**Starting and growing a venture at a time of economic crisis – practical legal and policy considerations**

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Recession and subsequent recovery present great entrepreneurial opportunities for those

intending to start and grow their business. However, despite numerous initiatives by the UK

government offering substantial financial and technical supports, aspiring and entrepreneurial

individuals continue to be put off by myths and shocking tales of business failures during such difficult times. This article re-examines some of the myths surrounding the development of a business venture under the current economic climate, and shows that many of these are in stark contrast to the facilitating legal and commercial realities. Having said that, this brief overview is not intended to replace formal legal and taxation advice, but to provide an overview of the relevant rules to the entrepreneurs.

**Myth 1 – It is expensive and time-consuming to start a business**

**Reality – Starting a business can be inexpensive and hassle-free**

Aspiring entrepreneurs can start a business in the form of sole trader or general

partnership where applicable, if they want to start trading immediately

without going through any formality. The former refers to a self-employed

person running his or her own business, whilst the latter can be formed when

two persons or more came together to ‘carry on a business in common with a

view of profit’ (s.1(1), Partnership Act 1890) even without any written

agreement. Whilst forming a limited liability partnership (LLP) or Public

Limited Company (PLC) would require registration with Companies House,

the processes are quite straightforward with Companies House’s easy-tofollow

guidance. Entrepreneurs can incorporate an LLP for a fee of £13 or a

company for a fee of £15 electronically within 24 hours; or for a fee of £40

within five to ten working days if the incorporation was filed by paper form

(Companies House, 2013a; 2013b). For those who do not want the hassle,

there are formation agencies that can set up an ‘off-the-shelf ’ company or an

LLP within 24 hours for an all-inclusive fee of around £50 (Orangefield-Waterlow, 2014). A same-day incorporation service is also available at both

Companies House and the formation agencies for a further fee. There is also

no minimum capital requirement for setting up private limited companies in

England and Wales. It is therefore possible to set up a company with a share

capital as little as a penny.

If the business becomes successful, the shareholders can choose to change it

into a PLC (with a share capital of at least e50,000 or equivalent) by initial

public offering (also known as ‘public floatation’), along with the other exit

options such as trade sale (when the share capital of the company was sold to a

third party trade purchaser in entirety) or buyout (an acquisition of a target

company or business by a management team that is assembled by either

members of the existing team or one for the purpose).

The caveat is of course that there is no one-size-fits-all solution. In order to

make the right decision, one should weigh up the advantages and disadvantages

of trading in the specific forms of business by taking into consideration

various factors such as the ease of formation and dissolution of business,

statutory duties in relation to the particular form of business, right to manage,

tax and liability issues. Entrepreneurs who want to draw up specific agreement(

s) for the partnership or LLP, or want to have a bespoke set of the

constitutional documents such as the memorandum of association and

articles of association for their businesses should always consult legal or

company secretarial professionals which will mean additional costs and time.

**Myth 2 – I will incur a massive personal debt if my business fails**

**Reality – Yes or no, depending on which form of business you have set up**

It is true that you will be personally subject to the unlimited liability that may

be incurred by the business during the ordinary operation of the business if the

business is in the form of sole trader or general partnership. That means if the

business lost e.g. £10million, you and your partners will need to pay off the

debts personally or go bankrupt.

However, if you set up the business in the form of a limited company, since

the law considers the company as a separate legal person, the shareholders’

(also known as members’) personal liability to the debts incurred by the

company will be limited to the amount that they invested into the company or

the amount that they promised to pay to the company in return of the shares

that they subscribed to (Salomon v Salomon& Co. 1897 AC 22). It means that

if, as in the previous example, the business lost £10million, but you have only

put in or promised to put in £1,000 to the business, then your loss is only

£1,000.

**Myth 3 – When a business terminates, it always ends in tears, particularly when you have co-owned the business with someone else**

**Reality – Not if you plan ahead**

The common myth is that if you have a co-owner of the business, disputes

inevitably arise as to whether and how the business should be ended and who

would get what after the business was terminated.

The reality is that all these potential disputes can be avoided if you have

planned ahead at the outset. For a joint venture business, financial assets can

easily be split according to the shares of capital contribution. For innovative

businesses, however, where the present and future values of the intellectual

properties are hard to calculate, great difficulty may be encountered when

division is required. Nevertheless, the ownership and licencing arrangement

in regard to intellectual property rights existed before the joint venture

business and those developed during the course of the joint venture can all

be agreed upfront, which would help to reduce the risk of dispute at exit.

Moreover, since it is common to commercialise new technologies that the

business developed, it is essential for the various parties to agree upon a profit

sharing mechanism in the joint venture agreement from the outset.

When capital is raised through equity finance, legal documentation such as

an investment agreement will be drawn up between the investors and the

company (including the shareholders, who are usually the entrepreneurs

starting the business) if you want to avoid disputes and tears at the end.Awellthought-

out exit strategy to include potential routes of exit such as a trade sale,

initial public offering or buyout and related arrangements, amongst others,

should be agreed and documented from the outset so as to avoid the potential

risk of future disagreements: a successful exit relies on the supportive

management team of the company (Lewis *et al.*, 2013; Sanders, 2014).

Typically, the terms that should be agreed by the parties are usually contained

in the company’s articles of association and the investment agreement.

In order to maximise the value of the business, investment agreement and

the articles of association of the company often contain restrictions on the

transfer of shares by shareholders (Lewis *et al.*, 2013) so as to ensure that all

shareholders stand together and exit together by delivering the share capital of

the company in its entirety to the acquirer, rather than a partial stake. These

are typically clauses regarding the pre-emption rights on share transfer, drag

along rights, tag along rights (also called a ‘co-sale’), leaver provisions and

prohibition on the management’s sale of shares without the investor’s

consent. Investors with stronger bargaining power are also likely to insist

on the inclusion of a priority return clause.

The inclusion of such clauses has become standard practice and they serve

as providing a framework for an exit transaction, to ensure that the investor’s

expectations and requirements are well known and documented. Whilst final

exit terms will be negotiated when an exit transaction is actually under

consideration, the inclusion of these clauses at the outset will provide

negotiating leverage for investors, entrepreneurs and acquirers, and be more satisfactory for all concerned (PLC, 2013).

**Myth 4 – Financial support from the government dried up after the recession**

**Reality – Depending on whether you know where to look**

Contrary to common belief that the government’s finance has dried up, both

the public and private sectors actually offer many incentives to entrepreneurs.

The caveat is that funders now often demand that borrowers fulfil specific and

niche concerns, and that the generic emphasis of local and regional development

is no longer deemed sufficient. This would mean that a start-up or a

venture would have to meet stringent criteria in order to qualify. For instance,

in the case of a clean tech industry such as those specialising in recycling,

sustainable energy and green transportation, there are numerous loans and

other financial initiatives for businesses seeking to reduce their energy

consumption, most notably the Energy Efficiency Financing Scheme offered

by the Carbon Trust. In addition, the government also offers various tax

incentives to the investors of the small and medium enterprises (SMEs) which

are further explored in our discussion of Myth 7.

**Myth 5 – To qualify as a ‘green’ company requires compliance with complicated environmental reporting**

**Reality – Not if your business is a ‘small’ company**

The statutory environmental reporting obligation applies to companies other

than those eligible for the small companies’ regime for accounts and requires

them to prepare a strategic report for each financial year of the company,

containing a fair review of the company’s business and a description of the

principal risks and uncertainties facing the company (Sections 414A-414D,

CA2006). So if your company is a ‘small’ company as defined by the

Companies Act 2006 (Section 382(3), CA2006), i.e. one that fulfils two of

the three following criteria: with turnover under £5.6 million, balance sheet

total of under £2.8 million, and less than 50 employees, you are not required to

conduct environmental reporting. Nevertheless, the business may still consider

conducting voluntary environmental reporting to help boost its public

profile by demonstrating its commitment to corporate social responsibility

and ‘green’ credentials, and thus potentially attract more investors and clients,

recruit and retain high calibre employees and grow the business. In addition,

since lenders are increasingly becoming more cautious regarding the risk of

environmental liabilities that they may face (including criminal liability, being

required to carry out clean-up or to comply with an enforcement notice, and

civil liability of nuisance or negligence), there is a growing trend of lenders

having environmental policies and credit approval procedures in place to

conduct environmental due diligence and environmental assessments over

borrowers’ activities preceding any investment or financing (PLC, 2014).

Therefore, having a voluntary environmental report in place may also help in

acquiring a bank loan.

**Myth 6 – Business taxes are very expensive**

**Reality – Not necessarily**

A business only pays tax if it has made a profit. Moreover, the rates of tax vary

depending on the form of business that you set up. Sole trader, partners and

LLP members are all treated as self-employed individuals for tax purposes and

their share of the net profits of the business are subjected to the same tax rate as

those in employment. The tax rate to the company is fairly favourable.

Currently, the corporation tax rate for the ‘small profits’ (less than

£300,000) of a company is 20%; profits over £1.5 million are taxed at the

main rate of 23%; profits between these lower limit and upper limit are taxed

from 20% to 23% on a sliding scale with the application of the marginal relief.

From 1st April 2015 onwards, there will be a unified corporation tax rate of

20% for all non-ring fence profits (HMRC, 2014a). Moreover, the government has offered a number of tax incentives to the owners/investors of the

company which make the tax position of a qualifying company very favourable.

This will be explained further below in Myth 7.

One caveat is that entrepreneurs, as shareholders of the business, will also

need to pay personal income tax on the dividends distributed to them.

**Myth 7 – It is hard to attract investors in a climate of uncertainty**

**Reality – There are various tax incentives on offer to investors**

It is true that when a business is started, it is not as easy to get investors as when

the business has been established for a few years. The UK government has

offered various tax incentives to investors who have not owned substantial

interest (i.e. more than 30% of the company’s issued share capital, or of its

voting rights, or of the rights to its assets in a winding up) in the company at

any time from the incorporation date to ‘the third anniversary of the date of

issue of the shares’ (HMRC, 2014b). Therefore, the entrepreneurs can still get

someone to invest in the start-up period so long as the interests that the

investor(s) hold are not the ‘substantial interest’, then after the three year

moratorium, the same investor(s) can invest more substantially in the

company and still qualify for the tax incentive.

Incentives currently offered to the investors of the small and medium

enterprises include the smaller seed (i.e. start-up) enterprises are through the

Seed Enterprise Investment Scheme (SEIS), Enterprise Investment Scheme

(EIS), Venture Capital Trust Scheme, Share Loss Relief and Corporate

Venturing Scheme (CVS). Nevertheless, entrepreneurs will need to maintain

this attractiveness by keeping the conditions required under the schemes

fulfilled.

**Myth 8 – It is easy to be dragged through the mud in the current socio-economic climate**

**Reality – True, which is why you need to have safety nets in place**

A business often deals with its suppliers and their customers during the

operation. Even if a business interruption event – such as strikes, acts of God,

war, fire and flood – did not happen to the business itself, if an event affects a

counterparty, such as a supplier, thereby preventing the latter from performing

its contractual obligations, this may have a domino effect on the business’s

ability to fulfil its underlying contractual duties with a third party. A logical

thought would be to sue the supplier for breach of contract. Nevertheless, the

supplier may be able to argue that the contract was frustrated (J Lauritzen AS

v. Wijsmuller BV [1990] Lloyd’s Rep1): the occurrence of such event(s) are

outside its control and rendered it physically or commercially unable to fulfill

the contract, or the obligation to perform the contract was rendered radically

different from what the parties originally agreed to. Since the courts haveadopted a very narrow approach in applying the doctrine of frustration so that

mere inconvenience, hardship, financial loss involved in performing the

contract, for example, is insufficient to amount to frustration (Blue Sky

One Ltd v. Mahan Air [2010] EWHC 631(Comm)), it is a common practice

for commercial contracts to contain force majeure provisions. The force

majeure clause is a contractual creation based on the outcome of the

contracting parties’ negotiation, and functions in a broader sense to excuse

the party/parties from performing the contractual obligation, or to allow the

contract to be terminated following the occurrence of certain defined force

majeure events that were beyond the reasonable control of the affected party).

Therefore, having failed the argument of frustration, the supplier may still be

able to argue that it was excused by the force majeure clauses in the contract

and therefore was not liable to perform the contractual obligations which

would result in the business’ loss. In such cases, businesses are indeed likely to

find themselves in hot water.

To counter this risk, it is advisable for entrepreneurs to plan from the outset

the setting up of a business continuity plan as well as securing appropriate

insurance cover so as to minimise loss in the event of interruption to its own

business and even to a counterparty’s business. Entrepreneurs should consider

taking out business interruption cover, contingency cover or events insurance

cover as an add-on cover to the business’s main insurance programmes such as

those covered for property or all-risks (Padgham *et al.*, 2012). Once in place,

they can cover the business’ loss of incomes if directly caused by physical

damage to the insured property, as well as losses caused by business interruption

events or events being cancelled, postponed or interrupted due to

business interruption events even if there is no physical damage to the business

property. Entrepreneurs should also have disaster recovery procedures in

place, such as archiving vital business records off-site (Padgham *et al.*, 2012),

in order to cope with business interruptions events. As a matter of fact,

insurers often require businesses to have a business continuity plan in place

before they accept an insurance application. Entrepreneurs should also

periodically review the policy wording under the insurance cover to ensure

that the cover is still applicable or provides the optimum protection in the

changing economic conditions (Watts and Le Grys, 2009).

A business should also incorporate the appropriate business continuity

support they require from suppliers in its supply contracts, in which

case, events or the consequences of events which could have been prevented by

the suppliers’ proper implementation of their business continuity support,

will generally not be deemed as force majeure and will allow the business to

exercise its rights against the suppliers. Entrepreneurs should note that it

would be logical for the suppliers to ask for a reciprocal commitment, so it is

advisable to make reasonable requests rather than trying to impose onerous

commitments on counterparties (Padgham *et al.*, 2012).

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