaneously. Probably in 2015 there will be a single patent available to cover most of the EU.

## Designs

There are actually 4 different kinds of design right in the UK@

	Registered	Unregistered
UK wide	UK Registered Design	Design Right
EU wide	Community Registered Design	Community Design Right

<sup>2</sup>Which would normally be protected by copyright.

<sup>3</sup>If you think this is overly subtle you are right. Exactly what computer programs are or are not patentable is a subject of much debate.

## Confidentiality

The good news is that English law has developed a fairly common-sense law of confidentiality. If:

What this means in practical terms is that

Example NDA's:

- in the IPO's guide to NDA's (towards the end)

## Social enterprises

I don't have time in the talk to discuss options for social enterprises, but there are far more of these:

- Company limited by guarantee
- Company limited by shares
- Industrial & Provident Society
- Charitable Incorporated Organization

### *Community interest companies*

A community interest company (CIC) is a restricted form of limited company (by guarantee or shares) the assets of which (and in some cases the profits of which) have to be retained for the community. A CIC cannot also be a charity.

### *Charities*

A charity is not a corporate structure, it is something a corporation can be. Charities obey very strict rules concerning their objects (the purposes for which the charity may operate) and the use to which their finances are put. Charities themselves will generally not engage in extensive business activities, but there is no reason why they cannot own a subsidiary business entity.

Any of the following may be used for a charity: - Company limited by guarantee - Industrial & Provident Society - Charitable Incorporated Organization

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Corporate form	Regulator	Charitable regulator
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Company limited by guarantee	Companies House	Charity Commission
Industrial & Provident Society	FCA	FCA
Charitable Incorporated Organization	Charity Commission	Charity Commission

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## Company terminology

### *Directors*

Directors run a company from day to day. They are its “controlling mind”. Together the directors are often referred to as *the board*. A company must have at least one director. The company’s constitution will set out how directors are elected  
\_???MODEL ARTICLES HERE???

### *Company Secretary*

Companies used to have to have another officer known as a “company secretary”. This is no longer true, but companies may still have one. A company secretary can be used as one of the two joint signatures of the company instead of a director.

### *Shares*

Each share in a company has a “face value”. For example, a company might be created with 100 shares each with a *nominal value* or *face value* of £1. In later funding rounds shares may be sold for much higher values than their face value, representing (you hope) an increase in the company’s value.

When you create a company you need enough shares to allow you to divide initial ownership between the founders.

Although the face value loses any meaning after a while, it does represent the amount of money the first holder of the share has to pay to the company. If the shareholder has done so the shares are “paid up” otherwise they are not “paid up”. There are technical advantages to having all shares paid up and no reason not to where the sums are really small. A common mistake of founders is not to actually pay in the small number of pounds into a company for their initial shareholding. It



may seem foolish to pay a few pounds in, but as a matter of administration you should do it.