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**Clive Rich**

Lawyer and owner of LawBite





# *Law for Small Business*

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**by Clive Rich**

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**Law for Small Business For Dummies®**

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# Introduction



**S**mall companies are often described as the engine room of the country's economy. The UK has over five million of them. They represent over 99 per cent of all companies in the UK, employ two-thirds of its workforce and deliver almost half its revenues. Yet they often find affordable, understandable legal advice hard to find. That's one of the reasons for all the anti-lawyer jokes:

'What do you get when you cross a lawyer with the Godfather?'

'An offer you can't understand'.

'How do you get a group of lawyers to smile for the camera?'

'Get them to say "Fees"'.

But I'm being unfair. Many people feel that there's no such thing as an anti-lawyer joke – they're all true.

Joking aside, this perception of lawyers as being expensive, difficult to understand and generally unhelpful is a serious problem for small companies, which encounter legal issues every step of the way: when they're setting up; employing staff or consultants; dealing with their intellectual property; contracting with customers, suppliers or distributors; dealing with disputes; or selling up. Yet research carried out by the Legal Services Board shows that almost half of the small companies in the UK don't use a lawyer to deal with these issues. They prefer to go it alone and take risks with their revenues, margins, profits and exit values by not taking care of their legal business properly.

Of course, many good, decent, helpful lawyers are available, but the traditional law firm structure probably doesn't cater very well for small companies and their needs. Law firms like to have regular clients that they can regularly bill for large amounts, to support their own partnership and overhead costs – but small companies don't need legal advice the whole time and are usually strapped for cash. Law firms like to take their time to consider thoroughly all the issues – but small companies are always in a hurry. Law firms like to give extensive advice and usually hedge their bets ('on the one hand you can do this, on the other hand you must consider that') – whereas small companies just want the essentials of the problem described to them and want to be told the answer.

As a result, a mismatch exists between what small companies need in the way of legal advice and what's available to them.

## *About This Book*

This book gives small companies an easy-to-use guide to the law: it's highly practical and covers most of the typical situations in which small companies need legal help.

The book loosely follows the likely trajectory of a small company from set-up and start-up, to launching the business, growing the business and exiting. It maps the legal challenges that come up along the way, providing tips and analysis to help small companies solve them.

I have a caveat, of course (well, it is a legal book after all). Reading this book is helpful, but it can't be the same as taking legal advice. As a general handbook, it doesn't cover all circumstances, and other special features may apply to you and your case. If in doubt about your situation, talk to a lawyer – good ones are out there, I promise.

## *Foolish Assumptions*

Small companies embrace a wealth of talented, committed, passionate individuals and contain some of the country's brightest minds. These people are often too innovative or driven to be contained by the boundaries of a more conventional larger corporation. They don't have a lot of time for (and aren't interested in) long-winded legal explanations that have nothing to do with their practical problems.

I assume that you're bright, in a hurry and looking for practical legal help written in plain English. I also suspect that you may have had a previous disappointing experience with lawyers – because they were too expensive, too slow or spoke a language only they understand. Why do I suspect this? Because the Legal Ombudsman received over 76,000 complaints about law firms in the last three years! I know that I may need to overcome your scepticism about the value of legal advice.

You've taken a great first step by buying this book. Now my responsibility is to show you that it's useful and make sure that you enjoy using it – so that it doesn't end up unused on the shelf.

## Icons Used in This Book



Keep a look-out for the following icons. They highlight areas of special interest.

This icon points you to a little gem that makes things easier or helps you get more from the book.



I could almost put this icon on every page, but these bits are super-crucial to keep in mind.



I make a real effort to avoid legal terms, but where insider words and phrases are so important that you need to know what they mean, I indicate them with this icon.



When you see this icon, you're steering through dangerous waters; I don't want you capsizing or even getting your feet wet.



Maybe not essential or riveting stuff about the law, but the text by this icon gives you a deeper understanding of the material.

## Beyond the Book

Running your own business can get lonely, but you aren't alone. The legal tips and knowledge you gain from this book are sure to stand you in good stead throughout the life of your business.

In addition to the main text, I also provide several exclusive extra articles online at [www.dummies.com/extras/lawforsmallbusinessuk](http://www.dummies.com/extras/lawforsmallbusinessuk). They include tests for your knowledge on intellectual property, contracts, keeping your business safe and raising funding. Plus, I provide ten tips to pull the rug from under the bullies of the negotiating world. I also share some essential legal pointers to keep in mind at all stages of your business in a handily-contained Cheat Sheet at [www.dummies.com/cheatsheet/lawforsmallbusinessuk](http://www.dummies.com/cheatsheet/lawforsmallbusinessuk) – something you can print off to decorate your office with, if you so desire (perhaps not, but you may want to file it somewhere for ease of reference).

Also, you need to find a lawyer or law firm you can feel comfortable with to help you through the inevitable legal issues involved in building a successful business. Don't try and deal with the challenges on your own if they're beyond your experience or expertise. Good, practical, affordable lawyers are around if you look for them. A little spent with the right lawyer at the right time can avoid far larger costs or expenses later.

Don't forget to get your lawyer involved in an issue early rather than waiting for a crisis to develop. Good lawyers can help you shape a strategy that avoids a problem developing and so save you money in the long run.

## *Where to Go from Here*

I set out this book so that you can dip into any part, chapter or section that you need without reading the rest. Of course, you're welcome to read it from cover to cover, but if you don't have the time or inclination, this book is ready-made for cutting to the chase and getting straight to the legal subject that concerns you.

The law is a big subject and I can't discuss everything, but I definitely cover a range of issues that I know come up regularly for small companies. Search the theme of each part and chapter to find what you want. For example, if you're facing an urgent issue with getting your firm's software sorted, move straight to Chapter 9. If you need to hire some help in your firm and you're unsure of the difference between contractors and employees, read Chapter 5 before you make any mistakes you come to regret.

Good luck with your venture, and if you're sceptical about the usefulness of lawyers, I hope that this book changes your mind.

## Part I

# Getting Started with Legal Requirements

getting started  
with

**law for  
small  
business**



Visit [www.dummies.com](http://www.dummies.com) to discover more and do more with *For Dummies* books.

## ***In this part . . .***

- ✓ Discover the right business structure for you.
- ✓ Set up your chosen legal structure.
- ✓ Work out the kind of funding (and funder) you need.
- ✓ Navigate your way through the various types of funding agreement.

## Chapter 1

# Starting Your Legal Journey: Business Structures and Initial Research

---

### *In This Chapter*

- ▶ Deciding on the right legal structure for you
  - ▶ Checking various business registers
- 

**S**o, you have a big idea for a business: maybe you've created a prototype for a machine that removes the overpowering aroma of gorgonzola or invented a cost-effective method of transporting irritating celebrities to another solar system. Perhaps you've created a *minimum viable product* (an initial version of your product that's good enough to test in the market) – and identified one or more individuals you want to work with. The sunlit peaks of entrepreneurial success lie before you. Exciting times!

Although I'm reluctant to draw cloudy shadows over this sunlit image, I have to point out that legal dangers lurk for the unwary new business owner, which can ruin your enterprise before you even start. Therefore, you need clear, comprehensible legal information from the initial start-up, through business growth and especially with disputes and serious problems (turn to Chapters 15 and 16, respectively, when you feel ready to think about that). You wouldn't start your business without a business plan, and I suggest you have a legal plan too.

For example, before you can get going as a small and medium-size enterprise (SME), you have to decide what business structure you want for your undertaking. Fortunately, along with some considerations for when you're registering your business, that's exactly the subject I cover in this chapter! Along the way, this chapter also acts as your guide to the rest of this book, which can continue to help you when you're ready to trade overseas (travel to Chapter 13), expand into other adventures (see Chapter 17) or sell your

company for a well-earned cushy retirement (saunter with sand between your toes to Chapter 18)!

## Deciding on Your Trading Structure



You can choose one of the following three main trading structures for a commercial business:

- ✓ Sole trader
- ✓ Partnership (including a limited liability partnership)
- ✓ Limited liability company

Each structure has different characteristics and distinct advantages and disadvantages, which I describe in this section. (When forming a charity you have some other options, but I don't cover that subject in this book.)

If you want more information, jump to Chapter 2, which talks you through the legal formalities of each type. For funding ideas and legalities, slip a coin into the slot and dispense the info in Chapters 3 and 4.

### Going it alone: Sole trader



A *sole trader* arrangement is essentially a 'one-man band' where the business owner is self-employed and in effect *is* the business. Sole trading is one of the oldest and most traditional models of business ownership and has been used widely throughout many industries. A significant increase in the number of people setting up businesses as sole traders has occurred due to the sense of independence it brings. As a sole trader you have complete control over the business and can run it in any manner you choose.

This structure is also popular because of the ease with which you can combine it with other employment. On the other hand, personal liability attaches to you if the business gets into any difficulties.

#### Advantages

Here are some of the advantages of sole trading:



- ✓ **Autonomy and control:** The sole trader is truly independent and is in full control of the business and how it's conducted and any earned profits. You can therefore fully realise and develop your vision for the business without interference. Great!



- ✔ **Low administrative burden:** The lack of a formal setting-up structure makes for a cost-effective process requiring less paperwork. Usually, you don't need specialist legal or accountancy advice.
- ✔ **Less statutory obligations:** The Companies Acts don't apply to sole traders, and you have no requirement to file annual accounts or fulfil the other administrative burdens that fall on limited companies (see the later section 'Protecting your liability: Limited company' for details).
- ✔ **Flexibility:** As a sole trader, you can make decisions quickly because you don't need to consult anyone. Similarly, you can implement new decisions or ideas instantly.
- ✔ **Personal reputation:** A sole trader can build up an invaluable rapport with customers as the 'face' of the business.
- ✔ **Privacy:** Personal details of the sole trader, including address and profits, aren't in the public domain, because you don't have to register with Companies House (flip to the later 'Checking Companies House' section for more details).



- ✔ **Great for testing a new business idea:** Setting up as a sole trader is an inexpensive way to determine whether your business idea has true potential before you leave full-time employment.

If you're an employee of someone else though, check that you aren't breaching your employment contract by, for example, potentially competing with your employer or using confidential information.

- ✔ **Earning potential:** You retain any profits earned as the sole trader and (after tax) don't have to share them. When you've got your cake, you can eat it all yourself!
- ✔ **Ability to adapt:** If you begin your business as a sole trader, you can transition it into a limited liability company (see the 'Protecting your liability: Limited company' section later in this chapter) if it expands to a sufficient degree. No bar exists to *incorporating* the business at a later date by turning it into a limited company.

### Disadvantages

Life as a sole trader isn't all sweetness and light. Here are some of the difficulties you can face:



- ✔ **Personal liability:** As a sole trader you can be held personally liable for losses suffered by the business, because no distinction exists between your personal and business assets. This disadvantage is a real 'biggie' – don't underestimate its significance. If you're a sole trader, you can end up funding the losses of the business out of your own savings, pension or house. Ouch! For this reason, you need to get

your official Terms and Conditions (T&Cs) sorted to minimise your liabilities – check out Chapters 6 and 12 for your website T&Cs and other customer contracts, respectively, whatever business structure you choose.

- ✔ **Status or prestige:** An inherent snobbery exists regarding the sole-trader arrangement. Whether justifiable or not, sole traders are perceived as being less professional in nature and lacking professional credibility. Certain larger companies adhere to a strict policy of only dealing with limited companies.
- ✔ **Sole burden of responsibility:** A sole trader must operate as a ‘jack of all trades’. Whether you have an aptitude for a particular area or not, you’re required to fulfil *all* aspects of the business, such as administration (invoicing, filing, replying to customer queries and complaints) and finances (tax and National Insurance), as well as carrying responsibility for the core business’s operation. Life can seem like a daily triathlon, followed by a decathlon, followed by a marathon.
- ✔ **Financial support or funding:** Sole traders have to rely on their own personal credit rating when seeking financial support. Potential lenders don’t look on them favourably or as a secure option, which can cause difficulties in getting loans, a mortgage or investment for the business. (Chapter 3 has loads of great tips for early-stage funding).
- ✔ **Modest profits:** The effort you have to expend to achieve a profit can be burdensome when you’re working on your own: achieving a good work–life balance can be difficult, particularly in the initial stages of the business. Your domestic partner may have something to say about this aspect, even if you’re happy with it.
- ✔ **Unprotected business names:** No statutory protection exists for business names of sole traders, because they don’t have to be registered with Companies House, unlike limited companies (flip to the later section ‘Checking Companies House’). Protecting your name is therefore more complicated (see Chapter 8 under the heading ‘Enforcing Unregistered Trademarks’).
- ✔ **Less social security benefits:** A sole trader isn’t entitled to the same social security benefits as employees. Sole traders are classified as ‘self-employed’ and so the amount of National Insurance they pay is usually lower than an employee has to pay. Therefore, if your business as a sole trader gets into trouble and ceases to trade, you can find that you have less entitlements built up to access unemployment assistance and less contributions towards your state pension.
- ✔ **Insurance:** As a sole trader, you usually need public liability insurance if you deal with members of the public. Plus, if you take on even one employee, employer’s liability insurance is also necessary. These kinds of policy can be harder for a sole trader to get than a limited company or partnership – a double whammy given your risk of being personally liable for the losses of the business.



- ✓ **Harder to exit:** If a sole trader wants to sell the business (*exit*), no shares are available to sell because it's not a company. All that's really available is the trading book and reputation you've built up as a sole trader. These aspects can be hard to quantify and still harder to sell, because they're wrapped up in your personality and history.

## Collaborating with a colleague: Partnership



The *partnership* model of business is a vehicle in which two or more self-employed individuals are linked in a collaborative business structure with a view to making profits.

These arrangements have existed traditionally in the provision of professional advice services, such as law and accountancy firms. But whatever your sector, if you're working with someone collaboratively to make profits, the law may classify you as a partnership even if you don't think that you're one! In the past these *General Partnerships* haven't enjoyed the benefits of limited liability, and so the partners can be liable for their share of any debts of the partnership. Worse still, because the law says that partners are liable for the debts of the partnership 'jointly', you can be liable for the partnership debts of other partners as well as your own share of the partnership debt. Holy bank balance, Batman!



The law applying to partnerships has been significantly altered with the introduction of the concept of Limited Liability Partnerships (LLP) as regulated by the Limited Liability Partnerships Act, 2000. The LLP is a hybrid between a General Partnership and a limited liability company and offers its members protection from liability for partnership debts and partnership contractual liabilities, while retaining the flexibility of the partnership model. The formation of an LLP, however, involves a greater administrative burden than a traditional General Partnership.

### Advantages

Setting up as a partnership provides a number of advantages. Here are the pros for a General Partnership:

- ✓ **Simplicity:** Relatively simple and straightforward to set up, and doesn't require a high level of administration or formality.
- ✓ **Low costs:** No great overheads involved.
- ✓ **Privacy:** No requirement to register a General Partnership's details publicly (as with limited companies) – a distinct advantage because no competitor can access potentially valuable company information.

Now I cover the advantages for both types of partnerships:

- ✔ **Only two people required:** You need only two partners to start and can introduce new ones without difficulty. This arrangement can make decision-making easier than in a limited company (see the later section ‘Protecting your liability: Limited company’) where numerous shareholders may be involved.
- ✔ **Partnership of equals:** Each partner brings a unique set of skills to the business, allowing a well-rounded and balanced business to develop. A partner with a particular aptitude can focus on a certain part of the business while the other partner concentrates on the disciplines where she’s stronger. This type of collaboration allows for greater flexibility in the running of the business.
- ✔ **Professional requirement:** Some professional bodies and associations require that those trading do so via the partnership model: for example, accountancy and engineering firms. Setting up as a partnership enables you to operate in these sectors of business.



Here are some advantages of an LLP compared to a General Partnership:

- ✔ **Each partner enjoys limited liability against the partnership’s debts:** Liability is limited to the amount of capital a person agreed to contribute as part of the partnership agreement – which can be as little as £1 if the partnership doesn’t need capital to run itself. This is a big advantage over a General Partnership.
- ✔ **The LLP name can be protected:** The requirement to register an LLP partnership name ensures that no other company can register the same business name.

Finally, here are some advantages of an LLP over a limited-company structure:

- ✔ **LLPs retain the organisational flexibility and tax benefits of the traditional partnership structure:** They’re easier to set up and run than limited companies and the profits earned aren’t subject to corporation tax, which applies to limited companies.
- ✔ **No memorandum or articles of association and no holding of LLP meetings required:** You don’t need to register the LLP agreement or formulate director or share agreements, as with a limited company.

### *Disadvantages*

Lawyers are fond of saying ‘on the one hand this . . . on the other hand that’, which can be irritating for clients who just want to be told the right answer.

(No wonder that one U.S. President is reputed to have requested in exasperation that he only have to deal with one-armed lawyers, who might give him a single answer!) On the other hand (er, sorry), partnerships entail some genuine disadvantages, and so I look at some of those here:



✔ **No limited liability:** A General Partnership (of the traditional, non-LLP kind) has no limited liability. All partners are held personally and jointly responsible for the debts incurred by the partnership. If a partner enters into a contract that's not in the best interests of the partnership, it's binding on all the partners, for better or worse.

✔ **The 1890 Act applies if no partnership agreement is entered into:** Most General Partnerships are based on a deed of partnership agreement with specific provisions on how the partnership is to be run, in order to avoid the application of this Act. Given that the Act dates from Victorian times, you can imagine that it may have unintended consequences in a modern business environment – after all, it dates from a period when poorhouses were commonplace and so was eating offal!

For example, under this old-fashioned Act:

- **A partner can't retire (that is, leave the partnership):** If one partner decides to leave, or dies, the partnership has to be dissolved and the assets divided up.
- **A partner can't be expelled:** Again, the partnership has to be dissolved and a new one created.
- **All profits are shared equally:** All partners share equally in the profits irrespective of the amount of time or effort they devote to the business.



✔ **Consensus is required:** All decisions made require agreement by all partners unless the partnership agreement says otherwise. As such, the decision-making process can become slower and more protracted.

✔ **Shared goals and values are required:** Partners may not possess the same vision for the business and can have differing aims and ideas. Because control is shared, this situation can create difficulties in the running of the business.



✔ **Lopsided partnerships:** All partners may not apply themselves equally to the diligent operation of the partnership, but may still attempt to direct and manage the business (and take a pro-rata share of any profits). If efforts aren't rewarded justly, resentment and hostility are likely to grow.

✔ **Lower social security benefits:** A partner is entitled to less social security benefits than an ordinary employee. Because the partners are self-employed, they'll have made fewer contributions than employees

of a limited company (for example, National Insurance contributions). Therefore, they have less access to social security benefits such as unemployment assistance and may also have a lower state pension.

- ✓ **Less obvious ownership and funding opportunities:** Generally, all existing partners must agree that someone new can become a partner, and so limited flexibility exists for creating additional ownership opportunities. The partnership structure is also less suitable on the whole (compared to limited companies) for raising finance, which is why most of the capital from partnerships tends to come from the partners themselves. Chapters 3 and 4 discuss your funding options and associated legalities.
- ✓ **Limited Liability Partnerships:** Though not as onerous as for a limited company, the administrative burden is much greater for an LLP than for a General Partnership. Registration with Companies House is required, as is the filing of annual accounts and returns and any changes to business names, addresses or members. Penalties may be imposed for late filing and, unlike some soccer referees, Companies House is always happy to award a penalty (see the later section, ‘Checking Companies House’). I look at these formalities in Chapter 2.

## Protecting your liability: Limited company



One of the fundamental principles of company law, which applies to limited companies, is that a company has a separate *legal personality* from its *members* (shareholders). The company has its own rights and obligations: it has a right to sue and be sued in its own name, to own property and it isn’t affected by the death or insolvency of an individual member (unlike a partnership). This principle is known as the *veil of incorporation*.

Sounds very mysterious I know (after all, you don’t hear about the ‘cloak of isolation’ for sole traders or a sacred chalice from which partners in LLPs have to drink to seal the deal!). But veil of incorporation just means that any liability incurred by the company is limited to the company and doesn’t extend to its shareholders and directors.

The shareholders of the company are in principle only liable to the extent of the nominal value of their shares. The *nominal value* is the face value of the share (say £0.01 or £1.00 each) as opposed to the actual market value of the share if it were sold (which would hopefully be much higher). So that’s why the principle is referred to as *limited liability*. If you have 50 shares worth £0.01, then all things being equal, your maximum liability for the company’s debts is £0.50, even if the whole shebang goes up in flames and loses millions of pounds. What a relief. . . .