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Structuring the legal and commercial ecosystem for a closely held business for high growth in international markets

What are the key structural requirements and 'building blocks' for designing a high-growth business in a global economy? What inspires private equity investment? Early adoption of a holistic multinational structure is critical to the success of a small high-growth business. This article identifies the building blocks for such a structure.

Introduction

Business process management – the design and control of tasks – is critical to defining needs and global sourcing of goods, services and technologies. The vertically integrated multinational has largely been replaced by the horizontally integrated global supply chain. The advent of cloud-based software as a service (SaaS), accessible via mobile devices, means that customers do not need to know where or how goods or services are being delivered. Only speed and quality of service matter to internet-based mobile customers.

Holistic multinational structuring is essential to the growth of closely held businesses – whether startups, family-owned multigenerational businesses or formerly public companies that went 'private' – as well as intrapreneuring and innovation in mature enterprises. An effective multinational structure can deliver supply chain efficiency, limitation of liability and thus preservation of equity capital at risk, decentralised management that is 'close to the customer', a global brand, rapid growth, scalability and online service, with cost management through both insourcing and outsourcing of back-office support, procurement and compliance services.

Supply chains are global and local. As company founders in one country increasingly migrate to target markets (eg, the United States, Canada and certain European countries), they can benefit by identifying functions that can be performed in different countries, and enjoy the benefits of tax incentives and governmental benefits, while hiring third parties to handle essential, noncore functions available from SaaS-based online business services. Here are some steps for planning:

Define the core business and it processes

In today's disrupted global economy, virtually any goods or services can be outsourced. The key question boils down to: what is the core business? If the core business is a regulated business, then anything else is extraneous. For banking, financial services and insurance (BFSI), for example, the 2007–2008 US financial crisis forced many broker-dealers to become regulated banks in return for governmental guarantees of liquidity. As regulation became more complex, the core business became more focused. Years later, some broker-dealers are creating 'master services entities', 'centres of excellence' and other structures to support, but not perform, the core business. For internet-based service businesses, the core business is delivering an online customer experience and value, while also generating masses of 'big data' that can be reused for optimising the customer experience and, if lawful, resold to other businesses. What's your 'core business'?

From a capitalisation perspective, capital investment (equity fundraising) is justified only for the core business. Everything else is incidental and can be purchased on a marginal-cost basis.

Develop process metrics

If a process is not measured for inputs, outputs and efficiency, it is not a managed process. Process maturity reduces costs, increases profits, reduces mistakes and waste, improves quality and ensures customer satisfaction. Learn and apply the skills of mature processes. The Carnegie–Mellon paradigm of the 'capability maturity model' can help. Process metrics can be built into legal relationships across the supply chain. Thus, the role of suppliers – including 'outsourcing service providers' – business partners and customers can be designed, defined contractually and integrated into the company's business model.

Design the value chain and allocate internal and external resources

The end-to-end value chain for each line of business is the sum of the individual parts. A high-growth global company needs to design its value chains. This will enable it to identify all supply chain options necessary to support the core business.

Every business can operate by buying or self-providing the necessary support functions. High-growth companies can either outsource or source certain needs from affiliates, with contracting and accounting across all business segments:

- manufacturing: sales and purchases of stock in trade (inventory);
- procurement: sales and purchases of tangible property other than stock in trade;
- operations management;
  - contributions to the global platform used by affiliates;
  - cost sharing transactions, such as intercompany service agreements among affiliates;
- leasing: rents received or paid, for other than intangible property rights;
- licensing: royalties received or paid, for other than intangible property rights, such as for equipment, real estate, office space and other tangible property;
- intellectual property: sales, leases, licenses and so on, of intangible property rights (eg, patents, trademarks and secret formulas);
- services: consideration received or paid for technical, managerial, engineering, construction, scientific or like services;
- commission sales: commissions received or paid;
- corporate finance: amounts borrowed or loaned;
- corporate loans: interest received or paid; and
- risk management: premiums received or paid for insurance or reinsurance.

Manage knowledge through people, processes and technology

As a building block for company growth, knowledge combines the founders' vision with trade secrets, standard operating procedures (in software code and daily practices), contextual information, experience and the organisation's values and culture. In turn, knowledge management requires defining and organising these knowledge elements for optimal efficiency. Knowledge management requires legal insight and support, not only for efficiency, but also compliance, business continuity and transmissibility to new owners.

Human capital

From a human resources perspective, individuals should be encouraged to stay in the growth company through incentives, such as stock options, phantom stock, bonuses, commissions from new 'products', and recognition and rewards for the completion of innovation projects. The timing of incentives affects the development, retention and institutionalisation of a company's knowledge base. Stock-option vesting schedules of three or four years have become the norm.

Intellectual property

Today, no enterprise can survive without protecting its intellectual property (exclusive assets) and intellectual capital (personnel and trade secrets known only to the company or a limited universe). Copyrights and trademarks are basic. Patents for 'novel, useful and non-obvious' inventions are more complex, and the one-year deadline for filing a US patent application can expire suddenly. But the most essential intellectual property comes from the use of trade secrets, which might be known to some competitors but are not generally known. This requires the adoption of rules for obtaining non-disclosure agreements, limiting disclosures to others only on a 'need to know' basis, and training employees and independent contractors in security. Service agreements and license agreements generally include protective conditions across the supply chain.

Sourcing and procurement

Key knowledge needs to be 'insourced'. Use of outsourced resources can hurt a growth company's ability to create economies of scale, undertake new projects, and limit leaks in cybersecurity and intellectual property. Independent contractors, also known as third-party service providers, can suffocate a company unless roles and responsibilities are defined. The enterprise must retain key functions in-house for the control of business processes, institutional knowledge of business operations, supervision of regulatory compliance functions, business continuity planning and disaster recovery. When outsourcing, such considerations need to be built into the master service agreements for the procurement and integration of back office, middle office and even customer-facing functions.

Transparency

Organisations have developed wikis and other tools for knowledge management. Beyond simple searchability, the design of transparent institutional knowledge still requires a legal review to limit access to those with a need to know, limit liability to third-party licensees, protect the value of licenses granted and prevent inadvertent impairment of the patenting process.

Develop strategic alliances

For disruptive startups, and innovative small and medium-sized businesses (SMBs) and mid-market companies, strategic partnering becomes an essential skill. Consider teaming up with larger organisations that do not have your skills, niche or agility. Frequently, larger organisations will be happy to pre-arrange terms under which one organisation (eg, yours or theirs) develops the client relationship and the other organisation subcontracts to provide the particular project deliverables on a 'prime contractor-subcontractor' basis. A 'teaming agreement' can resolve issues of exclusivity, billing, credit risk, transparency ('white label' versus branded services), confidentiality and how to deal with the client's terms and conditions. Given the short life cycle of many strategic alliances, management and their lawyers drafting the contracts must take care to avoid unintended interlocking and interdependence, and lock-in.

Establish a multinational corporate platform

Designing your multinational corporate structure can save money and avoid frustration and waste. Tax planning can help you to decide where to establish a holding company and operating subsidiaries, and specialised asset holding companies (eg, for intellectual property). Establishing a virtual subsidiary in a country or region can be useful for enabling local banking transactions, even if the subsidiary is only a name, office address and occasional workspace for business development.

Managing the ecosystem of relationships

Managing supplier relationships becomes the glue that binds the high-growth company's high-growth core functions with its suppliers, licensors and other business partners. Relationship management includes governance, visibility into gaps in quality of service and rectification of problems before they disrupt the high-growth company's own quality of service to its customers. Managing the ecosystem requires allocating in-house people who can interface between in-house and external operations.

Examples of ecosystem development can be seen in various sectors. Individually, 'enterprise' customers can force suppliers to deal through online portals. In marketing, two companies with similar client targets can use 'teaming agreements' to share prospects and anticipate future prime contractor/subcontractor relationships. Collectively, the collaborative use by marketplace actors of 'blockchain' computing for 'ledgers' is being proposed in financial technology (fintech). In marketing, crowdsourcing can generate public participation. In crowdfunding, new markets for funding sources have been developed. In short, ecosystem management is critical to any business.

Continue to improve business processes

A culture of continuous process improvement enables the high-growth company to survive and thrive based on learning from mistakes, customer feedback and new insights built upon institutional knowledge. Carnegie–Mellon University has developed a 'Capability Maturity Model' that helps to guide process improvement across a project, division or entire organisation. At the lowest level, the process is feasible (level 1). Graduating up the scale, the process can be repeated and managed (level 2), and then defined objectively (level 3), qualitatively managed (level 4) and ultimately optimised.

Optimisation can be achieved by self-evaluation, for example, at the end of virtually each transaction.

High-growth companies adopt optimisation procedures 'by design'. Indeed, 'optimisation by design' is the hallmark of disruptive innovation and potential for global high growth.

Design has no value unless implemented. Thus, management needs to inspire a corporate culture of (disruptive) innovation, self-analysis for process innovation and openness to change. Such a culture should accept the risk of failure. From the human resources perspective, the reward – and punishment – system needs to be defined explicitly to enable in-house 'innovation projects' that have limited resources and limited expectations.

Conclusion

Careful legal documentation is fundamental for high growth. For external suppliers, legal documentation includes well-drafted commercial agreements, such as licenses, sales agreements, consulting agreements and service agreements. For 'internal' suppliers, intercompany agreements should be developed to ensure compliance with applicable international transfer pricing regulations of the tax authorities of all countries involved. Intercompany agreements can be structured so that intellectual property developed at the cost of two related entities can be allocated territorially on the basis of market size or market value, which is a design used by companies such as Apple and Microsoft with their Irish subsidiaries.

Disruptive, innovative companies can leverage the capital investment and know-how of strategic partners – and even their customers – through the effective design and implementation of supply chain management. 'Ecosystems by design' and process optimisation can open the door to rapid and sustainable growth.