**Farore Law Mini Guide for start-up founders**

We at Farore Law have represented a tech start-up in a shareholders’ dispute at the Business and Property Court, arising out of a falling out between Founders after the start-up had been incorporated and received substantial venture capital funding. Shareholders’ disputes between Founders may prove highly disruptive for the business and costly.

The purpose of this mini-guide is to set out ways to protect a start-up from Founder disputes at the moment of incorporation. This mini-guide also highlights potential risks arising from a departing Founder.

**Please note that this guide should not be construed as legal advice. If you are a start-up and you need guidance on preventing founder disputes or advice in defending a founder dispute, please contact us separately for specialist legal advice and representation.**

**Should the Articles of Association be based on the Model Articles?**

When you incorporate a company, you may adopt the Articles of Association based off the Model Articles or deviate from it.

Although the Model Articles is often fit for purpose for many private limited companies, start-up Founders should consider tailoring the articles to ensure that it is fit for purpose for a Founder-led company.

By way of example, sometimes founders have disagreements which results in one or more Founders leaving a start-up. In such circumstances, it would be fundamentally unfair if a departing Founder is allowed to keep his/her shares particularly where the start-up is at an early stage. After all, why should the Founder be allowed to benefit from the Company’s growth if he/she no longer provides services to the Company as an employee?

To avoid this from occurring, we regularly see start-ups adopting a vesting schedule in their articles of association whereby shares become gradually vested over a specified period time (e.g., 3 years).

In our experience, we have also seen Articles of Associations with provisions requiring shareholders to be Service Providers of the Company in order to ensure their shares become vested. This in essence imposes a requirement whereby the Founders must remain employed by the Company to ensure that their shares become fully vested.

By way of example, we’ve seen an Articles of Association with the following vesting provision:

|  |  |
| --- | --- |
| Date of departure as a Service Provider | % vested |
| Within 12 months of the Relevant Date (as defined in the Articles) | 0 |
| 12 months after the Relevant Date | 25 |
| Each quarter beginning on the first anniversary of the Relevant Date and until all such founder Shares are vested in full | Remaining 75% vested in equal instalments of 6.25% on a quarterly basis |

This is often coupled with Good Leaver/Bad Leaver provisions, where the manner in which the Company treats the departing Founder’s shares will depend on the circumstances of his/her departure.

By way of example, if a Founder leaves the Company as a Good Leaver and his/her shares are not fully vested, the Company may (depending on the provisions of the Articles) agree to buy the Founder’s shares on a fair market valuation. Whereas certain under certain circumstances, a Bad Leaver may be required to sell his/her shares at a nominal value.

Examples of a departing Founder becoming a Good Leaver includes where the Founder leaves the Company due to ill-health, disability or retirement.

**Why should we have a shareholders’ agreement?**

A shareholders’ agreement is vital in a start-up, as it is meant to regulate the affairs amongst shareholders. By way of example, the agreement can be used to agree the composition of the board structure, management arrangements and how shareholders exercise their voting rights in the Company.

If properly drafted, the shareholders’ agreement can ensure that the Founders’ interests are protected and not undermined by investors. We often see situations where Founders have to dilute their shareholdings in order to attract investments and a shareholders’ agreement, if properly drafted, can protect the interests of minority shareholders.

Many shareholders’ agreements also contain restrictive covenants to ensure that a shareholder does not act in a way which undermines the interests of the Company, such as by soliciting clients to a competitor within a specified time frame upon departure. Unlike restrictive covenants in a contract of employment, courts are generally more liberal in upholding restrictive covenants in a shareholders’ agreement, particularly where the shareholder subject to the restrictive covenant is given a substantial amount of shareholding.

**Should the Founders be given a contract of employment? If so, what provisions should be set out in the contract of employment?**

As set out above, some start-up’s Articles of Association imposes a requirement in their vesting provisions that shares only become vested so long as the Founder remains a Service Provider in the Company. In these circumstances, it is appropriate to provide the Founder-Director with a contract of employment that sets out the duties and responsibilities of the Founder as a Director of the Company.

Our experience is that some start-ups contain provisions whereby a Founder is required to resign from his/her position as a statutory director upon termination of their employment. In circumstances where the Founder refuses to voluntarily resign, the Company may have (depending on the terms of the contract of employment) power of attorney to procure the Founder’s resignation upon dismissal. Such terms are essential to ensure that the Founder’s status as a statutory director is conditional on remaining an employee of the Company. This also enables a Founder to cease his/her statutory directorship without the Company having to call a General Meeting to vote the Founder out of the Board of Directors (as is ordinarily the case under the Model Articles).

Typically, the contract of employment will not contain any contractual disciplinary procedures in place to ensure that the Company is able to summarily dismiss a Founder with greater flexibility. If a contract of employment does provide for a contractual disciplinary procedure, failure to adhere to such procedure may result in the Company being liable for wrongful dismissal.

**What risks might arise when a Founder is dismissed?**

The unfortunate reality is that when there is a falling out among Founders, litigation becomes a real possibility.

*Employment claims*

If the Founder has less than two years’ employment and the contract of employment does not contain any contractual disciplinary procedures, the Company is able to summarily dismiss the Founder. However, if the dismissal is improperly handled, this may give rise to a discrimination or whistleblowing claim depending on the circumstances.

*Contractual claims*

There is also the risk of becoming subject to High Court action where it is alleged that the Founder’s departure was in breach of the contract of employment, shareholders’ agreement or the Articles of Association. For example, the Founder may disagree with becoming labelled a “Bad Leaver” and may bring a breach of contract and/or declaratory claim in the High Court as a result of this.

Some Good Leaver/Bad Leaver provisions may give the Company the discretion to label a Founder a “Good Leaver” notwithstanding the nature of the Founder’s departure. Although such provisions are ordinarily drafted to confer broad discretion on the Company, the Company nonetheless owes a duty not to exercise its discretion in an irrational or capricious manner. Failure to adhere to such duty may give rise to a breach of contract claim.

*Unfair prejudice*

Given that Founder/Directors are almost invariably shareholders of the start-up, there is also the risk that the start-up may become subject to an unfair prejudice petition. An unfair prejudice petition may be sought by a shareholder where the affairs of the company are being, or have been, conducted in a manner that is unfairly prejudicial to his/her interests as a shareholder. The most common remedy sought is for the shares of the petitioner to be bought by other members of the Company.

Unfair prejudice petitions can be made where the shareholder can demonstrate that he/she had any interest other than to have the company’s affairs conducted in accordance with the Articles of Association or any other written agreement governing the terms of membership (such as a Shareholders’ Agreement). With unfair prejudice petitions, the court is able to give effect to informal agreements and understandings which have been relied upon. Such informal agreements/understandings need not have binding legal force.

An Articles of Association or Shareholders’ Agreement, if carefully drafted, may protect a Company from an unfair prejudice petition. By way of example, courts have in the past struck-out unfair prejudice petitions based on alleged exclusion from management where provisions of the Articles provided the other members with an option to buy the shares of the petitioning member at a value to be determined by the Company’s auditors on their ceasing to be a director or employee of the Company.

*Just and equitable winding-up*

In exceptional circumstances, a Founder may attempt to wind-up the Company on just and equitable grounds, such as where a breakdown in trust and confidence amongst Founders result in the shareholders being unable to cooperate and the Company experiencing a deadlock at board or shareholder level.

It should be noted that winding up on the just and equitable ground is a remedy of last resort and is the exception, not the norm in shareholder disputes. For example, the court will generally decline a winding-up order if the petitioner is entitled to other relief (such as by bringing an unfair prejudice petition).

At any event, as set out above, a start-up with a properly drafted Articles of Association and Shareholders’ Agreement should be well placed to prevent a management deadlock in circumstances where there is a falling out between Founders.

**Farore Law is a boutique employment litigation firm with extensive experience in advising and representing senior executives, Founders and start-ups in employment/founder disputes and restrictive covenants. Our lawyers are well placed in representing clients in complex, high-value litigation in the Employment Tribunals and the civil courts. Our background as litigators also makes us well placed to represent clients in mediations and secure favourable settlements. If you are a start-up or a Founder requiring advice and representation in a shareholders’ dispute, please contact us at** [**info@farorelaw.co.uk**](mailto:info@farorelaw.co.uk)**.**