

Still putting off those founding agreements? Here's how it can cost you

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Our law practice deals with a lot of start-ups - we love working with innovative, entrepreneurial teams of people, but we also, sadly, get to see some start-ups implode because their founders put off doing some of the boring, but critical, foundation work like drafting a careful, appropriate founding agreement (including a memorandum of incorporation and/or shareholders' agreement).

Here's one example scenario: Everyone starts off very excited about their new business and the three founders of a start-up agree to split the shares equally between them. At this point, after all, the shares are worth nothing. Six months later, the company lands its first big contract. With the prospect of actual money on the horizon, suddenly those same shares are valuable and the two partners who've sweated blood for six months don't feel at all happy about sharing the spoils with the third member who has yet to quit his day job. But he still holds one-third of the shares, so he's fully entitled to his third of any dividends.

Here's another example scenario: The two founders of a start-up fall out and one leaves to start a rival company doing very much the same thing, but he refuses to sell his shares in the first company, entitling him to continue enjoying the rights attached to the shares in the original company while competing with the original company.

A lot of pain for everyone

Once you're in a situation like this, there's no way out of it that doesn't involve a lot of pain for everyone, but neither is it particularly unusual; it's all happened before. If either company had spent some time exploring all the scenarios with an experienced lawyer before they signed their founding agreements, they could have anticipated the pitfalls and protected themselves against the worst consequences.

The founding agreements are particularly important in start-ups, because a shareholder can't be passive in a company so small. If you buy shares in a publicly listed company, not much is expected of you. You can attend annual general meetings if you want, but nobody will insist on it; you are perfectly entitled just to sit back and enjoy your dividends.

In a start-up, things don't work like that. If I give you shares in my company, it will be in return for something valuable: either you're providing funding in some way or you're contributing your skills and expertise. We have to thrash out exactly what is expected of everyone before we start - and establish some objective criteria for deciding whether each person's obligations have been met.

Agree the value of each contribution before you start

This is never a comfortable conversation to have; it's like trying to cut a cake that hasn't been baked yet. Once it's ready, of course everyone will believe that they should get a large slice. To avoid conflict, you need to agree the value of each contribution before you start: How much is it worth that I bought all the ingredients? What is the person who mixes it all up entitled to? And what about the person who provides the kitchen, the utensils and the oven? You are guaranteed to have these arguments sooner or later and it's far, far easier and cheaper to choose the "sooner" option.

Taken together, the memorandum of incorporation and the shareholders' agreements are the documents that regulate every aspect of your relationship with the company and your fellow shareholders. In general, there are no basic legal obligations attached to being a shareholder, so whatever you require of each other must be agreed and contracted. It should include what happens if you don't meet your obligations and what happens if you want to sell. What process will you use to value the firm? What will the payment terms be? What happens if there's no cash to pay you out with? These are all important questions to resolve upfront.

Spending time on this kind of thing while you're trying to build a business can feel like a pointless distraction, but if you keep putting it off, it will become an issue at some point. So if you've never quite got around to sorting out that memorandum of incorporation and/or shareholders' agreement - take a deep breath, clear some space in your week and call your lawyer today.

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