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supercharging your start-up

The importance of good foundations

Imagine you, and three friends, have discovered a unicorn of an idea. An idea so big that it will disrupt, and change, the market. You don't have time to waste on papering your arrangement so, together, you form your company online, split up the shares between you and get to grips with starting out in your new venture.

The idea starts to come together and you are making great progress towards your first investment round when… one of your co-founders departs and heads off to set up a business with a very similar offering to the one you have developed, in more or less the same market and, for the kicker, your first (and key) team member is going to resign and join them.

A little time taken at the outset to put in place a founders' agreement could have future proofed the company, and the founders, against the risks that this situation presents. The old phrase 'it's all good until its not' couldn't be more apt. In this article we will cover the main questions we are asked when discussing founders' agreements with entrepreneurs.

So, what is a founders' agreement?

A founders' agreement is typically entered into by founders when a company is formed, and generally lasts until the company receives its first real equity funding, when it will be replaced by a more fulsome investment (or shareholders') agreement. A typical founders' agreement will not only deal with the day-to-day operation and management of the company (including allocation of roles and responsibilities), but also helps protect the value of the business for eventualities such as those above.

How does the company get the benefit of the idea we formed before the company existed?

A well drafted founders' agreement will ensure that founders transfer to the company any rights (including intellectual property rights) they may have in respect of the idea or the business itself. The last thing the company, the founders or an investor down the line will want to uncover is that critical rights have been left outside of the company and sitting with a founder. Such a situation has the potential to derail the entire business… an unwelcome outcome for years of hard work as a founder.

How will the company be managed?

Typically, founders will be both shareholders and directors of the new company. A founders' agreement usually sets out who will be appointed as directors and how matters arising at board meetings will be decided. It is crucial to strike the right balance on decision making. It is important to protect the interests of the founders, but it is equally important to ensure the company remains 'fleet of foot' in order to take advantage of market opportunities.

So, what will happen to the shares of a founder who leaves the company?

It is not generally in the interests of the remaining founders for a departing founder to continue to hold shares – the remaining founders won't want to share the value growth that their hard work could generate with the departing founder. Nor is it generally in the interest of the company for a potentially offside departing founder to have a say in decision making through retaining shares. A founders' agreement will usually contain leaver provisions allowing for the shares held by the departing founder to be acquired for a specified price, which will generally depend on whether the departing founder is deemed to be a good or bad leaver. Leaver provisions give all parties a clean break if a founder wishes to leave and, depending on the terms of the agreement, the shares could be recycled to a new employee joining the company and therefore act as an incentive for new staff.

Should founders be 'locked-in' to the company?

Founders do often agree to be 'locked-in' to the company for a period of time before they can transfer their shares. The rationale behind this is that the founders will be incentivised, by continuing to hold shares in the company, to work together to ensure that the business is a success. This is usually viewed positively by potential investors too. There will however be a degree of flexibility in relation to any lock-in arrangements – for example, a founder can usually transfer some shares to another family member (this is known as a permitted transfer) or the other founders could consent to a transfer of shares during this time.

What if a founder wants to dispose of shares without leaving the company?

If a founder is not leaving the business but wants to sell shares in the company then usually the remaining founders will want to have the first opportunity to buy those shares before they are offered to a third party. This is usually referred to as a 'pre-emption right' or a 'right of first refusal'. Often, the remaining founders can only buy the shares in proportion to their existing shareholdings to prevent one founder acquiring a significantly larger proportion of shares in the company following the share transfers.

Will a departing founder be prevented from competing with the company?

A founders' agreement will usually, in the UK, contain restrictive covenants which, as the name suggests, restrict the ability of a founder who has left the company from starting a business in competition with the company, or from targeting the same customers or market, for an agreed period of time. Typically, the restrictive covenants will also prevent a founder from offering employment to existing employees of the company (again, for an agreed period of time). It is important that the restrictive covenants go no further than is necessary to protect the legitimate interests of the company. Stray too far from that and they could be held to be unenforceable; framed correctly, they protect the value of the business.

How can I put a founders' agreement in place?

Speak to us. While it is true that a suitable founders' agreement will be invaluable if things do not go to plan, it is not the case that a founders' agreement is simply an insurance against worst-case scenarios. Instead, a founders' agreement will help you to grow your business, knowing that there is an agreement underpinning the routine day to day operation of the business. It is inevitable that situations evolve over time. Perhaps a founder may need to transfer their shares, or a significant decision will need to be made in relation to the business. In these instances, a founders' agreement will ensure that there is an agreed method of handling those matters, and how to proceed if they cannot be resolved. It also gives parties peace of mind that the business has the right foundations to allow for investment.

Shepherd and Wedderburn's corporate team combines industry knowledge and extensive experience with technical expertise, and is on hand to assist businesses at all stages of their growth journey. The team's Start to Scale initiative, comprising written guides, video content and in-person events, addresses some of the specific challenges affecting start-ups and scale-ups throughout their lifecycle to give entrepreneurs the insight they need to scale. Visit shepwedd.com/start-to-scale for more information, or contact John Morrison, Partner in Shepherd and Wedderburn's corporate team, at john.morrison@shepwedd.com.