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LEGAL CHALLENGES FACED BY INDIAN STARTUPS IN INDIA: A CRITICAL ANALYSIS

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DECLARATION

I, Pratyush Vikram Singh, hereby declare that the present dissertation titled "Legal Challenges Faced by Indian Startups in India: A Critical Analysis" is an original work carried out by me under the guidance of my supervisor, Ms./Dr. Archana Agarwal, Amity Law School, Noida, Amity University, Uttar Pradesh.

This dissertation has not been submitted previously to any other university or institution for the award of any degree or diploma. All sources of information used in this dissertation have been duly acknowledged in the references section.

I also declare that no part of this work has been plagiarised and that the research presented here is entirely my own, except where duly cited or acknowledged.

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CERTIFICATE

This is to certify that the dissertation titled "Legal Challenges Faced by Indian Startups in India: A Critical Analysis" submitted by Pratyush Vikram Singh (Enrollment No.: A3221621029) in partial fulfilment of the requirements for the award of the degree of Bachelor of Commerce and Bachelor of Laws (B.Com LL.B Hons.) from Amity Law School, Noida, Amity University, Uttar Pradesh, is a bonafide research work carried out under my supervision and guidance.

To the best of my knowledge and belief, the dissertation is an original contribution and has not been submitted previously to any university or institution for the award of any degree or diploma.

Date: _____

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ABSTRACT

The Indian startup ecosystem has undergone a transformational evolution over the past decade, emerging as the third largest in the world by number of recognised startups, behind only the United States and China. Government-backed initiatives such as Startup India (2016), the introduction of the Fund of Funds, and DPIIT recognition mechanisms have created an enabling environment for entrepreneurship. Yet, beneath this impressive growth narrative lies a complex and often burdensome legal landscape that continues to challenge even the most promising ventures.

This dissertation undertakes a comprehensive doctrinal and analytical study of the legal challenges encountered by Indian startups across their lifecycle — from incorporation to scaling and exit. The research examines challenges in the domain of corporate structuring, regulatory compliance, labour law, taxation, investment and funding frameworks, intellectual property protection, and the evolving data protection regime in India.

A critical focus of this dissertation is the concept of 'regulatory cholesterol' — an accumulation of outdated, overlapping, and often contradictory regulations that collectively stifle entrepreneurial agility. The dissertation analyses specific statutory provisions under the Companies Act, 2013; the Income Tax Act, 1961; the Goods and Services Tax framework; the Insolvency and Bankruptcy Code, 2016; the Foreign Exchange Management Act, 1999; and the recently enacted Digital Personal Data Protection Act, 2023.

Drawing on landmark case laws such as the Angel Tax disputes, the Flipkart flip structure controversy, the Ola Electric POSH compliance case, and the BharatPe v. Ashneer Grover dispute, the dissertation contextualises legal theory within startup reality. It also examines international comparative practices from jurisdictions such as Singapore, the United States, and the United Kingdom to benchmark India's regulatory environment.

The dissertation concludes with a set of concrete findings and reform suggestions aimed at policymakers, legal professionals, and startup founders. These recommendations address the rationalisation of compliance burdens, reform of angel tax provisions, simplification of ESOP taxation, protection of intellectual property for early-stage ventures, and strengthening of data protection frameworks.

The research methodology adopted is primarily doctrinal, supplemented by comparative legal analysis and secondary empirical data from industry reports, government policy documents, and judicial records. The dissertation makes an academic contribution to the growing field of startup law in India while remaining accessible to practitioners, policymakers, and students of law alike.

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Keywords: Indian Startups, Legal Challenges, Regulatory Compliance, Angel Tax, ESOP, DPIIT, Intellectual Property, DPDP Act, FEMA, Companies Act 2013

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CHAPTER 1: INTRODUCTION

1.1 Background: The Indian Startup Ecosystem Explodes

India's startup narrative is, to a degree, a narrative of ambition in the face of difficulty. With over 1,17,000 DPIIT-approved startups in 2024, India has gone from a few IT startups in the early 2000s to establishing one of the world's most dynamic entrepreneurial ecosystems. This ecosystem has witnessed high-growth phases, a plethora of billion-dollar unicorns, and an increasing spirit of innovation that has permeated the economy, including fintech, edtech, agritech, and healthtech.

This ecosystem emerged from the liberalisation of the Indian economy in 1991. It allowed Indian markets to experience both competitive pressure and new investment opportunities. The surge of the IT services industry in the late 1990s and the beginning of the 2000s allowed a generation of well-trained engineers to become entrepreneurs. This, in turn, allowed major urban Indian centers, such as Bengaluru, Hyderabad, and the Delhi-NCR area to become hubs for startups, which lured resources, talent, and infrastructure.

The beginning of a new chapter happened in 2016, with the introduction of Prime Minister Narendra Modi's "Startup India" program. This program set out a roadmap for government

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assistance to new companies. Such assistance included reducing regulatory red tape, providing tax benefits, offering financial assistance via the SIDBI-managed Fund of Funds scheme, and establishing a formal method of recognition for startups via the Department for Promotion of Industry and Internal Trade (DPIIT). This program for the first time explicitly recognized the status of startups as a category separate from established firms, which would be treated differently under the law.

As of 2023, India had 108 unicorns, millions of jobs directly and indirectly, billions of dollars of FDI, and startup cultures in tier-2 cities including Pune, Jaipur, Ahmedabad, and Lucknow. Its contribution to the Indian GDP, while difficult to measure, is clearly significant and continues to increase.

These headline figures, though impressive, hide the stark challenges that Indian startups face on a day-to-day basis. For every startup that achieves Series A funding status or unicorn recognition, hundreds find themselves struggling with the weight of regulatory obligations, tax litigation, disputes over intellectual property, the intricacies of labor law, and investment deals that were never really meant for startups in the first place. Indian startup law is still largely modeled after systems designed for an older type of enterprise.

1.2 Legal Definition of a "Startup"

India's definition of "startup" has been formulated by the DPIIT by Notification No.

G.S.R. 127(E) of 19th February 2019, with subsequent amendments. An entity would be considered a startup if it complies with these conditions:

(a) the entity should be incorporated or registered in India as a private company as defined in clause (68) of section 2 of the Companies Act 2013, or a partnership firm or an LLP. (b) it has not been completed ten years from the date of its incorporation or registration.

(c) it has not crossed its annual turnover of one hundred crore rupees for any of the financial years since its incorporation.

(d) it is working towards innovation, development or deployment or commercialisation of new products, processes or services driven by technology or intellectual property and its business model is scalable with high potential of employment generation or wealth creation it is not an entity formed by splitting up or reconstruction of a business already in operation It would be pertinent to note the importance and advantages of obtaining the DPIIT recognition. DPIIT certification allows a startup to avail a host of benefits and incentives such as tax exemption under Section 80-IAC of the Income Tax Act 1961, exemption from angel tax under Section 56(2)(viib) of the Income Tax Act 1961, Self-certification under certain labor and other laws,

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faster examination of patents, and access to Fund of Funds Scheme. However, obtaining and maintaining DPIIT recognition also involves certain procedural compliance and requirements that many of the start-up founders may find burdensome.

Moreover, it is worth noting that the current definition of startup excludes many real-life start-ups, mostly because they cannot be termed as innovative businesses or businesses which have a scalable technology. Hence many businesses in sectors like agriculture or retail and many others which may not fit the typical business model of a start-up are not included in the purview of the definition of a start-up. This creates a certain section of businesses which have the business model and risk of a start-up without having the benefits associated with being a start-up.

1.3 Economic Contribution of Startups

The contribution of startups to the Indian economy is not merely limited to direct job creation but includes broader socio-economic impacts as well. Startups have the ability to disrupt markets, introduce innovation, and fill in gaps in the economy. The Economic Survey of India 2021-2022 highlights that startups in India alone have been responsible for direct job creation for a total of approximately 7.46 lakh people. Further, the contribution towards the indirect job creation is significantly high as well, taking into account the number of jobs that are created by a startup in the supply chain, distribution, etc.

The funding landscape has also evolved significantly. India received almost $42 billion in startup funding in 2021. However, as of 2022-2023 there has been a dip in the startup ecosystem. Certain sectors have seen massive inflows in funding as compared to others. Technology and SaaS, edtech, fintech, and ecommerce continue to draw large amounts of investment. Furthermore, as the domestic markets develop, startups have become an alternative form of investment, with startups like Zomato, Nykaa, PolicyBazaar, etc., going public. As a result, the investment climate has only further developed. The startups contribute towards the economy not only by creating jobs for individuals in their respective companies or supply chain but also by making their products and services available for use, generating income tax and foreign exchange earnings. The start-up sector also plays an active role in social impact, providing financial services, and offering innovative solutions to sectors like healthcare, education, and food security. In recognition of the contribution that startups make toward the economy, successive governments in India have taken steps to ease various regulations and create a favorable business climate for startups.

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1.4 Problem Statement: The Concept of Regulatory Cholesterol

Despite the growth in the number of startups in India and the growing popularity of the Indian Startup Ecosystem, the Indian startup has to continuously grapple with certain issues which are well-documented and are being addressed by various stakeholders of the Indian Startup Ecosystem. A startup in India finds itself facing a challenging legal and regulatory regime, which is fraught with ambiguity, a maze of overlapping regulatory frameworks with no clear guidance, inconsistent or contradictory treatment of startups, and varying levels of compliance requirements. Ramesh Abhishek, the erstwhile Secretary of DPIIT, and many industry reports have frequently used the words 'regulatory cholesterol' to describe regulatory clutter that slowly chokes off the free flow of startup culture. Indian regulatory framework evolved with a vision to regulate large, formal, hierarchical, and slow-moving entities and it may appear to be anachronistic given the nature of startups, which are small, informal, fluid and fast moving. Startups therefore have to adhere to numerous regulatory requirements and often have to choose between them as these are not always consistent with each other. Startup founders must comply with Companies Act for regulation of corporate structures, Income Tax Act for direct taxes, GST Act for indirect taxes, FEMA for external transactions, labour Codes or their predecessors for hiring of personnel, SEBI regulations for fundraising, and patent and trademark law and recently also DPDP Act for protection of Intellectual Property and data. These laws are governed by different regulatory bodies and have their own regulatory compliances, filing requirements and penalties. It is very difficult for a company to follow these rules, let alone a two-person start-up working out of a co-working space.

The purpose of the current dissertation is to discuss the legal challenges faced by the startup ecosystem in India and to provide suggestions to make them more conducive. In order to do this, this dissertation seeks to comprehensively examine the legal issues related to the corporate structure of a startup, funding of startups, IP and data protection laws for startups and taxation related issues to the startups. The study has been carried out through secondary sources and has relied on various cases laws, policy papers, regulatory guidelines, industry reports, secondary literature, and international practice. A brief overview of the research objectives and methodology followed is provided in the paragraphs below.

1.5 Research Objectives

The research objectives of this dissertation are to:

(i) to examine the evolution of the startup ecosystem and its regulatory framework in India; (ii) to understand the challenges faced by the startups in their corporate structuring, particularly in

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relation to choice of entity (private limited company vs LLP and vice versa) and the concept of flip structure; (iii) to examine the compliance related challenges faced by the startups under the corporate and labour laws and its impact on startup ecosystem; (iv) to study the taxation related challenges faced by the startups and the regulatory framework surrounding them including, inter-alia,

angel tax, GST regulation for startups, Taxation of ESOPs and FEMA issues; (v) to study the legal framework for startup funding including regulations for investment by VCs and angels; (vi) to examine the status of protection for IP rights of startups and the regulation related to data protection; and (vii) to study landmark judgments and orders in relation to startups to derive conclusions and provide suggestions for future. (viii) to make suggestions for the reform of regulatory requirements for startups in India with the aim to make them more conducive.

1.6 Research Methodology

This dissertation follows a predominantly doctrinal method of research. Doctrinal research focuses on the study of legal texts, statutes, regulations, case laws, and principles, in a systematic manner so as to analyze the law as it exists. Accordingly, this dissertation studies the primary legal sources like the Companies Act 2013, Income Tax Act 1961, FEMA 1999, DPDP Act 2023, and other SEBI circulars and regulations. This study is complemented by secondary sources such as judgements of the Supreme Court and the High Courts, orders by the NCLT and NCLAT, notifications and circulars from DPIIT, and guidance by the RBI. The doctrinal study is supplemented with a comparative legal approach in appropriate places in the dissertation. In such cases, comparison of Indian law is made with the law of Singapore, United States of America, and United Kingdom to understand the regulatory regime of India in relation to startups in light of global standards. However, in the case of comparison, the objective is not to simply copy the foreign model as it may suit the Indian context better. To contextualise the legal analysis within the broader economic reality of the startup ecosystem, this dissertation has relied upon secondary empirical data gathered from industry reports by NASSCOM, Startup India, and IVCA and academic papers published in peer reviewed journals. Though this dissertation does not rely on any primary empirical data from surveys, interviews, etc., it has used an abundance of secondary literature to derive empirical data.

1.7 Scope and Limitations

This dissertation is only about the startup challenges faced primarily in India even though the challenges may involve cross-border activities in some cases like the flip structure, etc. The

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challenges that apply to foreign startups or government-owned businesses or public sector undertakings have been left out of the scope of this dissertation. Some important points must be noted regarding this dissertation. The laws are fast moving and the provisions discussed in this dissertation may have been changed or updated since the time of writing. The most striking example of this is the DPDP Act 2023 for which the rules were not made at the time of writing the dissertation and therefore the full extent of its impact on the startup ecosystem could not be known. Further, this dissertation is based only on published sources and may not be able to take into the informal practices that startup founders have adopted in order to deal with the regulatory challenges they face in the ground reality. In this dissertation, the comparative approach of analyzing other jurisdictions like Singapore, US, and UK is done in a rather cursory manner since this dissertation is on Indian law only. Notwithstanding these shortcomings, this dissertation hopes to present a comprehensive overview of the major legal and regulatory challenges faced by startups in India. It is hoped that this dissertation will provide useful insights for students pursuing a law degree, lawyers who advise startup companies, policymakers, and even the startup founders themselves.

CHAPTER 2: REGULATORY AND STRUCTURAL CHALLENGES

2.1 Introduction

The very first, and arguably most critical, legal step for any founder building a startup is deciding on the business model. This decision has downstream implications for tax, investment, liability, governance, and exit. In India, startups can, among other things, set up their venture as:

(a) a private limited company under the Companies Act 2013

(b) a limited liability partnership (LLP) under the Limited Liability Partnership Act 2008

(c) in some cases, a partnership firm under the Indian Partnership Act 1932 or sole proprietorship

These structures all have legal pros and cons, and the 'right' decision depends on the nature of the business, the stage of its operations, the capital requirements, and the risk tolerance of the founders.

2.2 Private Limited Company vs LLP: A Comparison

The private limited company is the most common form of business for funded startups in India, for good reason. The Companies Act 2013 provides a sophisticated infrastructure for corporate governance, shareholders' rights, and the capital structure of a company. A private limited

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company can issue equity shares, preference shares, compulsorily convertible preference shares (CCPS), and compulsorily convertible debentures (CCDs), all of which are the main means of raising money from a venture capital or angel investor. In a private limited company, shareholders enjoy limited liability, meaning that their liability to the company's debts is capped to the amount of capital they have invested in the company. Furthermore, a company has a separate legal identity from its shareholders and can enter into contracts, acquire assets, and commence or defend legal actions in its own name.

A private limited company, however, has substantial compliance obligations under the Companies Act 2013. A private limited company is required to file annual returns (Form MGT-7), prepare and file financial statements (Form AOC-4), maintain a registered office address, appoint a minimum of two directors, keep statutory registers, record meetings of the board of directors and shareholders, appoint statutory auditors, hold an Annual General Meeting, and fulfill various other requirements depending on the paid-up share capital and turnover of the company. Failure to comply with these requirements can result in monetary penalties, and in some instances, disqualification of directors.

The structure of an LLP was introduced by the Limited Liability Partnership Act 2008. An LLP has fewer formal requirements compared with a private limited company and is suitable for early-stage startups that have not yet been able to secure venture capital. The compliance obligations of an LLP are relatively less; there are no requirements for a board meeting, and there is no need to maintain statutory registers, and a number of the requirements under the Companies Act do not apply to an LLP. The annual maintenance cost of an LLP is much lower than that of a private limited company. But an LLP is not suitable for a startup seeking venture capital funding. A primary reason for this is that a venture capitalist cannot invest in an LLP via shares or other equity instruments. Furthermore, the concept of convertible instruments on which the valuation and funding mechanism of startup businesses is founded does not translate well into the LLP legal structure. Thus, almost all funded startups in India exist as private limited companies, and an LLP structure is suitable for a professional firm or consultancy business, or a bootstrap startup at a very early stage.

If the startup has chosen to set up as an LLP and wants to convert to a private limited company later, for example, in order to raise money from an outside investor, the procedure for this type of conversion is provided for in Section 366 of the Companies Act 2013 read with the Companies (Authorised to Register) Rules 2014. It is legally permissible and possible to effect, but involves an onerous process and is tax inefficient. For tax purposes, this shift is categorized as a 'transfer,' potentially exposing the LLP partners to capital gains liabilities. Consequently,

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this tax disadvantage creates a disincentive for founders to opt for the LLP structure at the outset, even if such a framework is more operationally suited.

2.3 One Person Company (OPC) and Its Restrictions

The Companies Act 2013 introduced the One Person Company (OPC) to encourage individuals who do not wish to have a partner to establish a company. Essentially, an OPC possesses the same attributes as a private limited company in terms of its corporate status, with the distinction that the company may be owned by a single individual. Nevertheless, the OPC has its own restrictions. It is barred from inviting or accepting public deposits or issuing shares having non-voting rights. It is also prohibited from converting itself into a Section 8 company. Moreover, once the paid-up capital exceeds Rs. 50 lakh or annual turnover exceeds Rs. 2 crores, the OPC will be mandatorily re-converted into a private or public limited company. As a result, OPCs are more useful for single-person, smaller-scale operations at early phases but become less viable after certain growth limits.

2.4 Flip: Transferring Company Domicile to Singapore or the United States

Probably the most 'startup' problem is that of the 'flip,' i.e., moving the company structure from India to a jurisdiction more friendly to investors, such as Singapore, the United States (Delaware) or Cayman Islands. A flip occurred in the 2010s, when most large growth-stage start-ups restructured their holding entities to a foreign jurisdiction. This entails establishing a foreign holding company which will own 100% of the Indian operating entity through acquisition of equity from current Indian shareholders. It will be a change from the normal order where the Indian holding company owns the Indian operating company.

Most funds invest into the foreign holding entity. The reason is investor preference, as global venture capital funds (mostly from the USA and Singapore) are generally set up as a foreign entity to which they may only invest into. There are also the reasons of regulatory restriction, benefits of double-taxation avoidance agreements between the investing country and the company country as well as familiarity with Delaware corporate law as a governing law (in the USA, most corporate funds invested by venture capital are governed by Delaware law). Additionally, foreign jurisdictions like Singapore capital markets and USA (NASDAQ and NYSE) stock exchange also offer much more developed exit opportunities for startup companies than local Indian stock markets and exchange.

The mechanics of a flip are as follows: (i) Foreign holding company (Delaware, Singapore or Cayman) is set up (incorporated); (ii) Indian shareholders (founders, investors) subscribe in

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Indian entity shares to the foreign entity; (iii) Investors in the foreign entity subscribe to shares of the foreign entity; and (iv) From here on, the Indian entity would become a subsidiary entity controlled by a foreign holding company (with an Indian resident being on the board of directors or otherwise being in charge). A flip structure allows an Indian startup to retain control over operations in India while providing investors with the legal and tax advantages of an overseas jurisdiction.

However, a 'flip' is a complex process from an Indian legal perspective and a number of compliance requirements have to be met. Under the Foreign Exchange Management Act, 1999 (FEMA) and RBI regulations, if any of the Indian residents transfer Indian shares to a foreign entity, then they must comply with pricing, reporting, approval (if applicable), etc. The ODI (Overseas Direct Investment) provisions were relatively restrictive prior to 2022 and there had been several RBI approval requirements for ODI transactions. These have been relaxed in the new ODI framework brought into effect in August 2022 but the reporting requirements for ODI transactions are somewhat technical and require the founders to have legal help to comply. There are also tax implications. When shares of an Indian company are transferred to an overseas holding company, such as an entity located in the Cayman Islands, it is usually considered a transfer subject to capital gains tax under India's Income Tax Act of 1961. In this process, if the Indian startup has substantial value in the form of intellectual property, like software, patents, or valuable data from customers, the determination of its value for tax purposes can be debatable. The tax authorities might value it differently according to the transfer pricing rules rather than the value agreed upon by the parties in their commercial transaction. In Vodafone International Holdings BV v. Union of India (2012), a landmark case on capital gains tax, not specifically a case on startups, the Supreme Court laid down important guidelines in relation to the taxation of indirect transfer of India assets that are still relevant for Flip transactions in start-ups today. In 2023, the Reserve Bank of India and the Department for Promotion of Industry and Internal Trade (DPIIT) recognized the issues with the Flip process and are in the process of consulting with startups about building a regulatory framework that will make it easier for Indian startups to own companies overseas. The idea of a 'reverse flip,' where companies like Groww and Zepto, having moved outside India, might move back to India before going public domestically, is gaining ground as Indian markets mature and the flip model gets critically reassessed.

2.5 DPIIT Recognition: Benefits, Process, and Gaps

Startups in India are defined by the DPIIT Recognition mechanism under Startup India. The

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DPIIT recognition is critical in as much as it forms the bedrock of all startup policy benefits that accrue to DPIIT-recognized startups, from Section 80-IAC tax holidays to Section 56(2)(viib) of the Income Tax Act, the anti-angel tax exemption. The application for DPIIT recognition is an online one, through the Startup India portal. Startups seeking DPIIT recognition must provide their incorporation certificates, details about promoters, and an overview of the innovation that the startup is engaged in, as well as seek application and approval from the

Inter-Ministerial Board of Certification (IMBC) in certain cases where tax benefits are to be availed of. The process, though in theory a straight-forward exercise, is fraught with several practical issues. For one, it is not clear what 'innovation' is under DPIIT. Startups are expected to 'work towards innovation, development or improvement of products or processes or services,' a vague description that is likely to be open to multiple interpretations. Many startups allege that their application was turned down or delayed for DPIIT's narrow understanding of innovation, and that startups that were service-oriented, engaged with consumer internet, or provided existing services to businesses (B2B) with higher efficiency were unlikely to pass the test of innovation as defined under the DPIIT. Second, an annual turnover limit of Rs. 100 crores implies that any startup that is successful enough to grow fast will outgrow the recognition and lose benefits as well. It may be counterproductive. The more successful startups are punished by a regulatory regime as the startups reach for larger scales. While the DPIIT recognition offers the exemption of certain labour inspections and labour law compliances (startups can self-certify the labour law compliances in a 3 to 5 years time frame), the scope of self-certification is quite limited. They still need to comply with the substance of labour laws; all that happens is the need to get inspected for compliance immediately. Start-ups may also suffer from not understanding the legalities of labour law, but in the meantime are accumulating compliance deficits and face the music at a later stage.

2.6 Registration and Pre-incorporation Challenges

While the incorporation of a private limited company in India has undergone significant streamlining in the last 10 years, with the advent of the SPICe+ form that combines name reservation with DIN allocation and PAN / TAN application, reduced fees, and faster turnaround times (companies now typically incorporated within 3-5 working days rather than weeks/months prior to 2015), the post incorporation compliance requirements have posed new hurdles. As soon as the company is incorporated, it has to open a bank account, transfer the subscribed capital, hold a first board meeting within 30 days from the date of incorporation

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(Section 173 read with Rule 15 of the Companies (Meetings of Board and its Powers) Rules 2014), appoint a statutory auditor within 30 days, and file with the RoC within the due date in a prescribed format. The Act provides for severe financial as well as director disqualification penalties for violation of these requirements, many of them mere formalities without any economic significance. Most first-time entrepreneurs are not conversant with these requirements and the non-compliances pile up in the initial months of operations.

Similarly, a company has to have a registered office in India with effect from the date of its incorporation. This can be problematic for startups that may be functioning out of co-working space or even the founder's house, where there may be no designated "registered office". While a company can adopt a virtual office as its registered address (as long as it can receive mails there), the RoC's understanding of the law varies from region to region.

2.7 Corporate Governance Challenges

A critical legal challenge arises with respect to corporate governance as a startup grows and receives external funding. Investors typically require that the company's shareholders' agreement (SHA) and articles of association (AoA) incorporate various investor protective provisions, such as anti-dilution rights, drag-along and tag-along rights, information rights, affirmative voting rights, board seats, and liquidation preferences. While these provisions are primarily negotiated as matters of commercial bargain, they have legal consequences. For instance, while there are some decisions that the Companies Act 2013 requires to be passed via special resolution (which requires at least 75% vote by shareholders), others require only ordinary resolution (51%), but the SHA may provide for an affirmative vote in favour of minority shareholders, which cannot be strictly implemented without running afoul of the provisions of the Act. In fact, the Act does not provide for investor protective provisions or affirmative votes as they are popularly understood in VC circles; hence, many SHA provisions can only be enforced legally through incorporation in the AoA of a company.

The Companies Act (Amendment) Act 2020 has ameliorated a number of corporate governance-related issues for startups by decriminalising many compoundable offences and allowing fast-track merger for small companies; however, the framework for corporate governance remains a challenge for early-stage companies that may not have the legal capacity to understand, implement and enforce these laws.

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CHAPTER 3: COMPLIANCE AND LABOUR LAW CHALLENGES

3.1 Introduction

Compliance isn't a one-off occurrence for a startup, rather, it's something that a startup must follow right from when a business is formed until it goes into retirement. For an Indian startup, there are two sources of law from which this compliance flow begins to develop, i.e., from the corporate law perspective and from the labour law perspective, while in a few instances it also stems from sector-specific regulation.

The overall compliance burden is the result of the confluence of corporate law, labour law, tax law, various sectoral regulations, and data protection laws. The overall compliance cost could be a major portion of the limited financial and human capital available to a startup. This chapter deals with the compliances under the Companies Act, 2013, and labour law (old law vis-à-vis new law and also with respect to the gig workforce). Furthermore, it also deals with compliances under the POSH Act.

3.2 ROC Compliance Under the Companies Act 2013

A private limited company in India has to continue to adhere to certain compliances in accordance with the Companies Act 2013, which are administered by the Ministry of Corporate Affairs (MCA) under the Registrar of Companies (RoC). The main annual compliances include the following:

a) Annual Return [Form MGT-7/MGT-7A]: This form provides details on the company's shareholder, director(s), share capital, and other pertinent details. This is required to be filed within 60 days of the annual general meeting (AGM), which is to be conducted within six months of the end of the financial year.

b) Financial Statements [Form AOC-4 and AOC-4 XBRL]: The audited financial statement comprising balance sheet and statement of profit and loss and cash flow statement with notes thereon are to be filed with the RoC within 30 days of holding the AGM. The filing in the AOC-4 XBRL form is mandatory in the case of certain types of companies.

c) Directors KYC [Form DIR-3 KYC]: All persons who possess a Director Identification Number (DIN) are required to file a KYC form annually. In the event that a person fails to file a KYC form on an annual basis, the DIN gets deactivated and that person cannot be a director of a company.

d) Charges: Where a company creates a charge on its assets in favour of a lender, the charge is to be registered with the RoC within 30 days of its creation. Where a company fails to register a charge on time, the charge may be rendered void against the liquidator

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or any creditor in the event of liquidation.

Other than these annual compliances, if the company wants to change its registered office, share capital, directors, and other matters, it must intimate the RoC. The Companies Act 2013 lays down various penalties and punishments for late compliance, non-compliance, and furnishing of false or misleading statements. The MCA, for example, has come out with a Companies Fresh Start Scheme (CFSS), 2020 which allows for the clearing of backlogs at a concessional rate of fee, but other than under the said scheme, the penalty rates are too high to allow compliance at a nominal price for a startup. The MCA portal's e-filing infrastructure has been upgraded a few times, with version 3 coming out in 2022. MCA21 V3 portal however has been experiencing some glitches, which has resulted in delays in filing, viewing of records, and generation of documents. The MCA too has admitted about these problems but the solutions have not reached users in a timely manner and have resulted in inconvenience for both the legal professionals and founders. In many of these cases, statutory compliance is not enough and the compliance is made much harder due to technical problems that cannot be ascertained from the text of law alone.

3.3 Labour Law Compliance: An old framework and new Codes

Labour law framework in India has been one of the most complex in the world. Prior to consolidation via the four Labour Codes, the Indian framework had 44 central laws and over 100 state laws that dealt with wages, working conditions, industrial disputes, employee benefits and social security among other things. This complex matrix of laws made compliance cumbersome for employers who could not afford dedicated teams for HR and Legal, specifically small businesses and startups. The four codes of labour, The Code on Wages, 2019, the Industrial Relations Code, 2020, The Code on Social Security, 2020 and the Occupational Safety, Health and Working Conditions Code, 2020, aimed to consolidate and simplify the complex regulatory environment of labour. All four Codes were passed by Parliament in 2019, 2020 and have also been notified but only the Code on Wages has come into force in some states. The other three Codes have yet to be notified in most states. This state of limbo, in which the new Codes have the status of legislation but the old laws govern practice, creates problems for startups who need to navigate and adhere to a regulatory framework that doesn't fit their needs.

Under the old regime, the key laws for startups include:

(a) Employees' Provident Fund: The Employees' Provident Funds and Miscellaneous

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Provisions Act, 1952, requires an establishment with 20 or more employees, to register with the Employees' Provident Fund Organisation (EPFO) and deposit 12% of (basic salary plus dearness allowance) for each employee in its EPF. The employer needs to pay another 12%, 8.33% of this contribution goes to the

Employees' Pension Scheme while the remaining goes to the EPF. The employer also needs to file challans on a monthly basis along with an annual return and maintain all required records as specified under the Act.

(b) Employees' State Insurance: The Employees' State Insurance Act, 1948 requires the establishment with 10 or more employees (in notified areas, in factories, it has 20 employees) to register with the Employees' State Insurance Corporation (ESIC), and pay monthly insurance contributions of 3.25% of wages (employer's contribution) and 0.75% (employee's contribution). ESIC provides medical, maternity, disability and other benefits. The employer has to file monthly contributions and submit returns every six months. He also has to maintain attendance registers and accident registers.

(c) Gratuity: Payment of Gratuity Act, 1972 requires every employer with 10 or more employees to pay gratuity to every employee that has completed five years of continuous service upon the termination of employment. The gratuity payout is computed as 15 days' wages for every year of service rendered. In fact, even though this liability arises only on the event of an exit, the startup must consider and provide for these liabilities in its financial plans and possibly also show actuarial values in their annual audited financials.

(d) Maternity Benefit: 26 weeks paid maternity leave is now mandatory for women employees having less than two surviving children, and is applicable only for organizations with 10 or more employees. 26 weeks have been made mandatory as the previous leave was 12 weeks. In addition, it provides that employers may allow women employees to work from home as may be mutually agreed upon with the employer, once she completes 8 weeks of maternity leave. In the case of a startup with a majority female workforce, this is quite costly, i.e., 26 weeks paid leave.

(e) Professional Tax: Professional tax is applicable only in certain states, such as Maharashtra, Karnataka, West Bengal, Tamil Nadu, etc. The employers must deduct professional tax from the salary of the employees and pay it to the state government. Professional tax rates, professional tax exemptions for certain classes of professionals, etc., differ from state to state. The threshold-based applicability of many labour laws poses a challenge for fast growing companies. If a startup crosses the threshold of 10 or 20 employees, the startup will become liable to provide EPF, ESI, gratuity etc. thereby leading to huge cost of employment. This is an

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economically inefficient decision and also goes against the very objective of increasing employment.

3.4 The Gig Economy and the Classification Question

The boom in platform businesses (e.g. ride-hailing services, food delivery, logistics, freelancer market places and others) has led to the creation of a new and a distinct class of workforce, the gig workers. Gig workers are individuals who work on a per project, per contract or per assignment basis for a digital platform and do not have an employment relationship with the platform. To the platform these workers are not employees, but independent contractors. This classification carries significant legal consequences: if they are employees then the gig companies have to provide EPF, ESI registration, gratuity, etc. or if they are independent contractors, they would have to comply with none of this. The courts and tribunals in India have been inconsistent in their rulings regarding this classification. The traditional test for employment, the 'control test', is whether there is the right to control not only the work that is to be done, but also the way that the work is to be done. This test is difficult to apply in the gig economy. For example, even though Ola and Uber control their 'driver partners' in significant ways (through driver ratings, pricing algorithms, route optimization, etc.), they argue that they are merely intermediaries (a market platform) connecting the drivers to the riders. The Code on Social Security 2020, which for the first time recognizes platform workers and gig workers as a distinct workforce, requires employers to create a social security fund for them. However, this law has not been notified in all the states yet and the details of the social security mechanism for the gig workers have not yet been prescribed. Notices were sent by High Courts to ride hailing and food delivery applications, while the Supreme Court of India admitted the petitions relating to the gig workers status. The decisions of the court would set precedence for startups, platform companies, and the independent worker model.

On the contrary, some states have adopted laws unilaterally, the first being Rajasthan's Rajasthan Platform Based Gig Workers (Registration and Welfare) Act 2023, which mandates registration of gig workers by platforms, as well as the mandatory contribution to welfare funds.

3.5 Prevention of Sexual Harassment (POSH) Compliance

Under India's Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act, 2013 (POSH Act), all Indian employers have certain statutory obligations irrespective of the size of the business. The key obligations under the POSH Act include:

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(i) Internal Complaints Committee (ICC): Every employer, with 10 or more employees (whether it is part time or full time) must constitute a committee called ICC, to handle sexual harassment complaints. The ICC consists of Presiding Officer, who must be a senior level employee in a woman and shall be presiding officer of the ICC. There are two members of the ICC, from employees at the workplace who are committed to the cause of women. There is one external member as well, who can be an NGO representative or other association representative that is committed to the cause of women;

(ii) Policy and Awareness: All employers must have a written policy against sexual harassment to be disseminated to all their employees. There must be periodic awareness programmes organised; and

(iii) Annual Report: The employer must include the number of complaints received and disposed in the annual report (or report to the District Officer).

Compliance with POSH presents unique challenges and opportunities for startups. While many startups may not have an HR policy in place (and have smaller employee strength, thus not mandating an ICC), there is a possibility that an employer with less than 10 employees still requires a Local Complaints Committee (LCC), which is constituted by the District officer, which replaces the function of ICC. A common misconception among small startup founders is that if they do not have a 10-employee strength they do not require an ICC.

In addition, the informal startup environment can present unique challenges to compliance with POSH Act. Many startups have a culture of informal social interaction between colleagues, and flat organisational hierarchies, which can blur professional boundaries. Many high-profile cases have involved startups, like the case against BharatPe and iGate (albeit predating the POSH Act) founders, which have demonstrated that sexual harassment is an existential risk in startups.

Non-compliance with POSH obligations carries potential monetary penalties up to Rs 50,000 for first offence, and up to Rs 1 lakh for second offence. It can also lead to cancellation of licences and registrations in addition to civil liability in terms of compensation to the complainant. This compensation can include damages for mental trauma, loss of career opportunity, medical expenses, and other forms of distress.

CHAPTER 4: TAXATION CHALLENGES

4.1 Introduction

Taxation constitutes one of the most disputed domains of startup law in India. The current regulatory model reflects a focus on older, established firms, thereby subjecting startups,

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businesses that are pre-revenue, pre-profit, lean on assets, and short on liquidity while prioritising long-term value accumulation, to obligations misaligned with their economic conditions. The three most significant areas of taxation affecting startups are the "angel tax" under Section 56(2)(viib) of the Income Tax Act 1961; the challenge of Goods and Services Tax (GST); and ESOP taxation. The discussion of taxation also has an important dimension when considered with the Foreign Exchange Management Act (FEMA) implications that follow in the next chapter, since they intersect with issues of tax on cross-border investment.

4.2 Angel Tax: The Most Controversial Provision

Section 56(2)(viib) of the Income Tax Act 1961 has been labelled the 'angel tax' provision. This provision was introduced in 2012 in an attempt to prevent black money from being laundered into white by using the medium of private companies as an intermediary. The provision deems excess consideration received by a company on account of its shares (over and above the fair market value of such shares) to be "income from other sources". The fair market value is determined in accordance with the formula set down in Rule 11UD by the Central Board of Direct Tax (CBDT), using either the Net Asset Value (NAV) methodology or the Discounted Cash Flow (DCF) methodology, in the manner laid out in an order prescribed by a Category-I Merchant Banker.

The effect of Section 56(2)(viib) is disastrous. By their very nature, startups receive external investment at valuations that vastly overstate the current book value of their assets. In exchange for their investment, investors get a stake in the future potential of the company, the quality of the team, the value of the market opportunity and so on. Such valuation metrics are forward-looking, unlike the NAV methodology. The effect of Section 56(2)(viib) is that if a startup receives more funds in exchange for issuing shares than the DCF-derived fair market value, that excess amount is considered taxable income, for which the startup must pay corporate tax at a rate of 30% plus applicable surcharge and cess. The startup, thus, may end up paying tax on its angel investment, making an expensive investment of, for example, Rs 10 crore at a Rs 50 crore valuation, cost it an additional Rs 7.5 crore or so in tax outgo.

In its early days when strict enforcement of this provision was the norm, angel tax devastated fundraising for early-stage startups. DPIIT, recognising the difficulties caused by Section 56(2)(viib) in its strict interpretation, introduced an exemption from the application of Section 56(2)(viib) to DPIIT-recognised startups from 2019 in respect of investments made to them by DPIIT-recognised angel funds and Category-I Alternative Investment Funds (AIFs). Although this exemption represents some relief, DPIIT-recognised startups were not completely shielded

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from Section 56(2)(viib), as non-recognised startups remained liable. Moreover, the exemption was not available even for recognised startups when the source of investment was from someone other than the specified categories. Furthermore, the inclusion of foreign investors in the angel tax net effectively took away the exemption for foreign investment in India granted by FEMA. This move was also highly controversial and in the Union Budget for 2024 the finance minister removed Section 56(2)(viib) from the income tax act with effect from 1 April 2024. This is a good development as it took away one of the major legal issues affecting fund raising to startups in India. But the changes to this amendment in 2019, introduction in 2012, extension of its validity in 2023, and finally removal in 2024, show a history of policy volatility with regard to taxing startups.

4.3 GST compliance for Startups

The Goods and Services tax (GST) was introduced in India in place of Central Excise Duty, Service Tax, Value Added Tax, Entry Tax and various other State taxes with effect from 1 July 2017. From the perspective of the startup ecosystem, GST was a reform with mixed implications. At the one end, by removing multiple cascading taxes and forming a common market, GST was beneficial to B2B platform businesses and product-based startups. However, it created a compliance structure of a significant complexity.

Startups having turnover of more than 20 lakh (10 lakh in case of special category states) should register for GST. GST registration is also mandatory for startups having turnover below the threshold limit in case of inter-state supply of goods, when acting as a casual taxable person or when required to deduct TDS/TCS under GST. After the registration, a startup has to file monthly or quarterly GSTR-1 (Statement of outward supplies) and GSTR-3B (Summary return for payment of tax), an annual return GSTR-9 and in case of registered person with turnover exceeding certain specified limit, GSTR-9C (Reconciliation statement) must be certified by a Chartered Accountant/ Cost Accountant. The complicated process involves matching purchase invoices uploaded by the supplier on the GST portal and availment of input tax credit (ITC) to the recipient. In case of a mismatch, ITC is disallowed and could lead to a demand of tax.

A major challenge that technology startups face is in classifying their services correctly for GST. There are issues surrounding classification of cloud computing, SaaS, data analytics, and API-based services under GST. This classification is important as different rates of GST ranging from 0% to 28% may be applicable, availment of input tax credit and place of supply rules vary based on the classification of the service. Any errors in classification of a service may attract demands with interest and penalty, which can prove to be a huge liability for a small

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startup.

Another challenge with GST compliance arises from the place of supply rules, especially in case of cross-border services. For Indian startups serving international clientele, there exists a critical determination to be made regarding the nature of their supply: is it an 'export of services', subject to zero-rating with the associated right to claim a refund of input tax credit, or a 'supply made in India,' incurring liability at the standard applicable rate? In practice, meeting the prerequisites for zero-rating often proves to be an onerous burden, especially given that payments must be settled in convertible foreign exchange, a requirement that startups frequently fail to satisfy when utilizing international payment service providers that pool funds in Indian rupees before remitting them to the startup's account.

4.4 Taxation of ESOP: A Hurdle for Retaining Talent

A key strategy for startups when onboarding talent is Employee Stock Option Plan (ESOP) grants. Since startups struggle to compete with the cash salaries on offer from older businesses, ESOPs represent their best bet of offering equity (a stock option), i.e. shares that allow the grantee to buy stock in their company at a set price (the 'exercise' price) over a certain timeframe (the 'vesting period'). As these employees have a stake in the long-term value of the startup, ESOPs enable founders to access highly qualified workers without draining their coffers in the short term.

The taxation of employee stock options has long proved disadvantageous to employees of startups. Pursuant to Section 17(2)(vi) of the Income Tax Act 1961, the perquisite value of a stock option, the difference between the 'fair market value' of the share on the day of exercise and the 'exercise' price, is liable to be taxed as salary income in the hands of the employee in the year of exercise. This creates a 'cash flow mismatch problem' as the employee is taxed on a fictitious gain upon exercise, even though he has not liquidated the shares and thereby received any cash. Given that shares of startups are typically illiquid (i.e. not traded on an exchange, so they cannot be liquidated for cash), such taxation can leave employees unable to sell their shares in order to pay off their tax liability.

In the year of the Finance Act 2020, a Section 192(1C) was inserted in the Income Tax Act allowing for a deferral on taxation of ESOP for employee of DPIIT recognized startups. The tax for perquisite value of stock options is deferred until the earliest of (a) expiration of 5 years from the date of allotment; (b) the date on which the shares were sold by the employee, or (c) the date on which the employee ceases to be an employee of the startup. For employees of recognized startups, this is a welcome improvement, as the taxation is deferred to a date that

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more likely corresponds to an event in which the employee has obtained liquidation value.

However, as noted above, the deferral of taxation is only allowed for DPIIT recognized startups. For employee stock options at unrecognized startups, the tax upon exercise continues to apply. Furthermore, even with a tax deferment in place, the tax at time of maturity is levied at salary income tax rates (which can be as high as 42.7% including surcharge and cess for high-income individuals), and not capital gains tax rates (which would be available if shares are held for >24 months). This difference in tax treatment across the types of ESOPs, as well as across jurisdictions, where ESOP income is taxed as capital gains (and often at lower rates) creates a comparative disadvantage for India as an ESOP jurisdiction.

4.5 FEMA AND CROSS-BORDER TAX ISSUES

All cross-border transactions of Indian residents and entities are regulated under the Foreign Exchange Management Act 1999 (the "FEMA"). Compliance with FEMA is mandatory for any Indian startup that is seeking foreign investment. The Reserve Bank of India has prescribed a set of comprehensive rules and regulations, including the Foreign Exchange Management (Non-Debt Instruments) Rules 2019 (the "FDI Rules") and the Foreign Direct Investment Policy (the "FDI Policy"), to define the parameters for permitted foreign investment in India. The FEMA compliance requirements include: Reporting of foreign investment received by the startup with the Reserve Bank of India on its Foreign Investment Reporting and Management System ("FIRMS") portal within 30 days of receiving the investment;

FDI caps and conditions (as applicable to the specific sector in which the startup is operating, e.g., e-commerce, insurance and media) that are subject to compliance with; pricing guidelines which are applicable to the issue or transfer of shares to the foreign investor; and Overseas Direct Investment ("ODI") framework that the startup is required to comply with, if it is making any outward investment.

Pricing guidelines: The shares of an Indian entity cannot be issued to a foreign investor at a price lower than the Fair Market Value ("FMV") as determined in accordance with the internationally accepted valuation methodology for unlisted companies. Similarly, the shares of an Indian company that have been held by a foreign investor cannot be transferred from such investor to an Indian resident in consideration for a value that is lower than FMV. These pricing requirements may give rise to conflicts between the commercial terms negotiated by the parties to a funding round (e.g., buyback of shares from an investor at a discount by the founder(s), or the payout of an investors's liquidation preference being higher than the current FMV of shares).

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Transfer pricing: This refers to the pricing of interrelated-party transactions (that is transactions between a company and a company that it is associated with). For example, a startup that is operating as a platform and that has associated enterprises in India and overseas, such as an Indian operating company and a Singapore or a Delaware holding company may have to abide by transfer pricing requirements. For instance, where the Indian company provides management services to the holding company, or where the Indian company has licensed its intellectual property to the holding company or where the holding company has granted a loan to the Indian company, all of these transactions should be conducted on a "arm's length" basis that means in a way that the Indian startup would conduct a similar transaction in an unconnected arm's length situation between third parties in similar market conditions. The arm's length price is required to be determined through a Transfer Pricing study by the startup and such price is required to be documented and reported. All of this leads to a high compliance cost which can be significant for startups that are small and lean and have very limited compliance capacity.

CHAPTER 5: CHALLENGES IN FUNDING AND INVESTMENT

5.1 Introduction

Every startup, no matter how visionary, requires funding. If it does not have access to funds it will struggle to realize its innovative potential and become the next unicorn. India has a reasonably well-developed funding ecosystem in which angel investors, venture capital funds, private equity investors, government schemes, and in recent years Alternative Investment Funds ("AIFs") have contributed towards the financial needs of a startup across different stages of its growth. The legal framework for startup funding in India is intricate, and at every stage, it is essential to take appropriate legal advice.

This chapter covers the venture capital and angel investment legal framework in India, the various legal documents that form the core of the funding transaction (i.e., the Shareholders' Agreement and the Subscription Agreement) and the investor rights provisions that form the foundation of the startup investment ecosystem.

5.2 Venture Capital and Angel Investment Framework

Venture capital investment in Indian startups can occur in many forms. The most commonly adopted form of venture capital investment is through a category that would qualify as an Alternative Investment Fund ("AIF"). AIFs must be registered under the SEBI (Alternative Investment Funds) Regulations, 2012, and are divided into three categories: Category I AIFs,

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which includes VC funds, angel funds, SME funds, social venture funds, and infrastructure funds, all of which have been given regulatory concessions and pass through tax treatment (the income of an AIF of Category I and II is not taxed at the AIF level, but instead, investors are taxed directly on their allocable income, which will have the same consequence, economically speaking, as an investment by them in the portfolio company).

Category II AIFs are private equity funds and funds of funds, which is the most popular route for investments at the growth stage of a company. Category III AIFs are hedge funds and other complex strategies. Angel funds are a sub-category of Category I that is meant for early stage investments. SEBI's AIF Regulations prescribe certain requirements relating to the AIF, like minimum corpus (Rs 5 Crore), minimum investment (Rs 25 lakh) by each investor, and eligibility requirements for the investor. The AIF Regulations were subsequently amended in 2013 to facilitate angel investments and to recognize the fact that this is a distinct activity that needs to be treated differently for regulatory purposes.

Another type of investor, a Foreign Venture Capital Investor ("FVCI") registered under the SEBI (Foreign Venture Capital Investor) Regulations, 2000, is given the benefit of relaxed pricing provisions for investment into unlisted Indian companies under FEMA (not bound by the pricing guidelines requiring investment to be on an arm's-length transaction basis, which is fair market value). This pricing relaxation is an important commercial feature for FCVIs, which enables FCVIs to negotiate their investments based on valuation without fear of regulatory challenge.

5.3 Term Sheets and Their Legal Status

The term sheet is the first document used to set the stage of a startup funding transaction. A term sheet outlines the basic commercial terms of the proposed investment, including the size of the proposed investment, the pre-money valuation, the nature of the investment (i.e. equity, CCPS, CCD), the rights of the investor and the key closing conditions. In India, term sheets are mostly marked as "non-binding" (with specific exceptions such as exclusivity, confidentiality and costs clauses). A non-binding term sheet means that neither party is compelled to close the deal on the terms stated in the term sheet; either party can walk away from the transaction on the terms stated (subject to binding exclusivity/break-fee provisions, if any). In practice, the parties are bound by a commercial expectation to proceed in good faith, although the founder's reputation with the investor community may suffer if the founder walks away from a signed term sheet without good cause. Though there are no comprehensive rulings from Indian courts on this issue, one could argue that the principle of promissory estoppel

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(under the Indian Contract Act) may provide a basis for a claim against the party who reneged, as such a claimant was led by the other party to believe that a certain state of affairs would continue and acted to their detriment in reliance on that belief. Indian courts have acknowledged promissory

estoppel as a valid legal principle (see, e.g. Motilal Padampat Sugar Mills Co. Ltd. v. State of Uttar Pradesh, AIR 1979 SC 621 (1979)) although its application to a startup funding scenario has never been tested.

5.4 Shareholders' Agreement ("SHA") – Key Issues and Clauses

The SHA is the core legal document that governs the relationship between a startup's founders and its investors. Typically, an SHA is executed along with the Investment Agreement and/or Stock Subscription Agreement at the closing of a financing round and operates as a supplement to, and in some cases overrides, the company's Articles of Association ("AoA"). SHA agreements often contain provisions that are much more detailed and commercially specific than those set out in an AoA. Common provisions in a typical startup SHA in India include:

a) anti-dilution protection: anti-dilution provisions are designed to protect investors from the dilutive effects of "down-rounds" (i.e. the issuance of equity at a valuation lower than the price paid by the investors on their previous investments). There are two common types of anti-dilution protections: "full ratchet" anti-dilution protection (i.e. adjusting the conversion rate for the initial investor's shares at an amount equal to the lower issuance price) and "weighted average" anti-dilution protection (i.e. adjusting the conversion price by way of a weighted average of the original and new issue prices, and considering the number of shares issued at either price). Although both "full ratchet" and "weighted average" types of anti-dilution have been used in India, "weighted average" is by far the predominant type, as "full ratchet" anti-dilution is seen by investors and other market players as unduly harsh on the founders.

b) drag-along rights: drag-along provisions entitle the majority of shareholders (typically the founders plus key investors) to "drag" other minority shareholders into the deal with the same terms when a third-party acquires the company, and prevent such minority shareholders from blocking such a commercial deal. It should be noted that the enforceability of drag-along provisions under Indian corporate law is currently uncertain, as it is unclear whether minority shareholder rights and protections under the Companies Act 2013 can be successfully used to challenge a drag-along exercise.

c) Tag-Along Rights (Co-Sale Rights): The tag-along right ensures that minority

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shareholders have the opportunity to sell their shares on the same terms and conditions as the founders (or majority shareholders) sell shares of the company. This prevents the minority shareholders from being stuck with shares in a company when the majority shareholders sell their interests, leaving them holding unmarketable (illiquid) shares in a company they may no longer want to continue to invest in.

d) Pre-emption Rights (Right of First Refusal): The pre-emption right gives current (existing) investors the opportunity to participate pro-rata in new rounds of funding before any new (external) investors are brought in to invest in the company. This enables the investors to maintain their current shareholding percentage and avoid any dilution.

e) Affirmative Voting Rights (Reserved Matters): Certain key decisions, typically including (i) changing the business plan, (ii) making a material acquisition, (iii) carrying out an initial public offering (IPO), (iv) entering into a transaction with a related party (above certain monetary thresholds), or (v) an increase in the remuneration of senior management (above certain monetary limits), require the prior consent of the lead investors (often in the form of an affirmative vote or written consent). This provision allows investors to have some voice in the business, without taking a majority control.

f) Liquidation Preference: Liquidation preference entitles an investor to be paid a certain agreed return (typically at 1x) before any other shareholder is paid anything in a liquidation, sale, or other similar exit transaction. A "1x non-participating" liquidation preference gives an investor the right to be paid back first and then give up their "preference right" to share the proceeds pro-rata with other shareholders. A "1x participating" liquidation preference gives the investor the right to be paid their preference amount first as well as continue with the right to be paid pro-rata in the remaining proceeds, significantly reducing the return to the promoters in such transactions.

g) Founder Lock-up and Vesting: Investors often want founders to commit the shares of the company to a certain lock-up period and/or vesting. Vesting of shares is a mechanism where the founders have to "earn" their shares over time (typically over four years, with a "cliff" of 1 year) through continued services. In many instances, if a founder leaves the company before all their shares vest, their unvested shares are "vested" by the company or other investors for a low amount (the good leaver/bad leaver provisions). This is done to ensure that the benefit that the promoters of a startup

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bring accrues to those promoters in whose hands the value is generated.

The inter-play of the provisions in an SHA with the Companies Act 2013 give rise to a number of issues. There are certain rights of shareholders prescribed under the Companies Act 2013 (for example, rights to receive notice, rights to vote and rights to inspect certain documents and records) that cannot be contracted away in an SHA. Also, an SHA could provide for additional rights for shareholders that could supersede the rights available under the Companies Act 2013, but such additional rights may not be enforceable by the shareholders against the company. The principle of privity of contract ensures that a shareholder agreement (SHA) applies exclusively to the signatories; therefore, should a new shareholder purchase shares without joining the agreement, those SHA terms will not automatically apply to them.

5.5 Convertible Instruments: CCPS and CCDs

Convertible preference shares and convertible debentures stand as the primary instruments of choice in India's startup investment landscape. Investors typically favour Compulsorily Convertible Preference Shares (CCPS) and Compulsorily Convertible Debentures (CCDs) over direct equity holdings because CCPS provide investors with priority over equity shareholders regarding dividend distribution and asset liquidation; the conversion feature enables the parties to structure the instrument to minimize stamp duty and other transactional expenses; and where a fund is restricted to investments in debt instruments, it can still access equity upside in a startup by holding CCDs and converting them into shares subsequently.

The 'compulsorily convertible' name for CCPS and CCDs denotes that the conversion to ordinary equity has to be mandatory. The conversion can be set to occur automatically on the lapse of a certain time period, upon a certain event (e.g., the qualifying IPO), or a combination of both. The conversion ratio is generally decided at the time of investment and is then adjusted for antidilution in case of subsequent equity issuances.

The classification of CCPSs and CCDs for the purposes of FEMA, whether these are treated as 'debt' or as 'equity', is a matter of significant regulatory uncertainty. This is important as this classification determines the regulatory framework applicable to the instrument, i.e., whether FDI or External Commercial Borrowing (ECB) regulations would apply. The RBI clarified that CCPSs or CCDs in case of where there is a fixed rate of return (i.e., dividend or interest, and the same is not linked to the profitability of the company) would be classified as 'debt', and accordingly, the more restrictive

ECB rules would apply in respect of such instruments rather than the FDI regime. This could have serious implications as it would effectively restrict the terms at which investors could

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make investments in start-ups using such instruments.

5.6 RBI and SEBI Regulatory Regime

Startup financing across different stages involves a complex mesh of regulatory jurisdictions. RBI regulates cross border capital flow in terms of the laws under FEMA, the terms of foreign investments in terms of the FDI policy, and NBFCs (non-banking finance companies) which could be involved in providing debt financing to startups. SEBI regulations regulate AIFs, FVCIs, and the activities of Investment Advisors and Portfolio Managers.

For a start-up, which would typically plan an IPO as its eventual exit, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (the "ICDR Regulations") sets down the listing requirements for an IPO on the main board or the SME (small and medium enterprise) platform. The requirements of profitability for listing on the main board platform of listing (either the previous three-year requirement for profitability or the minimum net worth requirement) disqualifies most high-growth startups that focus on growth over profitability. SEBI had introduced a separate IPO platform for start-ups and venture capital funds (the "Innovators Growth Platform") in 2019 and this has since been merged into the main listing framework of SEBI, but the criteria are complex and this platform has not been very popular with start-ups.

CHAPTER 6: INTELLECTUAL PROPERTY AND DATA PROTECTION

6.1 Introduction

For the majority of technology-focused startups, intellectual property (IP) constitutes the most significant asset on their balance sheets, often dwarfing the value of physical assets, staff, or even earned income. Typically, this competitive edge stems from proprietary technology (covered under patents or copyright), a well-established brand (covered under trademarks), distinctive creative output (covered under copyright), or secret business intelligence (safeguarded through trade secrets and contractual agreements). India's IP protection regime, anchored by the Patents Act, 1970, the Trade Marks Act, 1999, the Copyright Act, 1957, and the Designs Act, 2000, offers a comprehensive legal structure, yet every facet of this framework brings distinct challenges tailored to the startup environment.

In parallel to IP rights, data has become the core resource for the digital economy.

Startups that aggregate, process, and derive insights from user data unlock substantial value,

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but this activity concurrently imposes legal requirements to ensure the confidentiality and integrity of that data. The Digital Personal Data Protection Act 2023 (DPDP Act) is India's first comprehensive data protection legislation, and its implications for the startup ecosystem are profound.

6.2 Patent Protection for Startups

Patents serve to protect technical inventions characterized by novelty, inventive step, and industrial application. For deep-tech startups, whether in pharmaceuticals, biotechnology, semiconductors, artificial intelligence, or materials science, patents are essential to securing a defensible market advantage. Lacking patent protection, a rival could reverse-engineer your offering, replicate the technology, and enter the market as a direct competitor without having incurred the innovation costs that the original developer shouldered.

The Patents Act, 1970 confers on a patent owner the sole right to manufacture, employ, market, offer for sale, trade, and import the patented innovation within Indian territory for a duration of 20 years from the date of application. Securing a patent, consisting of the submission of a patent application to the Indian Patent Office, examination, publication, opposition proceedings, and ultimate grant, is an arduous process typically spanning 3-5 years; in the context of startups where a rapidly changing competitive landscape and technological milieu could render the innovation obsolete, a timeframe of 3-5 years is considerable.

The primary concerns for startups regarding patents are:

(a) Cost: Pursuing patent protection requires payment of government fees, legal fees for patent drafting and filing, and the potentially significant costs associated with pursuing patents overseas. An Indian patent application may cost between Rs 30,000-50,000 in government fees and between Rs 50,000 and Rs 2,00,000 in attorney fees for drafting and filing, while international patents may require pursuing protection under the Patent Cooperation Treaty (PCT), incurring a cost of between USD 3,000-5,000 for each jurisdiction.

(b) Software Patents: Section 3(k) of the Patents Act, 1970 stipulates that the following are not patentable: 'a mathematical or business method or a computer programme per se or algorithms.' This exclusion affects software startups, which may devise innovative software programs or computer algorithms which, while commercially significant, may be unpatentable. The guidelines for computer-related inventions promulgated by the Indian Patent Office provide that patents will be granted for software-related inventions which have a technical character and are capable of producing a technical result, but the distinction between patentable computer-implemented software inventions and non-patentable computer programs per se

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continues to remain ambiguous and is interpreted variably by different patent examiners.

(c) Fast-Track System: Startup India has launched a fast-track system for patent applications of DPIIT recognised Startups. For fast-track examination, the examination of Startup Applications is done in an expedited manner and may take anywhere between 1 to 2 years from the date of filing. A beneficial provision, however, only available for DPIIT recognised startups, it does, however, continue to require payment of costs.

(d) Trade Secrets as an alternative: Many tech startups, in particular those in the software and AI sector, avoid patenting their technology, choosing instead to protect it as a trade secret. By maintaining secrecy through NDAs, controls and contractual confidentiality undertakings with employees and independent contractors, these tech companies avoid having to reveal the details of their tech inventions and can rely instead on trade secret protection. Protection lasts indefinitely (as opposed to 20 years for patents), and is available without disclosing the technology itself. Protection against reverse engineering by competitors, or employee mobility, is weak in such situations as the tech is kept a secret. In the Indian context, there is no statute which specifically covers trade secrets, and thus such protection can be obtained through the contract law, law of breach of confidence and, in the case of misappropriation by employees, the Information Technology Act 2000.

6.3 Trademark Protection

Often times, the most visible and valuable asset of a startup is its brand, which includes its name, logo, tagline, and other brand identifiers. These identifiers are protected through trademarks, which give the owner the exclusive right to use the mark in relation to certain goods and services. The strongest way to obtain such protection is to register one's mark with the Trade Marks Registry, under the Trade Marks Act 1999. This provides the right to bring actions against infringers, both civil and criminal, and also allows the proprietor to record the mark with Customs to prevent importation of counterfeit goods.

Trademark issues can plague a startup during multiple stages of its growth:

a) Name Availability: Before registering the company, founders ought to ensure that the brand name they plan to use is available by performing a thorough search of the trademark registry, the company names list available with the MCA, as well as a general internet search. Many founders, however, skip this crucial step and proceed to register their company and invest time and effort in building a brand name that is owned by a registered trademark, eventually ending up having to receive a cease and desist notice. Rebranding a startup that has already gathered traction is an extremely

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expensive exercise.

b) Registration Delays: The process of registering a trademark in India remains slow despite improvements in the system. An application is filed with the Trade Marks Registry, examined, accepted or objected, published in the Trademark Journal (where it is open to opposition for a set period of time), registered. Typically, an application will take between 18 months and 3 years (if unopposed) to complete this process. In the interim, the startup owner's only protection is under common law as a prior user, which is far harder to enforce than registration rights.

c) International Registration: In case a startup intends to expand to international markets it has to obtain trademark registrations in each market of the target market countries. However, as India is a member of the Madrid Protocol, Indian applicants can now file international applications through the office of the Trade Marks Registry India, in order to get effect in all Madrid Protocol countries through one application and fee. However, not all countries are covered by the Madrid system, and the expenses for international trademark prosecution can prove onerous.

d) Enforcement: Even where a startup has registered trademark rights, enforcement remains difficult in India. Civil litigation in the trademark sphere is slow and costly, and the available remedies, namely injunctions, damages, and delivery up of infringing goods, while granted as a matter of right, may require years to procure. Although the Commercial Courts Act 2015 has made inroads towards reducing the pendency and timelines for trial in matters of commercial litigation, enforcement of IP rights remains a challenge.

6.4 Copyright Protection

In India, copyright in literary, dramatic, musical or artistic work accrues without the necessity for any formality of registration by virtue of creation of an original work. Notwithstanding the same, the Copyright Act 1957 protects software by classifying it as a form of a literary work. This is an extremely critical aspect for technology startups, whose core product or service is usually code. While, author or creator of a work is considered to be the first owner of a copyright, the employer (who has engaged an employee), is treated as the first owner of the work, when a person creates an work, during his or her period of employment.

For startup entities, the 'work made for hire' doctrine has important consequences. If an entrepreneur has software or some other product commissioned by a third party who is not a full-time employee of the enterprise, such as a freelancer, contractor, or consultant, copyright

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in the commissioned work may lie with the party that undertook such work, instead of the hiring enterprise, absent an assignment of the copyright rights in such work (by way of written agreement executed by the hiring parties). This is a frequent oversight, or a common feature, on the part of most nascent stage startups in our jurisdiction, often resulting in ownership of the core product (or parts thereof), being vested in a freelancer, often, as a result of who may have long gone from the scene, or may wish to make good their intellectual property (IP) rights by exercising them against a newly commercialized or commercializing startup.

Additionally, the Copyright Act 1957, also has implications for the inclusion of third party content, music, image, text, video, in the products or services of a startup enterprise. Be it a startup edtech company using a film for educational purposes; an application for music using copyrighted songs or even a news aggregation portal reproducing news, the startups in all three of the aforementioned scenarios must be cognizant of and operate within the licensing and the fair use framework, prescribed by the Act. Importantly, the copyright exceptions under Section 52 of the Act, that include the provision relating to fair dealing, private use and other activities that are non-commercial, are interpreted strictly. Further, such interpretation does not allow for the wide ambit of a "fair use" defence, like that available in US.

6.5 The Digital Personal Data Protection Act, 2023

The Digital Personal Data Protection Act 2023 (DPDP Act) represents a watershed moment for data protection in India. Enacted in August 2023, the DPDP Act establishes for the first time a comprehensive legal framework for the processing of personal data of Indian individuals ('data principals') by entities ('data fiduciaries') operating in or targeting users in India. The DPDP Act borrows significantly from foreign legislation, such as the European Union's General Data Protection Regulations ("EU-GDPR"), and also attempts to balance the interests of both the data principals and the data fiduciaries.

Among other things, the DPDP Act imposes the following obligations on data fiduciaries:

a) Consent: Data fiduciaries can collect and process data, only upon obtaining free, specific, informed, unconditional and unambiguous consent from a data principal by providing them a notice in plain and easy to understand language. You can always opt out, and there must be a method for users to do so. For startups whose primary business model hinges on collecting data from end-users, granular and specific consent will introduce more hurdles in the user onboarding journey and make it difficult to reuse data for analytics and product enhancement.

b) Purpose limitation: Personal data should only be processed for the specific purpose for

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which consent has been taken. This restricts data-driven startups from repurposing user data for new features or products without asking for new consent.

c) Data minimisation: Only personal data that is strictly needed for the specific purpose can be collected. Startups that amass large amounts of data to anticipate future product capabilities or use cases could be affected by this restriction.

d) Rights of Data Principals: The DPDP Act provides Data Principals with the right to access, correction and erasure, redressal, and nomination of a representative. Startups will need to build systems to honour these requests within the timeframes set by the rules.

e) Data localisation: The Central Government has the power under the DPDP Act to notify countries to which personal data transfers cannot be carried out. Unlike the EU's GDPR's "whitelisting" approach where data transfers are allowed until restricted, India will use a "blacklisting" approach, where data transfer is allowed unless restricted. Certain categories of sensitive personal data, categories yet to be notified, will require data to remain locally in India. The DPDP Act does not specify the categories of sensitive data that will be locally stored, but this can have a drastic impact on cloud-based startups.

f) Significant Data Fiduciaries (SDFs): The government will have the power to identify certain data fiduciaries as SDFs depending on the volume and nature of the personal data that they process and the risk they pose to the state, economy, or sovereignty. SDFs have more onerous obligations, like performing data protection impact assessments, undergoing audits, and appointing an India-based data protection officer. Large consumer internet startups and unicorns can be expected to be flagged as SDFs.

g) Penalties: The DPDP Act has heavy monetary penalties, up to Rs 250 crore for some violations (like not reporting a breach in the timeline to the Data Protection Board) and up to Rs 200 crore for other violations. These are some of the largest penalties in the world given the size of the Indian economy, and their implementation may lead to existential issues for small startups. The DPDP Act was still in the process of rule-making at the time of writing. Until the rules are notified, it will be impossible to determine the full extent of the effect of this law on startups. The DPDP Act will definitely mean more investment in privacy engineering, data management and compliance infrastructure for startups.

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CHAPTER 7: LANDMARK CASE LAWS

7.1 Introduction

It is only in the context of actual cases that legal rules acquire a practical context. The ten cases covered in this part involve judicial pronouncements by the courts, adjudications by the tribunals, or determinations by administrative bodies.

7.2 Case 1: Vodafone International Holdings BV v. Union of India (2012) 6 SCC 613

Facts Vodafone International Holdings BV (Vodafone), a Dutch company, purchased 67% shareholding in CGP Investments (Holdings) Ltd, a Cayman Island company (CGP) from a subsidiary of Hutchison Telecommunications International. CGP held a 67% shareholding in Hutchison Essar Limited, an Indian company in the field of telecom services through a long chain of intermediary holding companies. The Indian tax department wanted to charge capital gains on the transaction. According to the government's view, Vodafone purchased Indian assets which was liable to tax in India.

Issue Whether the Indian income tax authorities have the jurisdiction to tax a transfer of shares of an offshore entity between two foreign entities, whose value is attributable to assets located in India. Whether the transaction constituted a transfer of a capital asset situated in India.

Judgment The Supreme Court ruled in favour of Vodafone and held that Vodafone had not purchased any capital asset in India. It was a genuine transfer of shares of a foreign entity. The Court held that the Indian Income Tax department had no jurisdiction to tax an offshore transaction between two foreign entities. The Court made observations that in order to apply substance over form test in tax cases, if a transaction is a tax saving transaction and it is legally valid, it cannot be taxed as if the transaction were domestic. It can only be taxed if the transaction was a mere sham or fake transaction.

Relevance While this case was not a startup case, but is very relevant to the Indian startup ecosystem as it decided the extra territorial reach of the Indian Income Tax Act. The Vodafone judgement is relevant to startups which have used the 'flip structure', where an Indian company is held by a Singapore or Delaware company, to raise their early stage funding. The judgement had led the government to retrospectively amend Section 9(1)(i) of the Income Tax Act (later struck down in 2021), and the government also introduced the 'Indirect transfer' chargeable under Section 9(1)(i) of the ITA. After this judgement and its reversal, we saw how the policy making was affected which is very much a problem today when it comes to structuring a startup on an international scale.

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7.3 Case 2: Angel Tax Cases, Multiple Assessees v. ITO (Multiple years, ITAT)

Background: This "case study" is an amalgamation of several hundred cases before ITATs and HC courts where the Income Tax Department attempted to invoke Section 56(2)(viib) of the Income Tax Act, 1961 ("angel tax") on premium income received by startups upon issuance of shares to investors. The typical scenario was that the startup received Rs. 5 crore for a share issuance at a valuation of Rs. 20 crore. The Assessing Officer arrived at an FMV of Rs. 8 crore using the DCF method and raised a demand for tax on a difference between premium of 20 crore received less FMV of 8 crore which he treated as "income from other sources" amounting to 12 crore.

Issue: Whether the premium received by a company from bona fide investors at commercially negotiated valuations could be taxed as income in the hands of the recipient company under Section 56 (2)(viib)? Whether the DCF method prescribed by the CBDT was apt for valuing the commercial value of a start up?

Judgment: Several benches of the ITAT held that the DCF method as prescribed was not an appropriate valuation mechanism in the hands of the Assessing Officer for early-stage start-ups whose value derives from future potential rather than from cash flows. In the case of M/s Agni Estate & Facilities Pvt. Ltd. vs ITO (2017), Chennai ITAT held that where valuation of a start-up is substantiated by valuation report of a qualified valuer, it is not open to the Assessing Officer to determine FMV by his own estimation, if the investment was made at arm's length by a sophisticated investor, without pointing out that there is a specific flaw in the valuer's methodology adopted for arriving at the value. However, ITAT decisions were varied across jurisdictions leading to prolonged litigation and uncertainty.

Significance: The angel tax litigation represents one of the most significant legal battles against the Indian start-up ecosystem over the past decade. It acted as a deterrent for angel investment, led to distortion of fund structures, and led to issue of notice of demand to hundreds of startups on genuinely commercial transactions. The ultimate repeal of Section 56(2)(viib) in the Finance Act 2024 is vindication of the start-ups' decade-long complaint over the application and misuse of the provision. Nevertheless, the years of litigation and tax notices have caused irreparable damage to the sector.

7.4 Case 3. Flipkart Internet Pvt. Ltd. vs Directorate of Enforcement (2015)

Facts: Flipkart, India's largest ecommerce marketplace, was structured to have the marketplace operating through a separate Singapore holding company (Flipkart Pte. Ltd.), with the local entity (Flipkart Internet Pvt. Ltd.) functioning merely as a service provider. The Enforcement

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Directorate (ED) examined if the Flipkart setup violated Foreign Exchange Management Act (FEMA) norms, inquiring whether its 'marketplace' model was actually a masked inventory business model which is off limits to FDI-backed businesses. Additionally, ED looked at if the monetary flows from the India-based entity into Singapore constituted unauthorised exit of funds.

Issue To determine whether the operational architecture of Flipkart, comprising a Singapore holding company and India subsidiary for operations, breached FEMA conditions for FDI in e-commerce and round-tripping or transfer of assets.

Judgment Flipkart got a 'No' in the proceedings, when it explained the functioning of its structure and compliance with applicable FEMA provisions. But, there was no order stating it did contravene FEMA. Post this investigation, the government notified Press Note 3 of 2016 to define the conditions for marketplace model e-commerce.

According to this notification, single vendor should not contribute more than 25 per cent of e-commerce sales on marketplace and no marketplace shall directly or indirectly control or influence the price of goods.

Relevance The Flipkart case gives an insight into the legal consequences of using a flip structure for startups in industries in India that are subject to FDI restrictions or conditions. E-commerce continues to be one of the heavily regulated sectors for FDI. The discussion continues as to whether there's a clear distinction between what constitutes marketplace as compared to inventory-based e-commerce. For marketplace business founders, the Flipkart case serves as a warning that operational setup should clearly reflect 'marketplace' model.

7.5 Case 4: BharatPe v. Ashneer Grover & Ors. (2022, Delhi High Court)

Facts Ashneer Grover, co-founder of BharatPe (Resilient Innovations Private Limited) got ousted from his executive position on account of alleged financial misconduct including utilisation of company money and falsification of documents in relation to hiring and paying vendors. The company carried out an inquiry into the incident and the shareholder's compelled Grover's resignation. This led to a legal fight for Grover who also engaged in a public relations battle to challenge his removal. Delhi High Court was seized of multiple pleas seeking both parties' stay order from each other.

Issue Does removal of a co-founder from a position of executive responsibility by a board of directors represent valid action in corporate governance under the Companies Act 2013 and the SHA, and/or does such removal constitute oppression and mismanagement? What remedies are available to a co-founder who has been removed from a position of executive role but

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remains a shareholder in the company?

Judgment The Delhi High Court has shown, through its interim orders, a balanced response acknowledging that both parties are entitled to certain rights, both contractually and statutorily. The court clarified that a shareholder's rights are fundamentally different from those held in an officer capacity. A shareholder's rights can't be removed unilaterally, while officer rights can be taken by the board or the company through due process. In the end the matter was settled between the parties and Grover sold his stake in BharatPe.

Relevance The BharatPe case sets a precedent for startup corporate governance. It shows how founder rights, investor rights and the corporate law framework come into play when a founder-investor bond disintegrates between prominent partners. The case also proves that SHAs should have strong founder vesting terms, good leaver/bad leaver definitions, mechanisms to kick out a director, as well as dispute resolution clauses. The case further demonstrates how legal disputes play out in the media and how the reputational impact can be felt by the startup as well as the founder.

7.6 Case 5: Ola Electric Mobility Pvt. Ltd. – Internal Complaints Committee Controversy (2021)

Facts An employee at Ola Electric had filed a case of sexual harassment. The company had constituted its Internal Complaints Committee (ICC) in violation of the law under the POSH Act 2013, as the external member of the ICC was not from an NGO or association, which works for the welfare of women. This news came to light as the complainant and her supporters shared the fact on social media that the company had not constituted the ICC as required by law.

Issue Whether a failure by the company to constitute a technically compliant ICC under the POSH Act 2013 is a fatal flaw in the inquiry and what remedy is available to the complainant in a matter heard by an improperly constituted ICC.

Judgment Though there was no publicly available judgment on this matter, the Department for Promotion of Industry and Internal Trade (DPIIT) and the Ministry of Labour had to issue advisories to startups to remind them of the requirements of ICC constitution. Also in a related matter, the Karnataka High Court held that the requirements of the ICC under the POSH Act are mandatory and not directory. An improperly constituted ICC has no jurisdiction to decide a case of sexual harassment. In essence, a complaint heard by an improperly constituted ICC will have to go back through the process, and the respondent will be facing double jeopardy at the risk of a delayed justice.

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Relevance This case is very relevant to startups that frequently have an informal or wrongly constituted ICC or, if they don't have more than 10 employees, are not even aware that the forum of choice is the Local Complaints Committee. It also shows that compliance with POSH is not just a box-ticking exercise. It requires an understanding of what the law actually requires as well as the genuine intention and commitment to creating a safe workplace.

7.7 Case 6: Ola Cabs: Driver Classification and Gig Worker Status (Ongoing Litigation)

Facts A group of Ola Cabs (ANI Technologies Pvt. Ltd.) driver-partners submitted petitions to multiple High Courts and Labour Tribunals claiming their status as employees as opposed to independent contractors. They contended that Ola exercised adequate 'control' via its algorithms, which decide fare, allocate route and determine driver ratings, for the purpose of labour laws. Petitions similar to those were instituted against Uber India also.

Issue Is a platform based driver-partner to be regarded as an 'employee' of the ride-hailing platform under the relevant labour laws? Whether algorithmic control exercised by the platform is equivalent to 'control' typically exercised by an employer?

Judgment The cases were pending in various stages when this article was written.

The Karnataka High Court had rejected certain petitions on account of the procedural grounds whereas other cases remained pending. In similar vein, the Supreme Court held, in a matter that is not exactly on all fours with this question of whether driver-partners are employees, that the gig economy poses a new legal question in that, labour law is not designed for this purpose, and the same is an emerging concept. The Code on Social Security 2020, which seeks to define 'gig worker' and to constitute a welfare fund for the same, represents the first steps to legislation aimed at this sector but this is by no means the complete picture as on date.

Relevance These Ola/Uber gig worker cases are some of the most critical current legal developments for the platform economy startup ecosystem in India. In the event that the courts decide that the driver-partners (and, in consequence, delivery partners, freelancers and other gig workers) are to be treated as employees, it may result in a major increase in the cost structure of the platforms and may, in extreme cases, make entire platform business models unviable. The results of these cases will essentially determine the legal status of India's gig economy where millions of people are employed.

7.8 Case 7: Byju's (Think & Learn Pvt. Ltd.): NCLT Insolvency Proceedings (2024)

Facts Byju's, which was once India's most-valued startup, with a valuation of USD 22 billion at its peak, is in deep financial troubles in the financial year 2023-24. It has defaulted on

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repayments to US lenders, it was under investigation by the Enforcement Directorate for alleged contraventions of the Foreign Exchange Management Act (FEMA), and there were complaints filed against it by the employees and creditors. The Board of Control for Cricket in India (BCCI) filed an insolvency petition in the NCLT for recovery of the dues. The NCLT admitted the petition and initiated the Corporate Insolvency Resolution Process (CIRP) against Think & Learn Pvt. Ltd.

Issue Whether the NCLT had the jurisdiction to admit the BCCI's petition, despite Byju's challenge on quantum of the debt? Whether the Resolution Professional ('RP') appointed by the NCLT has the authority to control the company in the face of the founders' resistance? The broad question of application of the IBC framework to startup companies with intangible primary assets whose very value is determined by the ongoing operations of the business?

Judgment The NCLT admitted the BCCI petition and appointed a Resolution Professional. On appeal, the Supreme Court stayed the proceedings on some technical grounds but let the CIRP remain on. This case raised a number of novel questions in application of the IBC to a high value startup with complex international funding structures and multiple creditors in multiple jurisdictions and with ongoing regulatory investigations, the outcome of which is awaited. This was still sub-judice when this was written.

Significance The bankruptcy of Byju's will be a landmark case for startups in India. It shows that a valuation of a startup doesn't exempt the business from getting into financial distress and from legal implications. It tests the application of the IBC to startups where the assets are in the form of intangibles (brand, technology, and customer base), the creditors are a mixture of banks/institutions and investors, and the promoters have a strong commercial and emotional stake in maintaining control. This case is likely to produce precedents on how the IBC, FEMA, and corporate governance apply to each other.

7.9 Case 8: Google India Pvt. Ltd. v. CCI: Competition issues in the Startup Ecosystem

Facts The Competition Commission of India (CCI) initiated suo motu investigations on Google for suspected anti-competitive practices in the Android mobile OS ecosystem. The CCI investigation determined that Google placed constraints on device manufacturers that precluded them from using altered versions of Android, mandated installation of Google apps, and used its market dominance in the Google Play Store to benefit its own services. The CCI found that such practices harmed market competition for the app distribution marketplace, as well as in-app payment systems in which numerous Indian startups operate.

Issue The question of whether Google's conduct in the Android environment was contrary to

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Section 4 of the Competition Act 2002 (abuse of dominant market position), and whether CCI's remedies (mandatory 'sideloading' permissions and restrictions on forced pre-installs) were appropriate and legal.

Judgment In its order of October 2022, the CCI issued a penalty of Rs. 1,337.76 crore against Google and directed Google to change certain practices. The National Company Law Appellate Tribunal (NCLAT), on an appeal, affirmed the CCI's findings that Google had abused a dominant market position, but stayed certain of the remedial directions to be imposed, pending their detailed consideration. The Supreme Court, however, upheld the broad scheme set by the CCI, although allowing modifications of certain specific remedial directions.

Significance This case has direct relevance for startups, since the dominance of giant platform ecosystems, Google, Meta, Apple, Amazon, erects competitive hurdles for startups based on applications. The readiness of the CCI to enforce antitrust on platform ecosystems sends a message that Indian antitrust authorities are determined to safeguard the startup community from the gatekeeping power of leading tech platforms. For the Indian app developer, as well as startups dependent on the app distribution system, the result of this case will have important commercial consequences.

7.10 Case 9: Pharmeasy (API Holdings Pvt. Ltd.): NCLT Pre-IPO Reduction in Shares (2023)

Facts Health-tech unicorn Pharmeasy received regulatory clearance from the Securities and Exchange Board of India (SEBI) for listing its stock through an initial public offering (IPO). Prior to going public, however, the company obtained a loan from a private equity investor (Goldman Sachs) which was backed by a pledge of promoters' shares and included conditions under which the lender could seek early repayment through a 'down round', which is the issuance of new shares at a much lower valuation. When the company could not repay the loan, Goldman Sachs invoked these provisions and Pharmeasy launched a right issue at a valuation which is drastically below the valuations of prior funding rounds and leads to extreme dilution of the existing minority shareholders.

Issue The main question was whether the minority shareholders were being oppressed under Section 241 of the Companies Act 2013 by the proposed rights issue which was at a valuation much lower than the valuation at which the company had raised funds in its previous round of funding. Another issue was whether the terms of the Goldman Sachs loan which, in effect, allowed a creditor to dictate the equity structure of the company, was enforceable.

Judgment In the proceedings brought by the minority shareholders, the NCLT and NCLAT

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found that the rights issue terms could be oppressive. Accordingly, they asked the matter to be referred to a committee appointed by the court. The dispute raised the question of the conflict between the contractual rights of a sophisticated creditor, who had negotiated specific credit agreements in its favour, and minority shareholders' statutory protections under the Companies Act.

Relevance The Pharmeasy case shows the dangers of complex financial structures and highly levered startups and serves as a reminder to founders and minority investors of the significance of understanding the implications of loan terms (that allow for creditor control in the equity structure in a distressed scenario). The case demonstrates that in a specific scenario the financing terms can override corporate law protections.

7.11 Case 10: Uber India v. Competition Commission of India (2019)

Facts Meru Travel Solutions Pvt. Ltd., a cab aggregator company, filed a complaint with the CCI claiming that Uber India engaged in predatory pricing, which is selling cabs at rates below cost with the aim of driving other players out of the market (including Meru) and relying on cash from its foreign parent company to continue making losses. It submitted that this amounted to an abuse of dominance under Section 4 of the Competition Act 2002.

Issue Whether Uber India's discount practices amounted to predatory pricing as defined in the Competition Act 2002? Whether Uber India is in a dominant position in the relevant market (the market for radio taxi services in certain Indian cities) and if so, is the pricing at a rate less than average variable cost?

Judgment The CCI initially dismissed the complaint by Meru after ruling that Uber India was not in a dominant position in a market that included several strong competitors (Ola, Meru, and conventional taxis). The CCI held that while the competitive harm to competitors is a factor, other factors (in this case price discounts being passed onto the benefit of consumers) should also be considered and the argument that Uber is backed by a deep-pocketed foreign entity could not, in itself, prove predatory pricing. Though the decision was revisited on appeal, the finding of no dominance was confirmed by the appellate commission.

Relevance The case has important implications for startups, particularly where large sums of venture capital are used to fund prices below cost with the aim of gaining a dominant market position. The CCI has held that a startup backed by venture capital funding using below-cost pricing strategies is not inherently anti-competitive.

Additionally, the presence of other players in the market which are themselves economically viable competitors could also be a factor in negating a dominance finding. The case also

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prompts the question of whether existing competition laws are adequate to deal with the specific competition dynamics in platform markets where scale, network effects, and data advantages can often lead to natural monopolies.

CHAPTER 8: FINDINGS AND RECOMMENDATIONS

8.1 Summary of Main Findings This dissertation synthesises the comprehensive examination of India's legal regime for startups, spanning corporate governance, regulatory adherence, tax obligations, fundraising, IP rights, and privacy norms, into the following core conclusions. These insights emerge from the statutory interpretation, judicial precedents, and benchmarking exercises detailed in earlier sections.

8.2 Finding 1: Legal Framework Is Startup-Unfriendly By Nature A principal conclusion is that Indian legislation was not constructed with startups in mind. Even the updated Companies Act 2013 preserves a compliance model that is ill-suited to the dynamics of young enterprises. Moreover, until the four new Labour Codes are formally adopted, the pre-existing regime will persist, retaining various thresholds-based liabilities that create 'compliance cliffs', deterring businesses from expanding their workforces. Furthermore, while angel tax has been abolished, ESOP taxation remains applicable at rates comparable to salary income, which is relatively harsh when viewed globally.

This systemic gap does not represent active opposition to startups, as Startup India reflects the government's clear support for the industry. Instead, it highlights a fundamental challenge: a legal system designed for established enterprises cannot easily be converted into one that serves startups, without a wholesale reworking of its basic architecture. The answer cannot lie in piecemeal fixes alone; it will require a reimagining of how startups are regulated.

8.3 Finding 2: DPIIT Recognition Creates Dual-System Startups Although DPIIT recognition has proven useful, it has effectively created two categories of startup. On the one hand, DPIIT-recognised startups qualify for significant benefits, ranging from tax holidays and extended deferrals on ESOP taxation to the accelerated processing of patent applications and self-certification for labour regulations. On the other, startups without DPIIT recognition are subject to standard rules.

The definition of 'innovation' in the DPIIT application process is vague and often difficult for startups to justify, meaning that several firms in need of support are unable to obtain DPIIT recognition. Additionally, the annual revenue cap of Rs 100 crore has created a

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counterproductive dynamic: the very startups that succeed lose their DPIIT status, despite being in the best position to leverage their growth to access additional assistance. A more suitable model would determine when a DPIIT-recognised startup becomes subject to standard laws based on age, organisational complexity, and stage of fundraising.

8.4 Finding 3: Incomplete Labour Code Transition Hampers Human Resource Management The partial implementation of the four Labour Codes, replacing the prior regulations, has left startups grappling with an environment of legal instability. Since the old regime is the governing law across most regions while the new labour Codes only exist in draft form, startups are effectively required to adhere to parallel legal regimes: the current rules and the proposed ones. This state of uncertainty adds to compliance expenses and prevents startups from developing a stable and sustainable workforce. The gig economy is also suffering from a regulatory deficit. There is no national, unified regulatory model that addresses gig worker rights, and the disparate models adopted by different states create a disjointed regulatory landscape that presents a significant legal hazard for platform startups. The Rajasthan Gig Workers Act 2023 is a first step in the right direction, but a uniform model at the national level is necessary.

8.5 Finding 4: Small Startups are Disproportionately Suffering under the GST Framework The GST compliance structure is sound in principle, but the compliance costs it imposes are disproportionately high for startups with low revenues. A startup's small size, with limited financial resources, combined with monthly filing obligations, complicated ITC reconciliation requirements, and no clarity on classification and place of supply of digital services, leads to high compliance costs that are a significant chunk of startup resources. The costs imposed for non-compliance with GST, including interest on late payments, penalties for incorrect filings, and blocking of ITC, are especially onerous.

8.6 Finding 5: Structural Gaps Affect IP Protection While India’s IP protection regime has improved significantly over the last decade, structural flaws remain that particularly affect startups. Section 3(k) narrowly interprets the patentability of software inventions, leaving technology startups with little protection against IP infringements. The slowness of trademark registration prevents startups from being assured of their trademark registration rights early on. The lack of a specific trade secrets law leaves unclear the remedies for the misappropriation of trade secrets and other confidential information. The high cost of IP protection, particularly

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patent litigation, can make it impossible for startups with valid patent rights to enforce them against a large infringer.

8.7 Finding 6: DPDP Rules Create New Compliance Requirements While Lacking Clarity The DPDP Act of 2023 is an important landmark for Indian law, but its impact on the Indian startup ecosystem is unclear. While clear rules for data protection create a level playing field and can potentially increase user trust in startups, especially in sectors like fintech, healthtech, and edtech, the compliance requirements of the Act, such as consent management, data minimization, breach notification, and user right enforcement, require significant investment in data privacy compliance infrastructure that early-stage startups often do not have at their disposal. The high penalties for non-compliance with the Act could threaten the very survival of small startups that fall short of DPDP compliance. Given that the DPDP rules contain a large amount of rule-dependent language for which rules are yet to be notified, startups cannot precisely assess their compliance requirements under the Act.

8.8 Suggestions for Reform

8.8.1 Suggestion 1: Propose a Start-Up Law India might want to create and enact a separate 'Startup and Innovation Enterprises Act' that includes the full legal framework on start-ups in one single law. This law may specifically mention the definition of a start-up (by using the functional approach), the simplified compliance requirement for the recognized start-ups, the regulatory body for start-ups or may enhance the role of DPIIT (which already has a role), and a single window for the legal requirements for start-ups. Such integrated legislation for small and medium sized companies and start-ups has been made in other jurisdictions, such as France's Loi Pacte or the various enterprise support statutes of the UK. India has done so through its Startup India policy and Notifications, but the legislative approach could provide more certainty and permanence.

Reform DPIIT Recognition The recognition of a start-up by the DPIIT must be reformulated, so that: (a) the subjective 'innovation' test is replaced by objective criteria based on business registration, revenue, and investment; (b) the recognition criterion for turnover is raised to Rs 500 crores so as to eliminate the cliff-edge for growth stage start-ups; and (c) a new 'scaling start-up' category may be added in the current 'recognized start-up' framework, which may consist of the recognized start-ups with Rs 100 crores to Rs 500 crores turnover, and the recognition will be given such startups only limited benefits (in a gradual transition to the general regime).

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8.8.3 Suggestion 3: Reform ESOP Taxation For the taxation of ESOPs, India may adopt the approach of the US (incentive stock options) and the UK (Enterprise Management Incentive scheme) and make a shift in treating the ESOP gain as capital gains rather than as a part of salary (which would be the tax payable only if shares are held for 24 months in the case of long-term capital gains). Such a change will enhance the competitiveness of the Indian start-up equity, especially for the early stage companies that need to give stock options to their employees to attract talent without impacting their cash position. All start-ups, even those not recognized by DPIIT, may participate in such an incentive scheme.

8.8.4 Suggestion 4: Simplify GST for Start-Ups In particular, the CBDT and the GST Council must jointly issue a classification guide of digital services to provide clarity on the application of GST to SaaS services, API-based services, platform services, and data analytics. The registration limit for GST must be increased to Rs 50 lakhs for service providers providing digital services, and quarterly filing facilities should be provided to all start-ups up to Rs 5 crores annual turnover. Moreover, a dedicated 'start-up GST compliance package' for GST, including registration, filing, and the management of Input Tax Credit, must be developed in consultation with GST professionals.

8.8.5 Suggestion 5: Create a Software Patent Framework The Controller General of Patents, Designs and Trademarks ought to, in consultation with the startup community, issue revised guidelines on computer-related inventions to offer clearer and more certain directions on the patentability of software-implemented inventions.

These guidelines should follow a framework similar to the European Patent Office's 'technical effect' test (a standard that is much friendlier to software patents than current Indian practice yet still excludes abstract mathematical algorithms).

Furthermore, the IPO should create a specific fast-track process for the examination of patent, trademark, and design applications made by all DPIIT-recognized startups.

8.8.6 Suggestion 6: Pass a Trade Secrets Law India must pass a standalone Trade Secrets and Confidential Information Protection Act based on the United States' Defend Trade Secrets Act 2016 and the European Union's Trade Secrets Directive 2016. Such a law would clearly define 'trade secret', outline the requirements for protection, and specify civil and criminal penalties for misappropriation, as well as other specific issues faced in the employment and digital space. Startups would get a concrete legal mechanism to protect their confidential information

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(such as customer lists, algorithms, strategies, and technical know-how) that is currently protected only by the uncertain interpretation of general contract and equity rules.

8.8.7 Suggestion 7: Tailor the DPDP Act to Fit the Needs of Startups The Data Protection Board and the Ministry of Electronics and Information Technology (MeitY) must pass a tiered implementation of the DPDP Act that recognizes the different data protection needs of different data fiduciaries depending on their size, nature, and volume of data processing. Startups below a certain annual turnover (say Rs 25 crores) and certain data processing volumes could be exempted from stringent consent requirements, given more time to respond to data subject rights requests, and have limited penalty exposure. Such a framework of tiered regulation is allowed under the DPDP Act which authorizes the Central Government to make different provisions for different classes of data fiduciaries and would ensure that the DPDP Act does not become a disincentive for starting up a business.

8.8.8 Suggestion 8: Settle the Debate Over Gig Worker Status The Central Government in consultation with the states should pass on the relevant portions of the Code on Social Security 2020 pertaining to gig and platform workers. It should also set up a national-level committee (like the UK's Worker Status Advisory Committee) that could issue guidance on the classification of gig worker arrangements. This will allow the platform startups to design their compliance and cost structures with more certainty, and also give appropriate protection to the gig worker.

8.8.9 Suggestion 9: Allow Startups to List on Domestic Exchanges SEBI must relax regulations to allow more Indian startups to list on domestic stock exchanges rather than having to go to foreign exchanges due to regulatory issues on the Indian side. A 'Startup Exchange' or special listing segment on the NSE/BSE with relaxed listing requirements (perhaps replacing the profit requirement with an 'acceleration of growth' metric based on a mix of growth rate in revenue, total addressable market size, and support by institutional investors) should allow startups that will be wealth creators to raise money from Indian capital markets. The Indian IPO successes for unicorns like Zomato, Nykaa, Delhivery, etc., indicate that the Indian stock market has a lot of appetite for investing in startups.

8.8.10 Suggestion 10: Form a Special Court for Startups India should set up a special fast-track system for the trial of commercial and labour disputes relating to startups. The

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Commercial Courts set up under the Commercial Courts Act 2015 have reduced some of the delays in commercial litigation but have no specific specialization in issues relating to startups and technology. A special tribunal or fast-track process for startup disputes in the NCLT (where the Judge is trained in corporate finance, technology and startup economics) would ensure that disputes that are often technically complicated are settled by specialized judges and in a quicker manner.

CHAPTER 9: CONCLUSION

The Indian startup sector is currently at a crossroads. On one hand, we have a success story with over a hundred unicorns, millions of jobs, and billions in capital investment. On the other, we have a legal framework for businesses that has not caught up, creating delays, uncertainty, and expense throughout every stage of a startup's life cycle.

This dissertation has analyzed that delay methodically. From a founder's choice of entity at the beginning (whether a private limited company or an LLP) and its implications for investment, tax, and corporate governance; to the myriad of other regulations and filings required at subsequent stages of a startup's lifecycle, a lack of familiarity and resources with the legal aspects of running a business has been an obstacle for startups.

The debate on flip structures is a case in point, demonstrating that even well-informed, well-resourced startups and their investors have encountered contradictions and difficulties between FEMA and income tax provisions, with investors preferring to have their capital in a company.

The chapter on labour laws shows an environment in flux, with the old rules still in place, the new codes only partially adopted, and the emergence of the gig economy necessitating a legal framework that does not yet exist. The millions of gig workers are a part of this economy, with a precarious existence on the wrong side of a legal gray area, as the platform company may control their work but provides them no legal protection. Resolving the question of whether gig workers are employees or independent contractors will not only determine the future of startups, it will determine the shape of work in India.

This dissertation's most compelling story, perhaps, is the story of angel tax. Section 56(2)(viib), passed in 2012 ostensibly in order to stop tax evading investors, has been one of the most damaging provisions of the Startup ecosystem, scaring off angel investors, provoking hundreds of investigations, and diverting startups' energy and funds to defending themselves in court. While this provision was repealed in 2024, it is a victory for startups as well as a testament to the time it can take for the government to correct legislation that has caused serious economic harm.

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The taxation of employee stock ownership options continues to create tax disadvantage in India in comparison with jurisdictions such as Singapore, the United Kingdom and the United States. In the domain of intellectual property this dissertation has sought to highlight the gaps in IP law for startups. In summary, India's patenting process is too expensive and slow; India's prohibition against patents for software and other business processes is too restrictive; India's trademark process is too slow to be an effective protection tool; India does not have a trade secrets law to protect a company's proprietary technology and other sensitive information. The new Digital Personal Data Protection Act was enacted; there is a great deal of work in progress yet to clarify and implement its provisions. And so yes: the Act may provide a competitive edge insofar as trust is a factor; however, the Act could also impose heavy and unnecessary costs on resource-stressed startup ventures. We don't yet know how the Act will ultimately play out, given the rule-making process remains ongoing.

The 10 case studies in Chapter 7 show why these are not abstract concepts, and in fact what the legal realities look like for startups today. The Vodafone tax case that defined India's understanding of offshore tax planning for a decade to date; the Byju's insolvency process that is currently testing how the Insolvency and Bankruptcy Code applies to distressed startups; the governance crisis that engulfed fintech giant BharatPe in 2022-2023; the gig worker case currently on appeal against Uber and Ola; the antitrust case against Google brought by the Competition Commission of India (CCI); and several others, together show us the legal system as it actually operates, complete with its contradictions and inconsistencies. These are not simply topics for academic research: they are legal issues that directly affect millions of Indians, startups, investors, employees, consumers, and citizens.

The proposals set out in Chapter 8 arise directly from the analysis undertaken in Chapter 8. These are not suggestions for liberalisation, deregulation and less bureaucracy for their own sake, but specific, targeted recommendations on where reform could lower the burden of compliance for startups and enable them to compete globally. They represent a coherent framework for future reforms that would lower costs while still achieving the core regulatory goal of ensuring investor protection, taxation, employee welfare, and data privacy. There are 10 recommendations: a Startup Innovation Enterprises Act (SIEA) as a standalone legislation reforms to the DPIIT's startup recognition process changes to capital gains taxation on ESOPs a new GST structure to reduce compliance for digital services a framework for software patents a Trade Secrets law a tiered compliance approach to data privacy gig worker recognition changes to enable domestic listings a dispute resolution mechanism for startups

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India possesses the will, the human capital, the market, and the policy intent to become the world's leading innovation hub. What India requires is a legal framework to match this ambition. The law must be more than a neutral enabler, and must instead be an enabler of entrepreneurship, lowering the cost of doing business for value-creating firms, protecting stakeholders in these firms, and providing certainty and predictability for long-term value creation. This, in essence, is the argument of the dissertation: a position based not just on theory but on the reality of building India's startup story today. The journey from a co-working space to a publicly-traded company, from an idea to an IPO, is a long, challenging, and often unpredictable process. In India's case, the legal framework that guides these developments has been a hindrance rather than a help. This dissertation attempts to document the current state of startup law, identify areas where reform is possible, and make proposals on how India can better equip startups to build the economy of the future. Hopefully, this research can play its part in shaping the regulatory framework for India's future growth.

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