

## Legal documents for running SMEs

### Getting the right constitutional documents

By Alan Zeffertt

**When you are setting up a business, you need to make sure you have the right documentation to start with.**

**Using the simplest standard documents is an attractive option when you want to get things up and running as quickly as possible.**

**But how can you be certain that all issues relating to your particular company are covered? And what if things go wrong after a few years – will your position be secure?**

**The legal documents that will become the foundation of your business must contain everything owners and managers will need to participate effectively in the running of the business.**

#### **Partnership or limited company**

When setting up a partnership, the partners should have a partnership deed drawn up. If they don't, the default code prescribed by the Partnership Act 1890 will govern the running of the partnership and this would not be relevant to most modern partnerships.

The memorandum and articles of association of a limited company may be regarded by many business people as sufficient to regulate the affairs of a company. But they cannot contain all the mechanisms and provisions shareholders need to be actively involved in the company. There are limitations on the enforcement of the articles of association. They cannot be enforced by non-members which causes difficulties for institutional investors who seek additional security for their loans made to companies by imposing controls over the management of the company. There are also legal problems in enforcing the articles between the shareholders and the company. Accordingly, the use of shareholder's agreements has arisen. These are similar to partnership agreements in many respects, but with the important difference that the business will remain sheltered behind the corporate form. The use of a shareholder's agreement enables all the participants in the business to be involved in its management, but without losing the protection of limited liability.

#### **Dispute resolution**

Shareholders' agreements and partnership deeds can and should provide a dispute resolution mechanism, in order to avoid lengthy and expensive court proceedings.

The remedies given to shareholders claiming 'unfair prejudice' by Section 459 of the Companies Act (1985) have become notorious for their complexity - and expense, which in many cases is likely to exceed the amount in dispute. A carefully drafted shareholders' agreement or partnership deed will allow for disputes to be settled and can provide an effective remedy for disgruntled minority shareholders or partners.

#### **Exit route for shareholders and partners**

Many shareholders and partners do not realise that they are not automatically entitled to payment for their share in the company or partnership, on exiting. In the case of *Larvin v Phoenix Office Supplies Ltd* [2002] the Court of Appeal said that there was no automatic right to a 'no-fault divorce' – in other words, a shareholder could not, at will, require the other shareholders to buy his shares at a fair value following the breakdown of the business relationship.

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Accordingly, specific provision needs to be made for an outgoing shareholder to realise his investment. For example, there could be provision that on leaving the company, the exiting shareholder will serve an exit notice requiring the other shareholders to acquire all of his shares within, say, three months. The shares would be bought at the valuation put on them by an expert. This valuation should disregard the fact that the shares form part of a minority holding. In other words, no discount should be applied to take into account the fact that it is a minority shareholding which is being considered.

A shareholder's agreement should cover every situation where major disagreements over company policy arise between the members of a company. Where a deadlock situation has arisen, the agreement could state that one of the parties is deemed to have given notice to transfer his shares to the other member(s), and that his shares will be purchased at a price calculated in accordance with a pre-determined formula or at a price fixed by the auditors of the company.

#### Limited Liability Partnerships (LLPs)

Business owners now have the option of choosing a new type of company, namely a limited liability partnership.

An LLP is a hybrid between a limited company and partnership. To outsiders, it is a legal entity of its own and subject to company law regulation. But to its members it is akin to a partnership, in that the members regulate its management as they agree between themselves, but without the structure of a company memorandum and articles of association, directors and shareholders which a limited company would have.

Members of an LLP can enjoy the protection of limited liability, in the sense that they normally have no direct liability for the obligations of the LLP entity. At the same time, they still benefit from the tax advantages available to ordinary partners of a partnership.

Although LLPs were originally set up with professional firms in mind, over three quarters of registrations have been taken up by the wider business community. This may be because the LLP is a more logical structure for the smaller business, run as a 'quasi-partnership' and which would previously have operated through a private limited company.

The main disadvantage of an LLP, in the view of many smaller business owners, is the requirement to file accounts prepared on a 'true and fair' basis, with those accounts (and other information) then made available to the public.

It is very important to put in place an LLP agreement, along the lines of a partnership agreement, spelling out the rights and obligations of all the members. The management structure and other matters would also be set out in this agreement, which is not registered at Companies House and therefore remains a private document.

In the absence of an LLP agreement, the default provisions provided by the LLP Regulations will apply. The problem here is that those provisions are unlikely to be appropriate for most businesses. For example, the default position in the absence of an LLP agreement is that every member may take part in the management of the LLP, all the members are entitled to share equally in the capital and profits of the LLP, and no member is entitled to remuneration for acting in the business or management of the LLP.

Further, in the absence of an LLP agreement there is no right to expel any member of the LLP, even if that person has committed a serious offence. The only remedy left to the other members would be to wind up the LLP.

A comprehensive LLP agreement would:

- govern the duties and responsibilities of the members
- give the members a right to expel a member in certain circumstances
- provide an exit route for each member
- contain dispute resolution procedures

It is clearly essential for the small business.

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