

STRUCTURING FUNDAMENTALS

Legal perspectives on the basics of structuring for startups

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For startups, strategic structuring can make all the difference. This note explores the critical elements of crafting a successful startup business structure, from the advantages of a holding-subsidiary setup to the decision-making process for creating multiple subsidiary companies. We also emphasize the importance of a clear Startup Charter and well-defined relationships between entities. By the end, you'll understand how the right structure can drive your startup's growth, mitigate risks, and foster transparency and accountability.

WHY STRUCTURING IS ESSENTIAL?

1. CLARITY

A well-defined structure helps identify and establish the roles and responsibilities of various business constituents and individuals. This is required to be done in the early stages when each individual and innovation is critical, so that from the foundation itself the roles are clear, and the business is built on top of such clarity.

2. SETTING GOALS

Having a structured framework allows startups to prioritize tasks, allocate resources efficiently, and set achievable goals. This ensures that the limited resources are directed towards activities that have the most significant impact on the company's growth.

3. INVESTORS

Structuring is essential to attract investors and enable them to invest efficiently in the business. Investors could be Indian residents, or foreign entities, and subject to the legal and regulatory requirements, they may face inability to efficiently invest in startups whose businesses and operations are not properly structured.

4. LEGAL PROTECTIONS

A proper structure not just isolates and protects one part of the business from other parts, it also ensures that the risks and rewards of various segments of the business are compartmentalized, while the value is aggregated at the top. Tax, foreign exchange, and other corporate laws that affect the startup's business should be kept in mind while structuring.

HOLDING COMPANY: NEED

A. ORGANIZING MULTIPLE BUSINESSES AND VENTURES

Organizing multiple businesses and ventures becomes easier because the holding company can have multiple subsidiaries, where each subsidiary is engaged in a business different from that of other subsidiaries.

B. ORGANIZING BUSINESS IN MULTIPLE GEOGRAPHIES

Organizing the same business in multiple countries is seamless. While the holding company remains the same, a separate subsidiary may be incorporated in each country as per such country's laws and regulations. This simplifies territorial expansion.

C. SHIELDING ONE BUSINESS FROM ANOTHER

Shielding one subsidiary from another is relatively simpler. If one subsidiary faces some business or legal risk, the other subsidiaries are isolated from the risk because they are contained in separate legal entities with limited liabilities. This separation of liabilities safeguards the overall business.

D. TAX EFFICIENCY

Tax efficiency can be achieved by organizing different functions in different subsidiaries based on the relative tax rates and incentives available in different jurisdictions.

E. INTELLECTUAL PROPERTY AND INTANGIBLE ASSETS

Intellectual property and other intangible assets that the startup owns could be residing with the holding company and legal risks could be minimized. The holding company could license the intellectual properties to each subsidiary on a need-basis.

F. FLEXIBILITY OF INVESTMENT

Flexibility of investment is available to investors. Value-creation takes place at the holding company level and investors have the choice to invest either in the entire group (by investing in the holding company) or to invest only in one business (by investing in the particular subsidiary).

G. ACCESS TO GLOBAL FINANCE

Access to global finance is made easy by having a foreign holding company, which, on the basis of its financial strength, can have access to cheap funds from sources abroad which can be utilized to fuel the growth of its operations in multiple operational jurisdictions.

H. EXIT FLEXIBILITY

Flexibility of exit is available to investors as well as founders. They could exit from one business or the entire group. This is typically useful in case of reorganizations such as mergers and acquisitions.

HOLDING COMPANY: LOCATION

COMPLEXITY

Setting up foreign holding companies is relatively easy – thus, this idea should not be discarded merely because we’re talking about a foreign or unknown country where the founders may not be having any presence at all. Professional services are available of individuals and other service providers to take care of the initial friction in this regard.

INDIAN HOLDING COMPANY

In case the startup’s business is entirely, and forever, going to be located in India, the startup may choose to have an Indian holding company. Further, if the startup does not need immediate seed or angel or venture capital and does not also contemplate any exit to be provided to any investor or founder, it may restrict itself entirely within India.

FOREIGN HOLDING COMPANY

A startup that has ambitious global growth plans and requires access to global investor funds would want to have its holding company situated in a jurisdiction which has these factors readily available. Similarly, a startup that immensely relies on intellectual property generation and monetization would choose to base its holding company in a jurisdiction that offers a wonderful intellectual property regime.

EXPERT ADVICE

The decision regarding the exact location of the holding company should be made with expert advice because a number of factors would go as inputs into the decision making. The decision making would involve projecting the founders’ plans and vision into the business, legal, and tax realities of various jurisdictions, and a qualitative comparison of the relative advantages and disadvantages.

MULTIPLE SUBSIDIARIES

While multiple factors may govern the decision to form a new subsidiary for a new line of business, dependency on present business, fund availability and requirement, and risk involvement are the most critical factors in this decision-making.

FACTOR NO. 1 DEPENDENCY ON PRESENT BUSINESS

If the new line of business is naturally integrated and entirely depends on the present business, a new subsidiary would needlessly distance it from action and discount the possible synergies. Setting up a new subsidiary, where the end-product or service offering to the customer is integrated with the present business, would complicate the business model and optically look suspicious. On the other hand, if there is a remote degree of reliance on and connection with the present business, it would be desirable to run the new business in a new subsidiary.

FACTOR NO. 2 FUND AVAILABILITY AND REQUIREMENT

If the new line of business requires funds which are only available with the present business or subsidiary, and if the investors are not keen to separately fund the new business, a new subsidiary may not be advisable. However, if the holding company is deep-pocketed or the investors are ready to put-in additional funds either into the holding company or the new line of business separately, a new subsidiary would be a suitable option to go with.

FACTOR NO. 3 RISK INVOLVEMENT

If the new line of business is prone to risks (including legal, financial, competitive, and operational risks), it would be recommended to commence such business in a new subsidiary so that the existing business(es) could be isolated and shielded from the risks.

STARTUP CHARTER

WHAT IS THE CHARTER?

The Startup Charter is a legal document, serving as the philosophical guiding tool, the startup's Bible, and a guideline document containing the vision, mission, structural logic, roles and responsibilities, relationship definitions, and other aspects critical to the functioning of the startup.

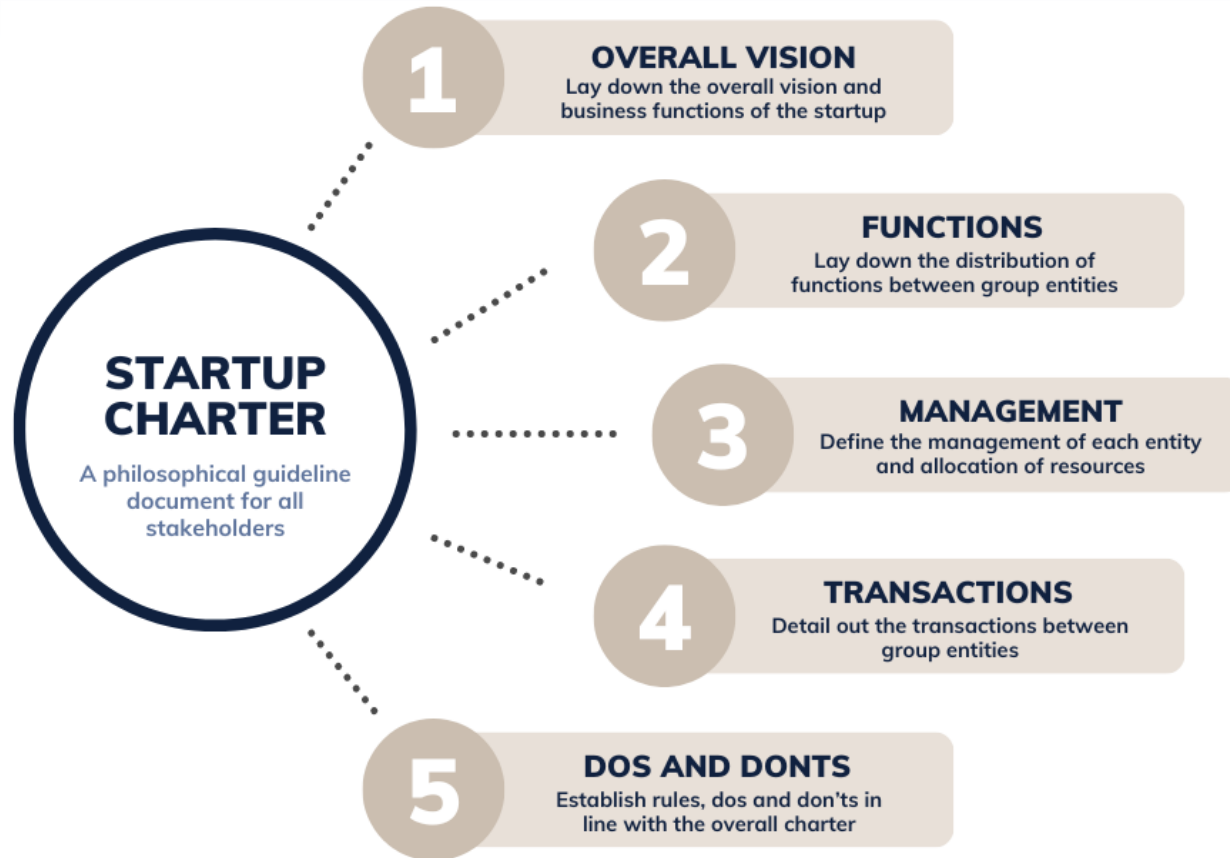
WHO IS IT MEANT FOR?

The Charter is meant for all stakeholders dealing with the startup's business. This would include founders, employees, investors, as well as regulators. There should be no deviation from what's stipulated in the charter document and any revision to the same should be carefully done, with expert advice, and only under exceptional circumstances.

WHICH LAWS NEED TO BE COVERED WHILE DEVELOPING THE CHARTER?

All commercial, tax, consumer, corporate and other laws should be taken as inputs for developing the charter. For instance, laws relating to companies, foreign exchange, competition, income-tax, GST, transfer pricing, international tax, benami properties, money laundering, corporate governance, investments, technology, privacy and data protection, commercial transactions, besides other laws, should be factored in.

STARTUP CHARTER: CONSTITUENTS



The Startup Charter should be developed closely between the promoters/founders (who provide the vision and business inputs) and lawyers/CAs (who provide the legal, accounting, and regulatory knowledge), to give birth to a comprehensive guideline document.

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Metalegal Advocates is a litigation and advisory law firm having offices in New Delhi and Mumbai, providing services in the fields of corporate laws, financial crimes, tax disputes (income-tax, GST, black money, VAT and other taxes), technology laws, securities laws, FEMA, and other related business and mercantile laws to businesses and individuals in a wide array of industry verticals.

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