CORPORATE MISTAKES YOUR BUSINESS MAY HAVE MADE …AND WHAT YOU SHOULD DO ABOUT THEM

Corporate requirements can be fiddly and, sometimes, unintuitive. It is easy for businesses to trip up on corporate issues. In this series we look 10 of the most common corporate mistakes companies makes, and, more importantly, what they should do about them.

1. BOTCHED BUYBACKS

When does it happen? Normally when an employee shareholder leaves a business and it is agreed that the company (rather than the other shareholders) will buy the shares. The business seeks to "cancel" the shares, but falls foul of the strict rules on buybacks. We very often see a botched buyback where tight budgets meant that good quality legal and accounting advice wasn't taken from start to finish of the process or the buyback of shares is wrapped up in a settlement agreement when someone leaves and the employment law aspects are all covered but the corporate law aspects are ignored or forgotten.

What mistakes can be made? Many!…Buybacks are very heavily regulated and hard to get right without comprehensive advice. Mistakes include:

- Not enough "distributable reserves" to allow a business to buy its own shares out of income
- Correct documentation not being in place (given that it is conceptually a simple transaction there is an unexpectedly long list of documents needed: buyback agreement, shareholders' resolution, board minutes etc. etc. etc.)
- The buyback being on terms which aren't permitted by company law e.g. a company cannot agree to buyback shares and pay for them later (though there is a way you can achieve the same commercial result – see this brilliant article here).
- Stamp duty not being paid and/or Companies House forms not being filed.

Why does it matter? If mistakes are made, then the shares **may still exist**. Even if the buyback was made a long time ago… The shareholder may come knocking for their share of dividends or the sale proceeds on a future sale.

If you ever wished to sell the business, a dodgy buyback will almost certainly come out during pre-sale due diligence which will be a **red flag** to a prospective buyer.

What can you do about it? This really depends on what went wrong (sorry, not the most helpful!). It could be anything from absolutely nothing (as the risk is tolerable), to obtaining new paperwork from the departed shareholder or even going to court. If you're worried about a historic buyback, we would recommending taking advice as soon as possible because:

- If you need anything from the departed shareholder it will be much easier (and cheaper!) to get their signature on documents, if your business has not grown in value.
- If you do need to go to court, then the process can be completed in good time ahead of any sale or corporate re-organisation which may happen in the future.
- Any fines/penalties for any unpaid stamp duty will be reduced.
- The mistake won't get compounded, if you restructure your company in the future based on an incorrect understanding of your shares.

2. EMI ERRORS

When does it happen? EMI options are amazing - when they are implemented properly. They have great tax advantages, and work as a brilliant incentive and reward for your best people with little upfront cost. However, they are notorious for going wrong (even when external advice is taken) as the rules although not complicated are fiddly. In most M&A transactions we advise on with EMI options, there is almost always at least one risk factor associated with the EMI options. At best, this can delay a transaction and increase seller costs – at worst it can kibosh a transaction.

What mistakes are made? Lots – and some of them are surprising. My colleague Kathy has written a brilliant article on this. There may be issues with the ways the EMI options were implemented or there may have been a “disqualifying event” since.

Why does it matter? All the tax advantages of EMI options can be lost to the point where employees may have a significant tax bill on exercise. Often the likely outcome is dreamy tax efficient share options have to be replaced with costly PAYE bonuses.

Key employees may also be extremely disappointed that the equity they have been promised doesn’t live up to expectations. Annoying your best people at the time of a transaction can have a real impact, especially in creative people-focused businesses.

If you wish to sell your business in the future, any prospective buyer will almost certainly insist that sellers bear all risk and cost associated with problematic EMI options.

What can you do about it? If you have any concerns about your EMI options, get a health check of them. The sooner the better. If the options need replacing, then it is much better to do this before your business grows and generally better to do this as far as possible ahead of a potential exercise of those options.

3. MANGLED MERGERS

When does it happen? When two businesses join forces, perhaps with a hope of creating synergies and a “whole” bigger and better than the sum of its parts. In the UK, companies don’t actually “merge” into one entity (subject to very limited exceptions) – typically one company buys the other or a new company buys both of them. The respective businesses and assets are then normally transferred into one entity (in theory leaving one or more empty companies). Often young businesses do these restructures (understandably) on a shoe-string budget.

What mistakes are made? It depends, but for example:

- Formal requirements for transferring certain intellectual property and client contracts are missed – for example for a client contract to be properly “novated” (i.e. fully taken on by a new company) there needs to be a tripartite agreement between the old company, the new company and the client
- Transfers where employees are involved trigger TUPE and the relevant requirements are not complied with Tax implications are also sometimes not properly considered.

Why does it matter? Assets can be in the wrong company if they have not been properly transferred (which is especially problematic if that company has been wound up). This creates additional complexities (and potentially significant cost) when the business needs to demonstrate that it owns the relevant assets – for example in the event of a potential claim or if the business comes to sell.

There can also be unforeseen tax implications which were not dealt with at the time of the “merger”, for example if one shareholder ends up with a piece of the bigger pie worth more than their smaller pie.

What can you do about it? If the “merger” was a long time ago, then the risk can be smaller. However, it is always best to make sure you keep all your records and get legal and tax advice if you have any concerns about how it was implemented. It will always be easier to address any issues when the need is not pressing.

4. ROGUE REGISTERS

When does it happen?

Every UK company must keep statutory registers (sometimes called “company books”). In days past, these would have been in a leather-bound book in a dusty cupboard, but now, more often than not, they are kept in electronic form. Statutory registers include registers of “members”, “directors”, “directors’ residential addresses” and “persons with significant control”. These are entirely separate to the information publicly available on Companies House (unless a company elects for the registers to be kept publicly on Companies House which remains unusual). Despite common practice to the contrary, the registers technically cannot be re-created without going to court.

Many companies simply don’t know they need to have these statutory registers or have bigger priorities. Companies often rely on a “cap table” which, although much more user-friendly, isn’t sufficient and won't comply with the Companies Act requirements.

What mistakes are made? Registers are wrong, incomplete, out-of-date or lost (or a combination).

Why does it matter? Technically, it is an offence not to maintain statutory registers, but it is rarely (if ever) prosecuted. The real issues we see are:

- If someone, with or without merit, questions the company’s shareholding, the company cannot use the statutory registers as evidence.
- On a future sale, a buyer may become nervous about a company’s share history. Being certain that they will be (a) acquiring 100% of the shares and (b) acquiring shares from the people who have the right to sell them will be a

key priority for a buyer. They will likely require additional indemnities etc. which sellers may not be keen to agree to. In an extreme example, a buyer may pull out of a sale if it can't get comfortable or insist that the sellers go to court to get them sorted (which may cause delays / be expensive).

What can you do about it? Try to dig out your registers. If there are issues, consider (with advice) what the appropriate action is. If there are uncertainties around shareholdings, in some circumstances, it may be appropriate to go to court, but legal advice should be sought first.

5. OVER GENEROUS FOUNDERS GIVING AWAY TOO MANY SHARES

When does it happen? Founders (or even investors) wish to incentivise management, but simply give too many shares away. This can create real problems with founders or investors losing control of a business and being unable to afford to get those shares back when employees leave.

What mistakes are made? There are many great ways to incentivise management using shares and options. However, if you don't have the right protections in place, with a cap table (backed up with well-thought-through articles of association and a shareholders' agreement) that works for the business, you can end up in a real pickle.

Why does it matter? You may lose control of the business! The level of control you lose will depend on how much equity you give away. You may also end up with ex-employees holdings shares you would like to use to incentivise new hires, and potentially "unfair" distributions of proceeds on an eventual exit or for dividends.

What can you do about it? The earlier you act, the more you will be able to do. It is always best to plan how much equity you want to give away and to who. Possibilities include:

- Using tax-efficient EMI options (where available) instead of actually issuing shares upfront. These can be only exercisable on an exit or if performance criteria are met (so that the employees have a "stake" in the business but no actual control).
- Consider issuing shares which don't have voting rights
- Updating your articles / shareholders' agreement (where possible):
  - to entrench your overall control of your business
  - to ensure that you can easily purchase ex-employees shares if they leave the business (and think carefully about what a appropriate price ought to be).

6. (LIABILITY-LOADED) LOANS TO EMPLOYEES

When does it happen? A business seeks to help out an employee or director by giving them a loan, unaware that loans are heavily regulated by law. It may be that they wish to help with some urgent home improvements or assist them to pay for shares as part of an employee share scheme.

What mistakes are made? Proper legal or tax advice isn't taken, and the loans fall foul of the (sometimes unexpected) legal requirements and/or the appropriate tax isn't paid.

Why does it matter? The loans may be unenforceable**,** and your business may be in breach of the Financial Services and Markets Act 2000 and/or Consumer Credit legislation with (at least in theory) criminal consequences for your business and its directors. Your business and the employee may also end up with an unexpected tax bill.

What can you do about it? Take good advice (ideally before the loans are made). Certain loans are permitted, you just need to ensure that you jump through the necessary legal hoops! Businesses should also take proper tax advice to ensure they are making the loans with eyes wide open!

7. FLAWED FILINGS

When does it happen? Companies House filings are managed on an ad hoc basis by external accountants or employees for whom the filings aren't a priority.

What mistakes are made? Filings are incorrect or missing.

Why does it matter? It is an offence for certain filings not to be made, though in practice mistakes are rarely (if ever) prosecuted. The practical issues are:

- Confusion! Decisions are (rightly or wrongly) very often based on Companies House filings. If these aren't right, then further mistakes will follow. For example, shareholder resolutions may not be validly passed because they haven't been sent to an up-to-date list of shareholders – this could result in a whole manner of issues, such as shares not being validly issued.
- Investors or other shareholders will be concerned if publicly-available shareholding information is incorrect or missing. It will also make disputes with shareholders much more likely, especially in conjunction with other errors.
- Companies House filings are a first port of call for clients/suppliers and banks to understand your business (e.g. who the directors are, who owns the business etc.). It may make opening bank accounts etc. and getting new clients/suppliers more difficult.
- If you seek to sell your business in the future, potential buyers will review your filings with a fine toothcomb. The

buyer will want certainty on the fundamental facts about your business (who owns the shares, who the directors are etc.), and Companies House filing mistakes may act as red flags and hinder a sale process.

What can you do about it? Review filings now before problems arise. This means that mistakes can be rectified promptly (where possible) and not compounded by further errors being made as a result.

8. SUB-VALUE SHARES

When does it happen? Where a business wants to incentivise employees by giving them shares or promising to give them shares in the future, but hasn't considered the tax consequences.

What mistakes are made? UK employees are given or promised shares at less than their market value without proper tax advice, which unexpectedly gives rise to income tax (and potentially employer national insurance and other employer tax liabilities). Common scenarios we see are:

- Employees being "promised" shares (or more shares) for a certain price in principle, but the paperwork not being put in place. In the meantime, the business grows in value or a buyer is identified, significantly increasing the market value of those shares (and therefore the tax consequences of the employees being given those shares).
- Shareholdings needing to be rebalanced to put shares in the hands of up-and-coming star employees. This is done with a rough and ready transfer of shares or issue of new shares.

Why does it matter? Employees may be faced with an unexpected tax bill, and also employer national insurance and other employer tax liabilities may potentially arise.

What can you do about it? It really depends. You may be able to terminate problematic arrangements, and implement a proper tax efficient employee share plan. However, it is almost **always** better to deal with unwanted liabilities as soon as possible.

9. ROGUE RECORDS

When does it happen? Usually where a business is a bit older; perhaps because the current management have not always been around and previous directors/shareholders have moved on.

What mistakes are made? Key corporate records are missing (or even never existed!). This can particularly be an issue if there has been a significant re-organisation in the past where current management were not involved. Significant re-organisations may include:

- A new limited company being set up and contracts and other assets transferred to it
- Shares being bought back from a former exec
- A new holding company being put in place

Why does it matter? If there is ever a claim from a third party that they own (or have a right to own) any shares in your company or any of your business' assets, then you may be poorly placed to defend that claim.

You may also be in breach of the record-keeping requirements under the Companies Act 2006 which may mean that your business and/or its directors are committing a criminal offence.

If you come to sell your business, the buyer will want absolute certainty as to what it is buying – the buyer will either want **you** to be legally responsible for any issues historically (e.g. by way of indemnities and warranties) which may seem unfair especially if you were not around when the restructure took place or, worse, **refuse to do the deal** altogether. Poor record-keeping can also be a "red flag" to a potential purchaser as to how well you run your business. Deals may also be delayed as you locate the documents or if you need to take other remedial steps.

What can you do about it? Act now. Locating records can take time, and it is best to do this without the pressure of a claim or a possible exit. Restorative steps are often much easier (and even more tax efficient) in this context. Taking action now will also paint you in a good light if you come to sell your business in the future.

10. BUSINESS ASSETS NOT ACTUALLY OWNED BY THE BUSINESS

When does it happen? Often when a business is in "start up" mode, it wants to get admin done quickly, so founders can focus on client work and pitching. Corners are cut and the budget for legal advice is limited or non-existent.

What mistakes are made? It is easier than you think for your business's assets to legally be in the wrong name. We see this in the following scenarios:

- Creatives are engaged as freelancers (rather than employees), but don't have proper IP assignments in their contracts. This may mean that freelancers or consultants could have an argument that they own the work they have created for you which could be your logo, website or proprietary software – which is not ideal, especially if they have moved on!

- To get things done quickly, employees/directors put business assets in their own name. This could be IT equipment, domain names or even contracts! This can be particularly messy if those employees/directors leave your business
- Founders buy equipment / enter into client contracts in the name of a limited company before it has been legally incorporated. The legal effect is that the business doesn't own them.
- Businesses strike off subsidiaries they aren't using, but those subsidiaries held assets that were not properly assigned to the trading company. The effect: those assets are technically owned by the Crown!

Why does it matter? If you don't own your assets you can't enforce your rights! For example, if a client didn't pay a bill under a contract that wasn't in your name, then it would be difficult for you to take action to enforce that bill.

The individual or company that does own the assets may seek payment for using their assets or even stop you from doing so.

If you wish to sell your business in the future, then the prospective buyer is likely to want all key assets transferred back into your business before signing on the dotted line. At the very least, they are likely to want you to be liable for any issues that arise.

You client contracts will often transfer to the client IP created for them once the client has paid the invoice – if that IP has been created using freelancers with inadequate contracts you may be in the awkward place of having sold IP to a client which you don't own.

What can you do about it? Get your assets back into the name of your company. The quicker you act the better. The precise steps will depend on the circumstances, but may include seeking IP assignments from freelancers who have created key IP and/or restoring old subsidiaries back into existence (which is messy, but possible!).

For more information on any of the topics raised in this article, please contact:

Joe Lythgoe
Senior Associate

+44 (0)20 7074 8290
joe.lythgoe@lewissilkin.com

Find out more

twitter.com/lewissilkin

linkedin.com/company/lewis-silkin

lewissilkin.com