11 steps for scaling a startup

David MacMillan

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Executive summary

Establishing a startup's business infrastructure early — that is, establishing support in the areas of legal, accounting, tax, insurance, and human resources (HR) — provides a number of critical benefits, including:

- Minimizing risk
- Increasing efficiency
- Standardizing contracts
- Quickly processing one-off contracts and special circumstances
- Safe harbors
- Advice on new business practices and new jurisdictions
- Providing a sounding board
- Facilitating tax benefits and avoiding tax problems
- Building wealth (e.g., founders' ownership and intellectual property rights)
- Smoother financings
- Effective employee management (i.e., avoiding employment-law issues)

Sections of this paper discuss each of the above benefits and provide suggestions for management teams that will facilitate establishment of an appropriate infrastructure.

Note: The situations described in this note are given only to illustrate concepts and should not be taken as providing legal, tax, or accounting advice.

Motivations for establishing infrastructure early

The infrastructure of a startup includes its relationships with its legal, accounting, tax, and insurance firms, plus its key business advisers. Infrastructure also includes HR functions, such as payroll, employment taxes, stock incentives, retirement plans, and the hiring and termination processes. Setting up a proper infrastructure early provides the critical benefits discussed in the following sections.

Minimizing risk

Founders need to decide where to take risks. Typically, technical risks are associated with a startup's product development. Often, marketing risks are associated with the release of a product in the market; these might include risks related to customer acceptance of the product and product pricing.

Additional risks are related to how the business is set up and managed. As soon as a startup hires its first employee, the company and the senior executives become exposed to a wide range of risks related to state and federal employment law, including hiring practices, rules on exempt and nonexempt classifications, hours worked, accrued vacation time and paid time off (including payroll adjustments), rules related to the workplace environment, and timely payment of employment-related taxes. There are also risks related to benefits and how they are administered.

Establishing a business infrastructure early can minimize these employment-related risks. The easiest way for a startup to manage these is to use external providers, including outsourcing. It is most efficient if a single outsourcer can handle most or all of these employment-related issues, because it allows a single point of contact for the company and complete, seamless coverage of all the issues.

Enabling efficiency

Setting up a smoothly running infrastructure is one of the first steps to allow a management team to focus on key value-creation activities such as product development and customer engagement. A smoothly running infrastructure also eliminates the constant interruptions and emergencies that arise if an infrastructure is missing or inadequate. A smoothly running infrastructure for employment-related activities should include easy-to-use online tools for employment-related tasks.

Standardizing contracts

A smoothly operating infrastructure includes having standardized contracts for activities that occur frequently. Potential standardized contracts include nondisclosure agreements (both one-way and mutual), employment paperwork, consulting contracts, licensing agreements, product evaluation agreements, distributor agreements and terms, and conditions of sale. The specific list will depend on the details of the company's business. In most cases the necessary standardized contracts for employment will be available from an employment outsourcer. The company's legal firm can provide the balance, which may also include modified employment contracts for the founders and key executives.

Quickly processing one-off contracts and special circumstances

If key professional advisers are in place, handling onetime contracts such as leases, special vendor relationships, and joint ventures is much easier. Since these advisers have been working with the startup, they understand its business and know its existing standardized processes. Therefore they are in an excellent position to assist with special requirements quickly and as they come up.

Safe harbors

Professional advisers can help a company structure its activities to fall within safe harbors and to follow generally accepted business practices. (A "safe harbor" is a structure for a transaction or event, typically defined by a government authority, which reduces or eliminates certain risks to a company.)

Leveraging the smooth operations that come from following tried and proven paths will help reduce risks. Deviations from that path should only be taken when they offer an opportunity to create a significant sustainable competitive advantage.

Advice on new business practices and new jurisdictions

A quick legal review should precede even the smallest initial steps outside of a startup's usual business practices or jurisdictions. For example, in the U.S., companies can be deemed to have inadvertently created a franchise with a third party if three relatively innocuous elements exist in a deal. That would immediately subject the company to a complex set of franchising laws.

A second example is that foreign jurisdictions and the U.S. have very different rules regarding sales representation. Engaging in certain activities that appear innocuous to untrained U.S. eyes may be sufficient under foreign laws to have created de facto contractual relations or employment situations. Getting out of these can be difficult and expensive. Infrastructure advisers with deep industry experience and international scope can help a company plan ahead so that it can avoid these problems.

Providing a sounding board

One effective tool for streamlining early problem detection is scheduling a quarterly legal, accounting, and tax review; during these meetings, the plans for the upcoming year can be reviewed with outside professionals, who can spot potential issues while they are still easy to solve.

Capturing tax benefits and avoiding tax problems

The formation of a business encompasses a complex set of business, legal, and tax decisions that can be difficult — or even impossible — to change later. For example, the issuance of qualified small-business stock may save the initial team substantial taxes when the stock is sold. Failure to take an 83(b) election could result in disastrous tax consequences because it creates massive tax bills long before any cash is received from stock sales.

One of the most important issues is the legal form of the business; these include the C corp or S corp, the limited liability partnership (LLP), and the limited liability company (LLC). Many startups choose to be a corporation, but real estate, energy, and entertainment businesses often make use of LLC or LP structures to provide more flexibility in tax allocation and profit sharing. These decisions can have a significant impact on the returns that the founding team and investors see. In some cases, this decision can also affect the types of investors the startup can attract.

Elections that are made when filing the entity's first tax return are difficult or impossible to change after the fact. The startup's accounting and tax firms can provide guidance on which elections to take.

Building wealth: founders' ownership and intellectual property rights

Many technology businesses start when a few colleagues get together and identify an opportunity. Key steps that should be completed at the start include reaching an agreement on intellectual property (IP) ownership and the ownership split in the business. If the stock split and vesting is not properly set up, a founding shareholder can walk off with his or her full stock award shortly after formation; this is unfair to those who stay with the company and put in the years of work to grow it over time.

Regarding IP, when filing a patent, every inventor needs to be listed, but no one else. Failure to abide by this simple procedure can be considered a fraud on the patent office and result in a loss of the patent rights. For an early-stage company, the list of inventors might include founders, current employees, terminated employees, consultants, and unpaid helpers.

If no agreement to the contrary exists among the inventors on a patent, any inventor can license, use, or convey patent rights without needing the consent and without having to account to other co-inventors. In other words, if five people invent and patent a widget and four form a company, unless a contract prohibits the fifth inventor (maybe someone who was just a helper early on) from licensing a competitor and pocketing the entire license fee, he or she can.

A professional investor will not invest until the issues of stock ownership and IP assignment are resolved. Immediately before closing the investment deal is the wrong time to make these decisions, because a co-inventor who does not want to be part of the future business may seek to extract a disproportionate payment for his or her IP assignment.

Smoother financings

Startups seeking venture capital (VC) will have a much smoother closing if the business is structured along traditional VC norms. The infrastructure team can advise what constitute acceptable terms. The team can also help identify key steps a company should take internally to simplify fund-raising and due diligence, such as establishing a system for tracking key items like contracts, board minutes, and stock ownership. During a VC's due diligence, the company should expect to provide all of these items.

Effective employee management (i.e., avoiding employment-law issues)

Employment issues emerge right at the start of a business. Even with a corporate structure, key executives can be personally liable if certain employment requirements are not met.

For example, in some cases, people working for free or helping out can result in problems related to minimum-wage laws and workers' compensation or business liabilities in the event of injury. When the business hires someone, it is immediately subject to a wide range of employment laws relating to the process used to hire, employment-tax-withholding requirements, mandatory tax filings, workplace conditions, maximum hours, and so forth. This can get especially messy if someone leaves on bad terms. Even a friendly termination needs to be properly structured to avoid downstream problems. These might arise, for example, if an investor doing due diligence discovered inadequate termination paperwork of a terminated employee.

Building an infrastructure

A business should approach the process of building an infrastructure team the same way it would approach recruiting key executives. The first step is to write down the capabilities needed, both immediately and over the next three to five years. Continuity with advisers is desirable, so assessing future needs is important.

In locating infrastructure providers, the new business should make use of referrals from other entrepreneurs, advisers, friends, and former employers. Firms can also be approached directly. Unlike VC firms, where introductions are crucial, having introductions into a service firm is helpful but not essential. Infrastructure providers, including law firms, accounting firms, and banks, often have representatives who attend events where VCs and entrepreneurs get together, such as business plan pitch contests.

In general, a new company should look for firms — and people at those firms — with the right set of experience for its needs and that have good chemistry with the startup's team. Interviewing a number of firms before making a decision is a good idea, just as it would be if a company were hiring a key executive.

Finding advisers, consultants, and board members

DEFINING THE NEEDS

Advisers and consultants can address a wide variety of needs, from executive sounding board and coach to interim executive to specialist assisting with a specific requirement. The new company seeking these advisers and consultants should be clear on whether it needs strategic advice, tactical advice, and/or hands-on implementation assistance.

Board members represent shareholders, so the relationship with a board member is somewhat different. Management works for the board and shareholders, whereas consultants and advisers work for management. If VC funding is planned, VCs will want seats on the board and will have approval rights on the selection of an independent board member. For this reason, holding off on actually appointing an independent director until the investors are located may be best. However, startups should be on the lookout for the best candidates from the beginning.

STRUCTURING THE RELATIONSHIP

Deal structures and payment terms can take a variety of forms. Deal structures can range from infrequent advisers who may interact mainly by phone to interim executives who are at the company every day and carry a company business card. Payment can range from all cash to all stock. However the relationship is structured, the company should make sure the necessary paperwork is in place. For that, a lawyer is required.

Finding a law firm

DEFINING THE NEEDS FOR A LAW FIRM

A startup's law firm should have extensive experience both with startups and with the startup's industry. Additional factors might include experience in other jurisdictions, international sales channels, licensing of technology (both to acquire and to provide), end-user licensing and terms and conditions of sale, mergers and acquisitions, and patents. Sometimes multiple firms are the best solution. For example, a specialist firm is often used for patents. Sometimes it is less costly to have a larger firm for the complex deals (like financings) and a smaller, less expensive firm (maybe even a sole practitioner) for general corporate legal work. This general work might include creating custom contract terms for the startup and reviewing contracts provided from other companies.

STRUCTURING THE RELATIONSHIP WITH A LAW FIRM

The CEO's primary contact at the law firm should be with a partner, even if an associate does most of the work and handles the day-to-day interactions. This is important because as the startup grows, the partner will be the liaison with the rest of the law firm and will provide continuity; associates may come and go. If the startup is acquired, the partner's experience and connections may be important in structuring and closing the transaction.

The partner is the person who will have the weight to negotiate the best up-front deal for the startup in deferred or reduced fees. Some law firms will significantly reduce or defer the basic startup costs for highly regarded startups until the first significant funding. That generally requires the company to have fund-raising as one of its first significant goals.

REPRESENTATION OF COMPANY VS. REPRESENTATION OF FOUNDER'S INTERESTS

The law firm represents the company. Once it is engaged, this law firm should be tasked with getting the startup's employment paperwork in order, including paperwork with the initial team. Counsel for the company will focus on structuring a deal that is optimal for the company and if VC funding is planned, has terms that a VC will be comfortable with. This may include establishing a vesting schedule on stock, with details of what happens if a team member leaves or is terminated.

Optimal employment terms for the company and for the employees will differ. The team, and in some cases individual team members, should consider hiring independent legal representation to advise on employment, stock, and IP terms. A lawyer who has strong experience with both executive compensation agreements and the types of funding sources that the company will use would be a good choice to represent the employees' interests.

Finding an accounting firm

Defining the needs of an accounting firm

In defining a startup's accounting and tax needs, a key decision is when to hire internal staff such as a CFO and a controller. On the one hand, a company can outsource everything, including hiring a part-time, interim CFO and part-time controller. This is ideal for small companies that have lighter accounting and tax requirements. Alternatively, a full-time CFO might be necessary if the company has complex budgeting, tax, or financing activities. A full-time controller (and maybe a staff reporting to the controller) might be needed for high-volume accounts receivable, accounts payable, or purchase-order activity.

The external infrastructure needed may include accounting support, tax support, and audit support. If significant international activity is expected, a firm with a large, possibly global footprint may be appropriate. For startups focused on a small geographic region, a local or regional firm may be a lower-cost option.

Structuring the relationship with an accounting firm

As with a law firm, establishing a strong relationship with a partner at the accounting, tax, and auditing providers is wise, even if associates handle the day-to-day work. Fee deferrals or reductions can be arranged in some cases. Once the firm is engaged, the startup should make sure that these firms and the HR infrastructure providers coordinate so that the startup has full coverage of all tax and accounting issues. If the company expects to go public, it should discuss these expectations with the accounting firm, since certain accounting data may need to be audited each year.

Establishing banking relationships

Defining the needs of banking relationships

A business needs a bank account as soon as it is created. Factors to consider include:

- Geographic footprint
- Local location and hours
- Minimum deposit requirements and fees
- Experience with startups and the startup's industry
- Willingness to lend to startups
- Online reporting and cash-management tools
- Availability of specialized services that might be required, such as international wire transfers, merchant account for credit card processing, SBA loans, lease lines, or venture debt

As discussed in the HR infrastructure section, banks also provide payroll services.

Other entrepreneurs, CFOs, accounting firms, and law firms are all good referral sources for finding startup-friendly banks and, within those banks, startup-friendly branches. Like lawyers and accountants, banks that pursue startups often have representatives at startup-related events.

Structuring the relationship with a bank

Developing a strong relationship with the local branch manager and key commercial-account employees can pay off when those individuals must make discretionary decisions on the company's account. This can include waiving fees and waiving holds on checks (especially out-of-state checks). In some cases, branch managers also have lending authority up to certain dollar amounts, even for startups that are not yet profitable.

Finding insurance

Defining the needs of an insurance company

The company's law firm, accounting firm, CFO, investors, advisers, and board are resources for deciding on the types of insurance that are needed and for locating good insurance brokers. Most businesses will need a basic set of policies for general liability and fire and theft. Depending on the nature of the business, a wide range of other policies may be appropriate, including officer and director insurance, product liability, errors and omissions, auto and truck, and umbrella policies. (Human resources policies are covered in the HR infrastructure section.)

Structuring the relationship with an insurance company

Once the startup identifies the types of policies it needs, it can select a broker. A broker's experience with the company's industry and the types of policies is critical to ensuring that the company has appropriate coverage, with reasonable deductibles, exclusions, and riders. The broker will also ensure that the coverage has no gaps and perils and that the company is not overinsured by being covered in multiple policies.

In the U.S., a captive insurance broker sells policies from only one company or group of companies or may be obliged to give his or her own company first right of refusal. An independent insurance broker represents a client in finding the best policies from any insurance company licensed to provide insurance in the geographic jurisdiction. An independent agent represents multiple insurance companies and seeks the best policies in the market for clients. A direct writer sells insurance directly to clients, bypassing agents and brokers. An independent agent will generally have the widest range of policies and types of insurance for a startup.

Establishing human resources infrastructure

Defining the needs of human resources

The human resources (HR) infrastructure needed will typically include functions like payroll, employment taxes, stock incentives, retirement plans, and workers' compensation, plus any specific items required for compliance with employment law, including appropriate hiring and termination processes. HR infrastructure needs may also include employee insurance benefits, including health, life, accident, short-term disability, and long-term disability.

In defining needs, the startup must identify which jurisdictions it will be operating in, looking ahead three to five years. Remotely located salespeople are often what cause an early-stage company to have multijurisdictional employment. The startup should consider what process will be used to ensure full compliance with employment law, including tracking changes in the law and implementing any required changes in a timely manner.

The benefits package should be competitive so that it attracts candidates rather than creates barriers to hiring. A firm that surveys benefits of similar businesses can provide guidance on what constitutes a competitive offering for the company's region and industry.

Structuring the relationship with human resources

HR includes a full range of solutions. A portfolio of service providers can be selected to provide complete coverage, or a single firm that covers most or all of the scope of coverage needed can be hired. An à la carte approach might include payroll and retirement services from a bank, workers' compensation from an insurance company, employment law from a legal firm, and perhaps multiples of each needed to implement multijurisdictional coverage.

At the other end of the spectrum are firms like TriNet, which provide complete nationwide coverage of all of these functions.

Summary

In establishing a new business, founders face a wide range of challenges and hurdles. Establishing a supportive infrastructure of advisers and services early can make the journey less risky. It also allows the management team to focus its attention on those aspects of its business that build maximum value. Among the key benefits are minimizing risk and increasing efficiency by:

- Standardizing contracts, then quickly processing one-off contracts and special circumstances
- Safe harbors
- Obtaining advice on new business practices and new jurisdictions, as well as having a sounding board for ideas
- Facilitating tax benefits and avoiding tax problems
- Building wealth (e.g., founders' ownership and intellectual property rights)
- Smoother financings
- Effective employee management as well as avoiding employment-law issues

About David MacMillan

David MacMillan is President of Capital Ideas. He has over 25 years of management experience with technology-based companies, including in CEO, board, and founder roles. MacMillan has helped form a variety of businesses in areas including semiconductors, communications systems, software, big data, the internet, and energy storage.

He is also an experienced investor. He is a former venture partner with BlueRun Ventures (a $1 billion early-stage global VC fund) and a former board member of Sand Hill Angels (one of Silicon Valley's most active angel groups). Prior to Capital Ideas, MacMillan founded Gazelle Microcircuits. Gazelle created the first GaAs ICs that were drop-in replacements for silicon, offering speeds that were 3 to 10 times higher. Gazelle is now TriQuint, a public company with over $800 million of annual sales.

MacMillan has an MBA from Harvard Business School, where he was named a Baker Scholar for academic distinction (top 5 percent). His undergraduate degree is a Bachelor of Science in Electrical Engineering from Queen's University, Canada, with an emphasis on Computer Science. His undergraduate project was the design and construction of a parallel computer, which was used subsequently for image processing at Queen's.

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