Research Paper

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Startup Laws - Demystified

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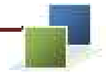

1. DECIDING UPON AN APPROPRIATE STRUCTURE

Startups primarily are set up by the founders / promoters based on the location in which they are based, without taking into account other considerations applicable in setting up the business. Following are the factors relevant to picking a location for setting up of a startup:

1.1 Location of business:

One of the more important considerations relies on where the startup expects to do its business. A startup geared towards local customers should ideally be close to the place where it intends to operate. Conversely, where a startup intends to do business across the globe (like for example launching an application or service which they expect to be used not just in India but outside), then the startup will have to ensure that its setup is properly structured.

1.2 Presence of management team / founders:

The other primary consideration is the presence of the management team. It may not be very cost effective for a startup setup in the US, to have a management team that effectively operates out of India.

1.3 Ease of doing business:

Seeking licenses to do certain kinds of business, ease and efficiency of registering intellectual property and ability to procure the relevant licenses required to set up a business are also considerations that should be taken into account when choosing a location for a startup.

1.4 Regulatory and tax considerations:

One must also take into account and ensure that the startup is compliant with applicable regulatory consideration. Although initially tax may not act as a primary consideration for setting up a business, as it grows and generates income it may want to restructure to more efficiently plan its affairs. It must be noted that if not initially thought through (on at least a preliminary level) re-structuring later may be expensive and fraught with potential risk of being subject to additional taxes. The structure gives the startup a different identity as far as the laws and regulations are concerned, which will be instrumental in determining the taxation policies governing it as well as the regulatory environment. Accordingly, it is necessary to decide a proper structure for the startup and the jurisdiction where any intermediary holding company is to be situated. There are various issues which need to be

carefully examined by the startup while structuring its operations. The startup has to consider the nature of its operations, the attributes of the markets, and where it proposes to hold its intellectual property while determining the location which is most suitable for its business. The choice of jurisdiction and region for setting up the business of a start-up varies on a case by case basis, however, we have considered a few instances below where specific consideration may play a role in determining the choice of jurisdiction for setup.

2. STRUCTURING EXTERNAL INVESTMENT

Typically, after setup most startups look for angel investments from serious angel investor or friends, family or benefactors. There are specific considerations (from a legal standpoint) that should be kept in mind when approaching an angel investor.

2.1 Copy of charter documents and any existing founder’s agreement:

All charter documents relating to the startup, the share capital and any other agreement governing the behavior of the founders should ideally be provided to angel investors at the earliest.

2.2 Term Sheet, Letter of Intent or Memorandum of understanding:

This is usually the first step in angle or venture capital (“**VC**”) investment. It sets out the basic commercial understanding between the VC and the startup. It is also important to have ready a brief and succinct term sheet that provides a clear outline of the investment sought, the stake offered and the investment rights that may be made available to the investors.

2.3 Shareholders’ Agreement:

- Provides for the appointment of the investor’s directors on the board of the startup and provides the structure of the board.
- Provides information and reporting rights which require the startup to keep the investor informed of developments and provide the investor with, *inter alia*, regular financial reports.
- Provides the investor’s exit route to cash out their investment at some future date.
- Provides various rights to the investor including, pre-emptive right, right of first refusal or right of first offer, tag along rights, drag along rights, call option, anti-dilution rights, and liquidation preference.

2.4 Share Subscription Agreement:

- Provides for the issuance of shares in the share capital of the startup to the investor in consideration of a subscription amount, which is determined as per the valuation of the startup. It also provides a broad outline of what the money will be used for.
- Provides for representations and warranties by the founder (in relation to the startup) which will allay any risk the investor may face due to legal, regulatory or tax related liabilities of the startup. Representations and warranties are usually protected by an indemnity provided by the startup and/ or the founders, if any losses occur as a result of any breach of representations and warranties.
- Provides covenants which are designed to keep the startup's activities in check in terms of legal, regulatory and tax compliances. It also provides conditions precedent/ conditions subsequent, which aim to cure any issues that are identified during the due diligence process.

2.5 Compulsorily convertible preference shares ("CCPS"):

Compulsorily convertible preference shares ("CCPS") can be used as an effective instrument as they continue to carry a preferential right of dividend and a preferential right to recover investment in the eventuality of a winding up.

2.6 Compulsorily convertible debentures ("CCDs"):

CCDs are another investment instrument that may be considered. A debenture is a debt security issued by a company, and typically represents a loan taken by the issuer company with an agreed rate of interest. Debentures may either be secured or unsecured. The Ministry of Finance, Government of India, through its press release dated April 30, 2007, and a subsequent circular issued by the RBI on June 08 2007, directed that all preference shares and debentures, other than compulsorily convertible preference shares/ debentures, viz. non-convertible, partially convertible or optionally convertible preference shares/ debentures, issued on or after May 01, 2007 , would be regarded as debt and not share capital for the purposes of investment into India and therefore issuance of the same would be subject to the terms and conditions of the External Commercial Borrowings Guidelines ("ECB Guidelines"). The ECB Guidelines which place various restrictions on debt and certain securities that are treated as debt. These restrictions include restrictions on who may be a recognized lender, who is eligible to borrow, and what such borrowings may be used for.

3. INDIAN PROMOTERS / FOUNDERS INVESTING OUTSIDE INDIA

Indian foreign exchange control laws place certain restrictions on ability of an Indian resident to remit monies outside India. Individuals looking to set up entities outside India typically do so under a scheme introduced in February 2004 by the Reserve Bank of India ("RBI") as "Liberalized Remittance Scheme" or LRS. Under the LRS, resident individuals can acquire and hold shares or debt instruments or any other assets including property outside India without requiring any specific approval of the RBI. It must be noted that monies sent out under the LRS, cannot be utilized in (amongst other countries) Mauritius. When setting up entities outside India, resident individuals utilize the LRS in order to make such remittances. However, certain restrictions have since been prescribed by the RBI including restricting resident individuals from making direct investment in entities involved in real estate business, banking business or financial services activity. Further, investment by individuals is only allowed in entities engaged in bonafide business activity.

4. OFFSHORE COMPANIES IN INDIA

Till very recently, offshore companies have been treated as "non-resident" in India unless wholly controlled and managed from India. The consequence of this is that the income of such offshore company is not taxable in India unless distributed to an Indian resident shareholder. However, recently via the Union Budget of 2015, this has been changed to a more subjective test of "place of effective management" ("POEM"), and considers a foreign company resident in India if its POEM is in India. This means that startups set up outside India whose management team is deemed to have primarily sat in India may now face the risk of being classified as a tax resident of India for which all of its income may become taxable in India. General business considerations for choice of jurisdiction would include an instance where if a startup proposes to have purely Indian operations and operate in the Indian market, the most likely jurisdiction for setting up the operations could be India, so that it does not have to face the various intricacies of a foreign entity operating in the Indian market. However, if a startup envisages global operations and a global market, than the location and the structure of the startup could be decided depending upon the nature of business and the market of the startup.

4.1 General rules applicable to foreign investment in Indian companies:

Foreign Direct Investments can be made either through the “automatic route” or the “approval route”. Under the “automatic route” neither the foreign investor nor the Indian company requires any approval from the FIPB. The startup in such case is only required to file certain forms and declarations with the RBI after the foreign investment is brought into the Indian company, whereas under the “approval route” prior approval of the FIPB would be required. Foreign investment usually comes in either by way of subscription to, or purchase of, equity shares and / or convertible preference shares / debentures of the startup. The investment amount is normally remitted through normal banking channels or into a Non - Resident External Rupee (NRE) / Foreign Currency Non-resident (FCNR) account of the Indian company with a registered authorized dealer (a designated bank authorized by the RBI to participate in foreign exchange transactions). The company is required to report the details of the amount of consideration received for issuing its securities to the regional office of the RBI in the forms prescribed under the regulations relating to Foreign Direct Investment together with copies of the Foreign Inward Remittance Certificate, arranged for by the Authorized Dealer evidencing the receipt of the remittance. Further requirements include the “Know Your Customer” report on the non -resident investor within 30 (thirty) days of the receipt of the foreign investment. The report must be acknowledged by the regional office concerned, which office will subsequently allot a Unique Identification Number for the amount reported. A certificate from a duly qualified merchant banker or a chartered accountant indicating the manner of calculating the price of the shares issued is also required. Pricing restrictions apply on any issuance of shares by Indian companies to non-residents which state that shares may be issued only at a price which is not less than the fair value of shares calculated as per any internationally accepted pricing methodology. The Indian company is required to issue its securities within 180 days from the date of receipt of foreign investment. Should the Indian company fail to do so, the investment so received would have to be returned to the person concerned within this time-frame. While it is possible for a company to raise external debt, the same is governed by the external commercial borrowings guidelines prescribed by the RBI which make all such borrowings subject to end use restrictions, limit on interest payable in relation to the borrowing - i.e. it would have to comply with an ‘all-in-cost-ceiling’ as well as restrictions on who can borrow (eligible borrower limitations) and who can lend (eligible lender restrictions). Furthermore, the ceilings on interest payable on the same may discourage foreign lenders from providing debt to Indian borrowers.

4.2 Foreign Investment in Limited Liability Partnerships

A limited liability partnership ("LLP") is a form of business entity which permits individual partners to be shielded from the liabilities created by another partner's business decision or misconduct. In India, LLPs are governed by the Limited Liability Partnership Act, 2008. LLP is a body corporate and exists as a legal person separate from its partners. Foreign investment in LLPs is permitted only under the Government approval route and can be made in LLPs operating in sectors where 100% FDI is allowed through the automatic route and there are no performance linked conditions. An LLP is utilized in certain instances by promoters, but due to issues in procuring investment into an LLP, a company incorporated under the Companies Act, 2013 is usually preferred.

5. OTHER CONTRACTS AND AGREEMENTS

Once a startup has been incorporated, certain basic documentation should be formulated to ensure that business can be carried out. First, in order to carry out business with third parties, a standard confidentiality and non-disclosure agreement template must be ready. This can be used by the startup to enter into preliminary discussions with third party vendors, consultants, contractors etc. whilst ensuring that appropriate protection is provided to the startup and its ideas.

5.1 Confidentiality & Nondisclosure Agreement:

A non-disclosure agreement ("NDA") is an agreement in which one party agrees to provide access to its confidential information to a second party about its business or products and the second party agrees not to share this information with anyone else for a specified period of time. Some important clauses in NDA's include: definition of 'confidential information' and exclusions thereof, term, if any, for keeping the information confidential, provisions regarding obligations on the use / disclosure of confidential information including use of information only for restricted purposes, disclosure of information only to persons on a 'need to know' basis, adherence to a standard of care relating to confidential information, ensuring that anyone to whom the information is disclosed further abides by the recipient's obligations. Second, certain documentation relating to the recruitment of employees has to be put in place including but not limited to template offer letters and employment agreements, NDAs and invention assignment agreements. While there is no particular requirement under the central labour statutes to have written employment contracts certain state specific Shops and

Establishments Acts require an employer to issue an 'employment order' to employees, within thirty days from the date of appointment. It is however recommended that the terms and conditions of employment, remuneration and benefits should be clearly documented.

5.2 Offer Letter / Employment Agreements in India:

It is a general practice that employers issue offer letters to employees at the time of appointment. This document briefly outlines the terms and conditions of employment including probationary period, remuneration and other documents required to be produced at the time of joining. While many employers stop at this stage, it is recommended that employers execute employment contracts each of their employees in addition to the offer letters. While drafting the offer letter and employment agreements and determining the terms and conditions of employment, it is critical to ensure that all applicable employment laws are being complied with. Although there is no prescribed format for an employment contract, some of the important clauses in such contracts include: Term of employment and termination of employment (including as a result of misconduct); Compensation structure – remuneration and bonuses; Duties and responsibilities of the employee; Confidentiality and non-disclosure; Intellectual property and assignment; Non-compete and non-solicitation obligations; and Dispute resolution. A NDA is also executed with an employee by the employer to ensure that details learned by the employee during the course of employment is not otherwise used to the disadvantage of the employer / startup.

5.3 Non-Competition & Non Solicitation Agreements:

Employers may choose to enter into non-competition and non-solicitation agreements with their employees. Alternately, these obligations may be included in the employment agreement. While non-compete clauses during the term of employment are generally enforceable in India, a post-termination non-compete clause is not enforceable under Indian laws since they are viewed to be in 'restraint of trade or business' under Section 27 of the Indian Contract Act, 1872 ("Contract Act"). Courts in India have time and again reiterated that a contract containing a clause restricting an employee's right to seek employment and/or to do business in the same field beyond the term of employment is unenforceable, void and against public policy. An employee cannot be confronted with a situation where he has to either work for the present employer or be forced to idleness. Though the stance of Indian courts on the question of restraint on trade is clear, such clauses are commonly included in the terms of employment for their deterrent effect. With respect to non-hire restrictions,

courts have viewed the arrangement as an extension of a post-termination non-compete clause and therefore unenforceable. The trend of incorporating restrictions on solicitation of employees, customers or clients during or after the term of employment has become common in recent times, especially with the increasing usage of social media and professional networking sites. A non-solicit clause is essentially a restriction on the employees from directly / indirectly soliciting or enticing an employee, customer or client to terminate his contract or relationship with the company or to accept any contract or other arrangement with any other person or organization. In determining the enforceability of a non-solicit clause, the courts have generally taken the view that such clauses shall be enforceable, unless it appears on the face of it to be unconscionable, excessively harsh or one-sided.

5.4 Intellectual Property Assignment Agreement:

In India, the Copyright Act, 1957 specifies that typically an employer becomes the owner of a copyright-able article created by an employee during the course of and within the scope of employment. However, other forms of intellectual property rights still need to be specifically assigned. To this end, a "confidentiality and invention assignment agreement" is typically entered into by an employee with the employer which, amongst other things covers the following:

- Scope and extent of intellectual property sought to be covered;
- Definition of the intellectual property included, including defining proprietary information being provided to the employee;
- Covenant stating that all intellectual property developed by the employee during the course of the employment should be adequately disclosed to the employer;
- Assignment of any intellectual property developed by the employee during the course of employment;
- Waiver of any rights to claim rights - whether economic or moral over the intellectual property so developed; and
- Cooperation related covenants that would allow the employer to utilize the intellectual property so assigned / provided to the employer through the invention assignment agreement.

5.5 HR Policy / Employee Handbook:

It is recommended that all employers clearly set out the various policies and procedures applicable to employees and circulate such policies to employees periodically. Many subjects

covered in a company's employee handbook are governed by laws which may be specific to the state in which the workplace is located. Hence, it is recommended that the employee handbook be drafted in accordance with all applicable national and state laws. In recent times the law has mandated that specific anti-sexual harassment policy be drafted in accordance with the Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act, 2013. The general provisions incorporated in an employee handbook include (but are not limited to):

- Employee benefits;
- Leave policies including paid leave, casual leave, sick leave, maternity leave etc;
- Compensation policies;
- Code of conduct and behavior policies;
- Anti- discrimination and sexual harassment policies;
- Immigration law policies;
- Complaint procedures and resolution of internal disputes;
- Internet, email and computer use policies;
- Conflict of interest policy;
- Anti-drugs, smoking and alcohol policy;
- Accident and emergency policies;
- Travel and expense policy;
- Prohibition from insider trading.

5.6 Employee stock option plans ("ESOPs"):

Employee stock option plans ("**ESOPs**") are designed to give an employee stock in the employer company. They may be granted either after completion of certain years of employment or may vest immediately upon joining. In order to recruit and retain top performers, the company could use ESOPs as incentives to its potential employees by offering stock options to them. This is a popular strategy with companies that cannot afford to provide large pay packages in order to attract the right level of employee. ESOPs are generally executed through an ESOP plan document that specifies the scope, extent and manner in which the ESOPs will be granted to employee. This is accompanied by a "grant letter" which is a quasi-agreement entered into with the relevant employee which more specifically outlines the terms of the grant, vesting and exercise. An ESOP is a right but not an obligation of an

employee to apply for the shares in the company in future at a predetermined price. These options may be converted into shares upon fulfillment of certain conditions. These conditions could be performance -based or time-based. All schemes floated by public listed companies have to comply with the guidelines issued by the Securities and Exchange Board of India ("SEBI") – namely the SEBI (Share Based Employee Benefits), Regulations, 2014. Further, it is also possible to grant ESOPs in the foreign companies to employees of the Indian subsidiaries such foreign companies subject to certain guidelines as per FEMA. Therefore, the company would have to structure its ESOP in a manner so that it falls within the regulatory environment. At the time of exercise of the stock options, the difference between the fair market value of the shares and exercise price of the options will be taxed as salary income in the hands of the employee. Further, the employee is required to pay capital gains tax at the time of sale of shares acquired under an ESOP on the difference between the sale consideration and the fair market value on the date of vesting.

5.7 Other Agreements:

The startup in order to conduct its activities will have to deal with various other players in the market, which fulfill the requirements as to raw material, advertisement or selling of the product. Accordingly, in order to deal with them as clients, suppliers or partners, the startup has to enter into certain agreements with them specifying the standard, which has to be met by both the startup and the other parties in order to conduct the business. So as the startup conducts business, it requires drafting or review of various agreements which it enters into with the other parties. These would often involve standard form agreements including those used by the startup and those used by third parties it deals with. It would also involve more aggressively negotiated agreements such as investment contracts and large supplier or customer contracts. These agreements are often structured differently. For instance, a startup may enter into numerous contracts with a customer for each assignment or may choose to have a master agreement setting out the essential terms and have assignments and their corresponding payments set out in statements-of-work under such a master agreement. These would include agreements such as: Software License Agreement; Software Development/Services; Assignment Agreement (Work for Hire Agreement); Equipment/ Technology Lease; Online Agreements; Shrink Wrap/ Click Wrap Agreements; Strategic

Alliance Agreements; Outsourcing Agreements; Customer Contracts; Contractor Agreements and Leases.

6. CONCLUSION

Perhaps the first step a startup needs to take is to determine how it will be setup, from where the seed investment required to set up the startup entity needs to be brought (colloquially referred to as "Structuring") and what sort of entity it would like to function as. For certain professions, this may be limited to partnerships though the preferred entity tends to be a company. Incorporating a company requires certain steps, which we deal with in this paper. Once a startup is incorporated, it will need to set up its offices. This process gives rise to numerous issues that startups may not even be aware of. For instance, the startup will need to obtain registrations with various labour authorities and will need to establish human resources (HR) related policies in tune with the relevant employment laws. Further, it may be beneficial for a startup in the IT sphere to obtain "Software Technology Park" status. Manufacturing units will need to comply with indirect tax laws including excise duty and value added tax. Once the business is up and running, it is usual for the startup to look for investors. These investors come in at various stages in the growth of a startup. In order to get the startup off the ground, the startup is invariably capitalized by either the promoters themselves or by an "angel investor" (usually someone with benevolent intentions). Venture capital (also known as VC) is a type of private equity capital typically provided to startup companies with high-growth potential in the interest of generating a return through an eventual liquidity event such as an IPO or trade sale of the company. Venture capital investments are generally made as cash in exchange for shares in the invested company. Venture capital is most attractive for startups with limited operating history that are too small to raise capital in the public markets and are too immature to secure a bank loan or complete a debt offering. In exchange for the high risk that venture capitalists assume by investing in smaller and less mature companies, venture capitalists usually get significant control over company decisions, in addition to a significant portion of the company's ownership (and consequently value). This is a particularly taxing time for the promoter as it often requires him/her to give up a considerable quantum of stock in the startup. Since most of the investments are expected from abroad, it is typically necessary to structure the investment from a legal, tax and regulatory point of view in order to comply with the necessary laws and regulations.