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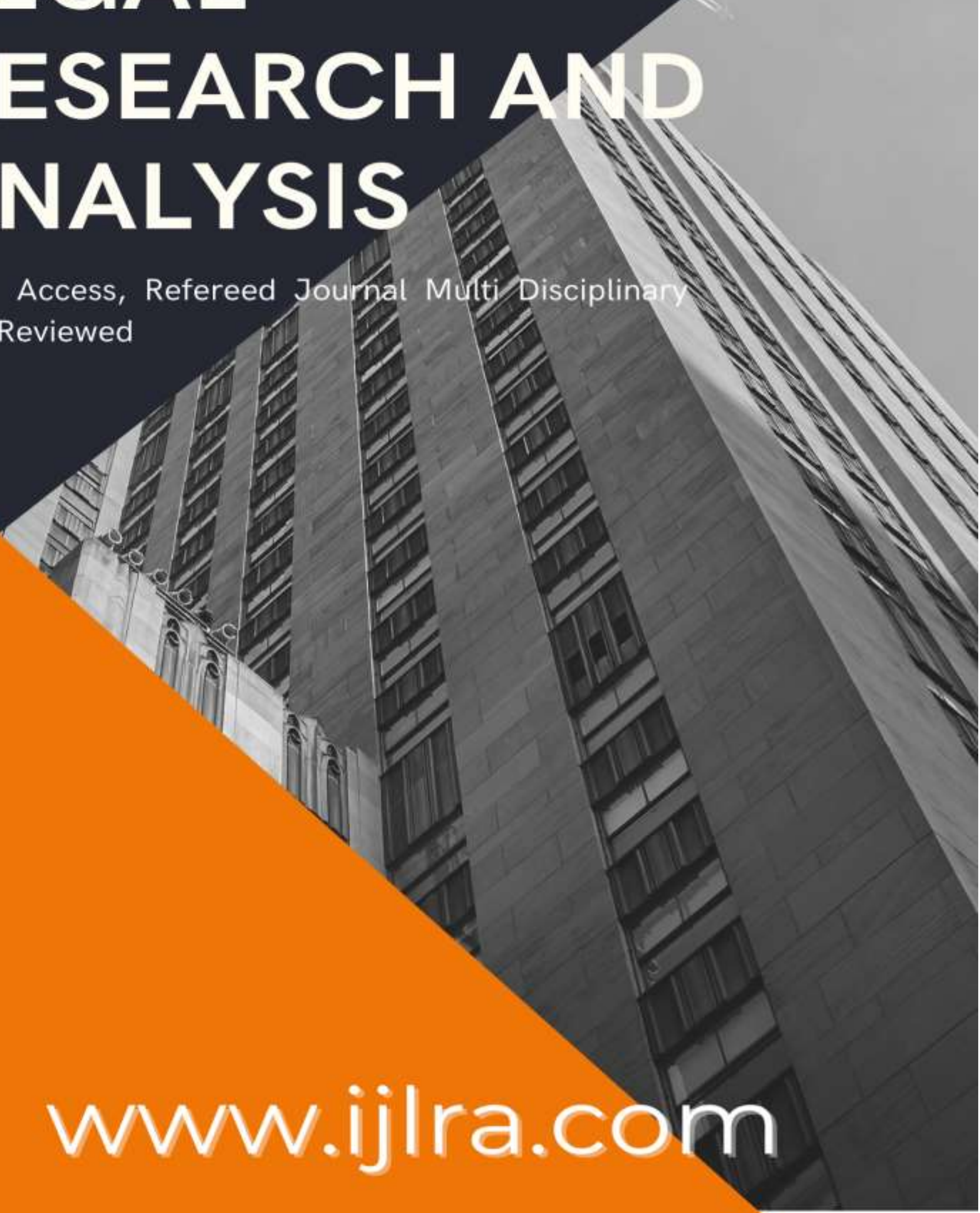

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Avinash Kumar

Avinash Kumar has completed his Ph.D. in International Investment Law from the Dept. of Law & Governance, Central University of South Bihar. His research work is on "International Investment Agreement and State's right to regulate Foreign Investment." He qualified UGC-NET and has been selected for the prestigious ICSSR Doctoral Fellowship.He is an alumnus of the Faculty of Law, University of Delhi. Formerly he has been elected as Students Union President of Law Centre-1, University of Delhi.Moreover, he completed his LL.M. from the University of Delhi (2014-16), dissertation on "Cross-border Merger & Acquisition"; LL.B. from the University of Delhi (2011-14), and B.A. (Hons.) from Maharaja Agrasen College, University of Delhi. He has also obtained P.G. Diploma in IPR from the Indian Society of International Law, New Delhi.He has qualified UGC – NET examination and has been awarded ICSSR – Doctoral Fellowship. He has published six-plus articles and presented 9 plus papers in national and international seminars/conferences. He participated in several workshops on research methodology and teaching and learning.

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OPPRESSION & MISMANAGEMENT IN STARTUPS AND SMALL COMPANIES: UNIQUE CHALLENGES

AUTHORED BY - CS SHRADDHA JAIN
Company Secretary, B.A. LL.B (Hons),
School of Law, Devi Ahilya Vishwavidhyalaya, Indore, PhD. (P)
Research Scholar at Oriental University, Indore

Abstract

Small businesses and startups are important contributors to any economy in terms of growth, innovation, and job creation. Unfortunately, these enterprises face severe governance issues in the form of oppression and mismanagement resulting from weak inter-relationships between various stakeholders such as investors, founders, and minority shareholders. There is inadequate management supervision in startup environments, exposing these firms to internal fights and malicious spending of resources.

In this article, the oppression and mismanagement provisions provided under sections 241 to 245 of The Companies Act, 2013 are examined. The article analyses numerous Indian and foreign governance failures, investor conflicts, regulatory gaps and case studies to expose the gaps in the legal framework. The study goes on to elaborate other issues such as the dismally low threshold for minority shareholder petitions, lethargic dispute resolution processes, and the overpowering control of venture capitalists over business decisions.

This paper seeks to map the landscape of corporate governance in India alongside best practice paradigms from other countries to identify missing gaps. For an effective and sustainable ecosystem for startups, there is need to enhance regulatory compliance, lessen the legal bounds placed on shareholders, and improve transparency. Solving these matters will increase compliance as well as investor trust.

Key Words: Oppression, Mismanagement, Startups, Shareholders, Companies Act, 2013

Introduction

Startups and small businesses are key to economic advancement, innovation, and employment creation. India, with its never-ending rising new ventures, is experiencing an unparalleled boom in new enterprises in some sectors backed by government programs like Startup India, Digital India, Make in India. Nonetheless, rapid expansion entails unique governance problems that culminate in internal strife, poor management, and abuse of minority shareholders.

In contrast to large public companies which have set governance policies, startups function with some level of autonomy, and in most cases, the policies are not fully formed or if formed are not properly implemented. Different parties like founders, investors, and other stakeholders have divergent goals, which leads to conflicts over spending, grand strategy, and operational control of the business. The lack of proper governance arrangements creates a power vacuum which the majority actors fill by abusing the minority shareholders' rights.

Conversely, poor management is often caused by too much power vested in an individual or a team who makes damaging decisions regarding the finances, business activities, or simply do nothing to deliver value to the business and its stakeholders. Increasingly common behavior includes startup founders withdrawing funds, not reporting financial information, or decisions without engaging the board. This illustrates the reason why having a strong legal protection system is vital for protecting investors and ensuring business continuity.

To a certain extent, Sections 241-246 of The Companies Act, 2013 provide solutions for oppression and mismanagement. However, lack of effectiveness stems from several practical problems like unreasonable barriers for filing complaints set by minority shareholders, prolonged legal battles, and enforcement of tribunal's decisions. In addition, the overwhelming power of venture capitalists and big investors most often tilt the balance of power against small shareholders seeking justice.

This paper seeks to address these issues by provisions of law, case studies and comparative analysis of best practices from other jurisdictions. This way, they proffer how best transparency and protection of stakeholder rights and long term sustainability of the startup ecosystem can be achieved.

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Definitions and Conceptual Framework

The words "oppression" and "mismanagement" are not defined in the Act. The meaning of these words for the purpose of Company Law should be used in a broad generic sense and not in any strict literal sense.

Oppression

Oppression is any action by the majority shareholders or the management that disproportionately prejudices or damages the rights of minority shareholders. It encompasses acts like unfair dilution of equity, withholding of voting rights, and exclusion from decision-making.

Mismanagement

Mismanagement takes place when the affairs of a company are handled in a way that is contrary to its overall health, financial stability, or compliance with the law. Instances include financial forgery, fund embezzlement, absence of transparency, and unethical operations.

Minority Rights

Minority rights are the legal safeguards and benefits enjoyed by minority shareholders to protect them from exploitation at the hands of the majority. Minority rights comprise equitable participation in decision-making, access to the books of the company, protection against oppressive dilution of shares, and the right to appeal to legal authorities in the event of oppression or mismanagement.

Legal Provisions under the Companies Act, 2013

Chapter XVI of The Companies Act, 2013, lays down several provisions to protect shareholders from oppression and mismanagement. The key sections that govern these issues include:

Section 241- Application to Tribunal for Relief in Cases of Oppression, etc.

According to section 241(1), any member of the company may apply to the Tribunal, provided such member has a right to apply under section 244, for an order under this Chapter, if he who complains that

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a) the affairs of the company have been or are being conducted in a manner prejudicial to public interest or in a manner prejudicial or oppressive to him or any other member or members or in a manner prejudicial to the interests of the company; or
b) the material change, not being a change brought about by, or in the interests of, any creditors, including debenture holders or any class of shareholders of the company, has taken place in the management or control of the company, whether by an alteration in the Board of Directors, or manager, or in the ownership of the company's shares, or if it has no share capital, in its membership, or in any other manner whatsoever, and that by reason of such change, it is likely that the affairs of the company will be conducted in a manner prejudicial to its interests or its members or any class of members.

Section 242- Powers of Tribunal

Section 242(1) provides that on any application made under section 241, the Tribunal may, with a view to bringing to an end the matters complained of, make such order as it thinks fit, if it is of the opinion—

a) that the company's affairs have been or are being conducted in a manner prejudicial or oppressive to any member or members or prejudicial to public interest or in a manner prejudicial to the interests of the company; and
b) that to wind up the company would unfairly prejudice such member or members, but that otherwise the facts would justify the making of a winding-up order on the ground that it was just and equitable that the company should be wound up.
c) Section 242(2) provides that without prejudice to the generality of the powers under sub-section (1) an order under that sub-section may provide for—
d) the regulation of conduct of affairs of the company in future;
e) the purchase of shares or interests of any members of the company by other members thereof or by the company;
f) in the case of a purchase of its shares by the company as aforesaid, the consequent reduction of its share capital;
g) restrictions on the transfer or allotment of the shares of the company;
h) the termination, setting aside or modification, of any agreement, howsoever arrived at, between the 685 company and the managing director, any other director or manager, upon such terms and conditions as may, in the opinion of the Tribunal, be just and equitable in the circumstances of the case;

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i) the termination, setting aside or modification of any agreement between the company and any person other than those referred to in clause (e): No such agreement shall be terminated, set aside or modified except after due notice and after obtaining the consent of the party concerned;

j) the setting aside of any transfer, delivery of goods, payment, execution or other act relating to property made or done by or against the company within three months before the date of the application under this section, which would, if made or done by or against an individual, be deemed in his insolvency to be a fraudulent preference;

k) removal of the managing director, manager or any of the directors of the company;

l) recovery of undue gains made by any managing director, manager or director during the period of his appointment as such and the manner of utilisation of the recovery including transfer to Investor Education and Protection Fund or repayment to identifiable victims;

m) the manner in which the managing director or manager of the company may be appointed subsequent to an order removing the existing managing director or manager of the company made under clause (h);

n) appointment of such number of persons as directors, who may be required by the Tribunal to report to the Tribunal on such matters as the Tribunal may direct;

o) imposition of costs as may be deemed fit by the Tribunal;

p) any other matter for which, in the opinion of the Tribunal, it is just and equitable that provision should be made.

Section 244- Right to members to apply

Section 244 (1) provides that the following members of a company shall have the right to apply under section 241, namely:—

a) in the case of a company having a share capital, not less than one hundred members of the company or not less than one-tenth of the total number of its members, whichever is less, or any member or members holding not less than one tenth of the issued share capital of the company, subject to the condition that the applicant or applicants has or have paid all calls and other sums due on his or their shares;

b) in the case of a company not having a share capital, not less than one-fifth of the total number of its members: Provided that the Tribunal may, on an application made to it in this behalf, waive all or any of the requirements specified in clause (a) or clause (b) so as to enable the members to apply under section 241.

Section 244(2) provides that where any members of a company are entitled to make an application under sub-section (1), any one or more of them having obtained the consent in writing of the rest, may make the application on behalf and for the benefit of all of them.

Section 245- Class Action Suit

This section provides for a group of aggrieved shareholders to institute a class action suit against a company and its management for:

- Fraudulent practices.
- Misappropriation of company resources.
- Any behavior that prejudicially affects shareholder interests.

Class action lawsuits offer yet another level of security against mass mismanagement.

Challenges in Implementation of Legal Provisions

Even with the existence of a strong legal system under the Companies Act, 2013, there are some challenges in law implementation regarding oppression and mismanagement in small firms and startups. Some of the major challenges are:

1. **High Threshold for Filing Petitions**

   Under Section 244 of the Companies Act, a minority shareholder must own at least 10% of the issued share capital (or satisfy other specified percentages) to make a petition for oppression and mismanagement. In start-ups, where ownership is very dispersed among angel investors, venture capitalists, and small stakeholders, it is hard for minority shareholders to satisfy the eligibility criteria to initiate legal action.

2. **Limited Awareness and Legal Knowledge**

   Most startup founders and investors lack knowledge of the corporate laws and their rights according to the Companies Act, 2013. The ignorance contributes to the minority shareholders being at risk of exploitation due to underutilization of available legal relief.

3. **Delayed Dispute Resolution**

   Startups do business in environments with high-paced turnover where delay in the administration of justice hits them hard in their business ventures. NCLT proceedings drag on for years as a result of pendency of cases, resulting in unnecessary uncertainty for stake-holders at stake. Slowness to resolve disputes detours investors away from approaching courts of law.

4. **NCLT Orders: Issues of Enforcement**

   Implementing orders stemming from cases of oppression and mismanagement is not straightforward even when the NCLT attempts to assist. Non-compliance with tribunal orders can create additional legal issues leading to more litigation. Most startups do not have the financial and organizational resources to remediate many of these orders.

5. **The Influence of Majority Shareholders and Investors**

   In most startups, venture capitalists and private equity companies control a significant degree of decision-making power. These shareholders can silence the lower shareholders and make it harder to overcome instances of oppression and mismanagement. The disparity of power between investors and founders create an ineffective legal environment where protective measures do little to help.

6. **The Fear of Retaliation**

   The majority of minority shareholders, employees, and even whistle-blowers do not sue for the blatant mismanagement of their startup because of the consequences that may follow. These consequences include unemployment, less pay, or being made an outcast in the industry. The lack of adequate whistle-blower protection makes this situation worse.

7. **Regulatory Gaps and Inconsistent Enforcement**

   Although the Companies Act, 2013, makes provision for the redress of oppression and mismanagement, regulatory oversight is lacking. Most startups are in new and fast-developing sectors where laws and regulations lag behind arriving challenges. Inconsistencies in enforcing rules create regulatory loopholes that unscrupulous founders and investors may take advantage of.

8. **Financial Burden on Minority Shareholders**

   Taking legal action entails enormous monetary means, and minority shareholders can lack them. Minority stakeholders are discouraged from instituting legal proceedings due to the legal costs, judicial fees, and long delays. Major investors and majority stakeholders may enjoy greater access to good legal facilities, hence making the minority shareholders at a disadvantage.

9. **Proving Mismanagement**

   In contrast to big companies with stringent audit requirements, most startups do not have adequate financial reporting systems. Minority shareholders might find it hard to obtain enough evidence to support allegations of financial mismanagement or oppression, and hence it would be challenging to win legal cases.

10. **Absence of Independent Oversight Bodies**

    Startups usually function with less regulatory oversight than publicly listed businesses. The lack of independent monitoring committees or outside governance organizations permits free rein decision-making, which heightens the chances of oppression and mismanagement.

Challenges in Startup Governance

1. **Founder-Investor Conflicts**

   One of the most urgent governance issues in startups is founder-investor conflicts. Startups in the early stage tend to receive funding from angel investors, venture capitalists, or private equity. But as the business matures, vision and priority differences in decision-making may trigger conflicts. Investors might urge speedy scalability and profitability, whereas founders prioritize long-term innovation and business sustainability. Conflicts may result in hostile takeovers, dilution of founder control, and operational instability.

2. **Minority Shareholder Oppression**

   In most startups, majority shareholders, who are frequently venture capitalists or institutional investors, have great control over business decisions. This imbalance of power may contribute to the oppression of minority shareholder rights, such as exclusion from crucial business plans, inadequate financial disclosure, and unfair dilution of their interests. Sections 241-244 of the Companies Act, 2013, offer redressal avenues, but the stringent requirement for making complaints (10% shareholding requirement) discourages small shareholders from being able to effectively challenge oppressive practices.

3. **Mismanagement and Financial Irregularities**

   Mismanagement is another serious problem that afflicts startups. Founders and senior executives can indulge in financial mismanagement, such as misuse of investor capital, absence of proper accounting procedures, or outright fraud like revenue inflation. The lack of effective internal controls and governance structures usually compounds these problems, resulting in financial instability and regulatory attention.

4. **High Legal and Regulatory Barriers**

   The legal environment for startups in India, although well-intentioned, poses serious enforcement issues. The procedure for filing a complaint under Section 241 is cumbersome, requiring voluminous documentation, legal counsel, and a long tribunal process, making it unviable for small investors or minority stakeholders to approach the courts for relief. Moreover, startups that operate globally encounter problems in reconciling with various jurisdictional regulations, raising compliance expenses and legal complications.

5. **Power Conflicts in the Boardroom**

   Startups' board composition and governance processes tend to privilege founders or large investors at the expense of independent directors and other important stakeholders. This imbalance may result in one-sided decision-making, decreasing accountability and raising the chances of mismanagement. Startups often do not have institutional corporate governance arrangements and consequently have unclear decision-making processes that prefer majority stakeholders.

6. **Lack of Clarity in Exit Strategies**

   Another major challenge is the lack of well-defined exit strategies for shareholders and investors. Unlike listed companies, startups lack a defined market for selling shares, and investors find it hard to sell their stakes. In the event of conflicts, the lack of well-defined exit mechanisms tends to result in long legal disputes, further entangling governance challenges.

7. **Employee and Founder Disputes**

   Conflict between employees, co-founders, and executives also gives rise to governance issues. Uncertainty about employment agreements, inadequate vesting schedules for equity, and disagreements regarding intellectual property rights lead to legal battles. With increasing scaling, it is challenging to handle an expanding number of employees with a transparent and equitable governance setup.

8. **Regulatory Uncertainty and Compliance Issues**

   Startups engaged in new industry areas like fintech, e-commerce, and artificial intelligence also encounter regulatory unknowns. Drastic policy alterations, ambiguous tax norms, and changing compliance conditions add more governance risks. Non-compliance by startups with new regulatory requirements might result in fines, business dislocation, or investor loss of confidence.

   Disputes arising in such scenarios are mostly over conflicting visions of the company, differences on finance strategy, and disagreements on exit or liquidity events.

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Indian Case Studies

1. **BharatPe Controversy**

   BharatPe, a fintech unicorn, was hit by a corporate governance crisis when its co-founder was charged with financial impropriety. The lack of effective oversight mechanisms by the board resulted in financial irregularities. This case suggests the dangers of weak governance within startups, especially in founder-led startups.

2. **Snapdeal's Investor Disputes**

   Snapdeal, a leading e-commerce player, experienced investor discontent and boardroom disputes, resulting in collapsed merger discussions with Flipkart. Governance issues within and strategic misalignment were among its factors for downfall.

3. **Blinkit Payment Delays**

   Blinkit (formerly known as Grofers) has experienced allegations of financial mismanagement, especially in the form of delayed payments to vendors and delivery partners. This was a matter of concern regarding operations transparency and financial governance.

Paytm's Regulatory Challenges

Paytm's regulatory compliance and financial loss issues have created governance and shareholder transparency concerns. Several instances of shareholder vs. management conflicts underscore the need for compliance in fintech startups.

OLA's Crisis of Leadership

India's premier ride-hailing firm, OLA, has experienced several executive departures and investor jitters regarding financial management and corporate governance. Board-founder disputes have further tightened investor relations.

BYJU'S Accounting Irregularities

BYJU'S, India's largest ed-tech startup, has been questioned on its accounting reporting practices, investors' conflicts, and claims of pushy sales. The governance issues of the company emphasize how transparency is vital in startup accounting operations.

Myntra's Leadership Changes and Operational Challenges

Myntra, one of the top fashion online players, has witnessed leadership transitions and operational inefficiencies that have affected its growth path. Investor management disagreements have cast a shadow over decision-making transparency.

Comparative Analysis: India v. Global Best Practices

United States (Delaware Law)

The corporate law of Delaware is very investor friendly, especially via strict fiduciary obligations over directors. Its legal system prevents the directors from taking decisions contrary to the larger good of shareholders rather than simply the majority of them. While in India business-unfriendly legislation slows down corporate governance-related disputes being resolved, that is not possible under Delaware law.

United Kingdom (Companies Act, 2006)

UK law has "unfair prejudice" remedies, under which minority shareholders can approach the courts with less restriction than under Indian law. This legal provision is especially handy where shareholder conflicts are a regular feature in startups.

Singapore's Startup Governance Model

Singapore highlights transparency and investor rights, creating one of the most startup-friendly regulatory environments in the world. Strong regulations ensure that governance failure is minimized and shareholder interests protected.

Conclusion

To overcome these challenges, a mix of legal reforms, enhanced regulatory control, and greater awareness among stakeholders is needed. Improved enforcement mechanisms, lowering the threshold for minority shareholders to file petitions, and speeding up the process of resolving disputes at the NCLT can make the legal framework more effective. Startups should also implement improved internal governance practices involving greater transparency, accountability, and safeguarding minority shareholder rights. By filling these gaps, India's startup ecosystem can build a more investor-friendly and equitable business environment.

Mismanagement and oppression in startups continue to be major issues, impacting investor confidence and business viability. Long-term stability requires strengthening governance structures and investor protections.

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