
REGULATION OF STARTUPS AND UNICORNS UNDER INDIAN CORPORATE LAW

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ABSTRACT

Over the past decade, the startup space and more importantly the unicorns in India have together totally altered the way the Indian economy grows, the way we think of innovation and how corporate governance functions. These new companies show off entrepreneurial energy but also throw up regulatory puzzles because they grow so fast, use odd business models, rely on VC and foreign money. This paper focuses on the extent to which Indian corporate laws has attempted to keep pace with startups - from incorporation norms to the Startup India Initiative, board responsibilities, dual class shares quirks and tax/compliance woes. I'll analyse whether the laws strike the right balance of promoting innovation and safeguarding investors, and I'll suggest how the laws might change in future.

Keywords: Indian corporate law, Startups, unicorn, regulatory frameworks, corporate governance, Startup India Initiative, dual class shares, foreign investment, compliance.

Genesis of Indian Start up Ecosystem and Regulatory Context

In the early 2000s, when India was only beginning to open up its economy, most businesses were small and medium-sized, and stuck in traditional industries. Then came the internet boom in the late 90s and mobile internet soaring off the charts in the 2010s which blew up an entire new crop of tech-driven companies as well. These agile firms - they called them "startups" - were built on innovative models and were able to scale up quickly. The term became pressed into official use when the Government in 2016 launched the Startup India Initiative which provided tax breaks, reduced paperwork and improved access to funding. Amidst all this exercise in economic transformation, Indian corporate legislation had to begin juggling old rules with the breakneck pace of fast-moving enterprise realities in the corporate startup world.

Prior to the 2013 Companies Act, Indian corporate law was based on an old Companies Act of 1956 that had served traditionally organised business houses with mature governance cultures. The explosion in growth of startups and unicorns - those behemoth private companies with more than a billion dollar value - prompted people to question if the legal framework that has existed for so long still fitted. Lawmakers began arguing over how to foster new growth while still protecting against fraud, unfair dealing with investors and bad management.

In legal doctrine and policy discourse, the management of startups and unicorns in India means juggling three things - make it easy to start a business, good governance, and attract money from within and outside India. The 2013 Companies Act brought big changes: it brought India in tune with global practises and enforced transparency, accountability and protection of minority shareholders. But when you apply those rules to the niche world of startups - with their unique equity packs, complex investor deals and explosive growth - you need to read them in context.

Corporate (Incorporation and Structural Flexibilities) Under The Indian Law

Under the 2013 Companies Act, the entire process of setting up a company is laid out - from how you set up the firm - who owns shares, how the board works and what paperwork you need. Startups often choose a private limited form of organisation, and occasionally, if they're considering an IPO down the road, they go public from the beginning. Private limited companies have their advantages, because they're flexible, they're easier to get cash and founders and investors suffer limited liability. The Act enables you to set up a private limited

firm with only two shareholders and directors - it is very much the start-up's dream.¹

Despite that flexibility, the Act keeps you stuck when it comes to some of the governance rules that may feel heavy for a young company. Things such as compulsory board meetings, maintenance of statutory registers and preparation of annual accounts compel firms to be bureaucratic. The government took a note of this and the Government of India's Ministry of Corporate Affairs (MCA) rolled out relaxations and exemptions in the form of circulars on the process for startups that qualify under the Startup India programme, reducing the compliance costs.

In addition to the legal architecture of the domestic context, there is another level of complexity by way of cross-budget funding. Indian law, in line of foreign investment policies, permits, in some sectors, companies to make external commercial loans and bring in equity via an automatic route to enable late start ups to attract VC and PE money, without a lengthy approval process.² This flexibility has been key to getting unicorns onto the radar in the area of fintech, e-comm, software and more. Still, the overlapping with FEMA rules - for foreign exchange, 1999, and related regulations - makes the legal environment really multi layer for these firms.³

Startup India Initiative: Policy Support and Legal Recognition

Back in 2016, the Indian government launched the Startup India Initiative, in essence trying to turn India into a global startup hot spot. The goal was to reduce the barriers to entry, offer tax rebates and make the red-tape less of a nightmare for newbies. Legally, the initiative created a "recognition" status for startups, which can get them out of the clutches of the Angel Tax under Section 56(2)(viib) of the Income Tax Act, 1961 - provided that they meet certain conditions.⁴ The Angel Tax thing had been a pain point, charging equity that was worth more than market value so this exemption was a big win for the ecosystem.

Also, it pushed for self -- in environmental, labour, "other regulatory fronts," so that young companies didn't have to slog through too many compliance hoops in their first years. Legal experts point out that by including relief as part of a policy rather than by amending

¹ Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India).

² Consolidated Foreign Direct Investment Policy, 2020, Government of India, Ministry of Commerce and Industry.

³ Foreign Exchange Management Act, No. 42 of 1999, India.

⁴ Startup India Action Plan, Department for Promotion of Industry and Internal Trade (DPIIT), Government of India.

fundamental laws, the government found a pragmatic sweet spot between not making regulations too stringent and not making them too lenient for start-ups to grow.⁵ That said, the absence of statutory support for some of these perks has led to debate over how sustainable or enforceable such measures actually are, which appears to increase when regulators approach them from different angles.

Apart from these tax discounts, the "recognition" status of Startup India ensures standardization of paperwork as well as reporting. This allows true startups to provide investors, and, subsequently, regulators, with solid, credible data, which then impacts corporate governance expectations. So, a recognised startup is expected to keep up with the disclosures that investors look for, to help build confidence in building the ecosystem from a loosely organised collection of projects to well-structured corporate entities.

Governance Issues: Dual-Class Shares, Investor Rights and Board Composition

One of the hottest topics of debate in the 'Regulation of Startups' and 'Governance of Unicorns' is the dual-class share (DCS) structure. Indian corporate law typically states that one share, one vote so that shareholders remain equal, but many unicorns have DCS preferences that allow more voting rights for the founders, so they can maintain control while increasing their finances through raising funds. DCS or differentiated voting rights (DVR) are not formally recognised under the Companies Act, 2013, however the 2018 SEBI rules for listed companies did permit DVR under strict conditions⁶-This demonstrates that the regulators recognise the need for flexible governance in innovative companies?

For private startups and unicorns, the statutory ambiguity about DCS in private companies leaves grey areas in terms of legality. Founders and investors frequently make up contractual mechanisms such as shareholders agreement to define these rights. Those agreements are enforceable between the parties, but they don't have statutory clout like formal share classes, so in trying to master that for your shareholders, it's difficult to actually enforce that on third parties or enforcement in a regulatory filing. The reliance on contract-based investor protections also highlights the problems for minority shareholders when large investors

⁵ R. Mukherjee, Regulatory Relief and Startup Growth: A Policy Assessment in India, 12 J. Indian Bus. & L. 45 (2020).

⁶ SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, Regulation 4.

negotiate special terms culminating in minority owners being at a disadvantage.

There is another level of complication with board composition in startups and unicorns. The Companies Act provides for norms of director independence and for the duties of the board, particularly the responsibility of boards in the case of big firms.⁷ Early stage ventures on the other hand are often founder dominated with little independent oversight, meaning blind spots can exist. Venture capitalists typically receive board seats and veto rights as part of investment contracts, however, this must translate into true alignment with the statutory duties that advance holders have to the Act, such as fiduciary duties and duty of care. Legal commentators make calls to make better guidance on how to combine contractual governance rules with statutory director responsibilities, so accountability is strong but entrepreneurs do have room to innovate.⁸

Taxation, Compliance & Financial disclosure requirements

Tax is a big freaking deal among startups and unicorns, from how much investment they can get, to the strategies they use. Apart from the exemption given to start-ups, Indian corporate law interacts with other tax laws to determine a company's tax burden. For example, in 2019 the government introduced a lower corporate tax rate for new manufacturing companies, which indirectly reduced the overall tax burden of startups - and unicorns are able to use those savings for growth.⁹ However, transfer pricing rules and a focus on related party deals introduce a degree of complexity for startups doing cross borders business.¹⁰

Also, the Companies Act requires startups and unicorns to prepare audited financial statements annually, maintain appropriate books, and place statutory returns with the Registrar Of Companies (ROC). These requirements increase transparency - but can be a heavy administrative burden for early stage firms that don't have big accounting teams. The MCA attempted to soften the load by including small company thresholds that provide some relaxation from certain disclosure obligations: but those limits don't always make sense for high growth unicorns which attract major capital flows.¹¹

⁷ Companies Act, 2013, §§ 149–152.

⁸ K. Dasgupta, Corporate Governance in Startups: Challenges and Legal Responses, 29 Indian Corp. L. Rev. 67 (2022).

⁹ Taxation Laws (Amendment) Act, 2019.

¹⁰ Income Tax Act, 1961, § 92 et seq.

¹¹ Companies (Accounts) Rules, 2014 (as amended).

At the last, with GST, the hue of the indirect taxation landscape underwent a big makeover, as a number of different taxation systems were consolidated under one system. For startups, the implication of the GST was revamping the invoicing process, the input-tax-credit processes, and filing schedules. While it helps to simplify the overall structure, the specific rules nonetheless give rise to litigation in areas such as e-Commerce and digital services where principles regarding tax can be tricky.¹²

Investor Protection, Insolvency, and where We Go From Here

Basically, protecting investors in the startup scene is a big regulatory deal. While the big institutional players - think venture capital funds - have the luxury to negotiate all those protective clauses, regular folks like retail investors and employees with stock options, might not have the same safety net. In India, corporate law package is not entirely devoid of safeguards for minority shareholders (they can seek compensation for misdeeds of the abuses and unfair prejudice of shareholders with the help of provisions for the shareholders in the Companies Act, and there are also class actions provision in certain cases).¹³ But these remedies may run into the sand at startups where shareholder agreements typically include arbitration clauses and forum-selection clauses that transfer dispute resolution out of the statutory courts.

The Insolvency and Bankruptcy Code (IBC), 2016 provided a very broad framework for insolvency resolution in India with respect to corporate. Even though the IBC has made it faster for struggling companies to become bankrupt, its fit for startups and unicorns is a bit tricky. Many tech startups operate on an asset light model, so locating the value of assets and how the claims of creditors will apply under the IBC can get really complicated. Regulators and courts have been stuck trying to find a way to adapt these rules without screwing up the primary objectives of creditor protection and maximising value.

Looking onwards, there's been debate in the legal world by academics and policymakers on the need for more flexible governance frameworks which capture the distinctive features of startups and unicorns. Ideas such as granting private companies a special status as to different share structures, developing levels of compliance collection to target growth stages and providing understanding on how contractual governance mechanisms interact with corporate law requirements are emerging as potential reforms. Still, maintaining accountability,

¹² Central Goods and Services Tax Act, 2017.

¹³ Companies Act, 2013, §§ 241–242.

transparency and fair treatment for all stakeholders is a key to maintaining investor confidence and sustainable growth.

Conclusion

The regulatory structure around startups and unicorns in India reflects the manner in which India is attempting to gel regulatory rules amongst corporate laws, in line with the fast-changing markets. Whilst there've been some notable improvements in flexibility and tax incentives and relief from compliance, there are still some gaps in legal clarity, governance frameworks, and investor protection. Finding the perfect balance between promoting innovation and ensuring adequate governance will determine the future of Indian corporate relations. As the ecosystem for startups matures, there will be a need for reforms that are responsive, specific and anchored to sound corporate governance to ensure that India remains a global leader in the field of innovation.