Entrepreneurs' Essential Guide to Law

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As India's economic growth story continues to fascinate the world, new facets of the growth are being discovered, e.g., domestic consumption, IT superpower, democracy, an amazing pool of talent. One of the, as of yet, unsung stories of this growth is also the mushrooming of domestic entrepreneurs. Hitherto limited to the established business or wealthy families, entrepreneurship has now become more egalitarian. We are increasingly meeting people from all walks of life starting their own ventures, for a thrill, to exploit the serious market opportunities or, of course, because they have the next big idea! In this context, being entrepreneurs ourselves, we at, Narasappa, Doraswamy & Raja, thought we should do our part to help budding entrepreneurs.

This Entrepreneurs' Essential Guide to Law is the first in a series of steps that we hope to take to promote entrepreneurship. This Guide addresses some of the basic questions that an entrepreneur has when he starts a business. While not exhaustive, the Guide intends to help the entrepreneur identify the issues which he needs to be concerned about and seek advise on. We hope to revise this Guide annually. So, any feedback will be appreciated.

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PLEASE NOTE THAT THE CONTENTS OF THIS GUIDE IS NOT MEANT TO BE A SUBSTITUTE FOR OBTAINING LEGAL ADVICE. THE GUIDE IS ONLY AN INTRODUCTION AND WE URGE YOU TO CONSULT YOUR LAWYER FOR SPECFIC ADVICE.

§ 1 :: Getting Started

A. The Business Entity

Choice of Entity – Types

Entrepreneurs in India do not have too many choices as regards the vehicle they can use to start their enterprise. Unlike in other jurisdictions, Indian law permits businesses to legally organize themselves into two broad types of entities: -

(a) a partnership firm, or

(b) an incorporated company, whether private or public or whether with limited liability (by shares or guarantee) or with unlimited liability.

Of course, if a single individual is starting a business, he / she could choose to run the business as a proprietorship.

Choosing an Entity

The choice of the entity is generally determined by the following factors: -

1. <u>Taxation</u>: A company tax regime involves two layers of tax. There is an incidence of tax on the company's net income, and the shareholders may also be taxed when they receive dividends or other proceeds, as incomes from the company. On the other hand, profits earned by a partnership firm are taxed only once.

2. <u>Liability</u>: Generally the liability of the members of a company is limited, although it is possible to incorporate an unlimited company. In a company limited by shares, a member is liable to pay only the uncalled money due on the shares held by him when called upon to pay and nothing more, even if liabilities of the company far exceeds its assets. In a company limited by guarantee, the liability of the members is limited to such amount that they undertake to pay in the event of liquidation of the company. So, the liability arises only when the company has gone into liquidation and not when it is a going concern. On the other hand, in a partnership, the partners of the firm have unlimited liability, i.e., if the assets of the firm are not adequate to pay the liabilities of the firm, the creditors can force the individual partners to make good the deficit from their personal assets. This cannot be done in case of a company limited by shares or guarantee once the members have paid all their dues towards the company.

3. <u>Convenience</u>:

(a) *Separate Legal Entity*: A company is a separate legal entity from its members. It has its own assets and liabilities distinct from those of the members, and is capable of owning property, incurring debt, entering into contracts, suing and being sued separately. Even though there is no actual physical presence, its acts through its board of directors to carry out its activities under the name and seal of the company. On the other hand, the property of a partnership firm belongs to the partners as the firm does not have any separate legal existence distinct or separate from its partners.

(b) *Perpetual Succession*: A company does not die or cease to exist unless specifically wound-up. Change in the membership of a company or the death or insolvency of any members of the company does not affect the life of the company as a separate entity. This quality ensures that the company survives even in the event of a change in ownership of its shares. On the death of a partner, the partnership is dissolved unless there is provision to the contrary by agreement between the partners.

Public Company vs. Private Company

The Companies Act, 1956 (the "**Act**"), provides for the incorporation of either a private company or a public company. A private company, as an entity, has several advantages as well as disadvantages: -

1. <u>Advantages</u>: -

a) A private company can be incorporated by a minimum of two members, as against a minimum requirement of seven members for a public company.

b) The minimum paid-up capital currently for a private company is Rs One Lakh, as compared to Rs Five Lakh for a public company.

c) Numerous restrictions imposed by the Companies Act on a public company are not applicable to a private company. These include restrictions such as the requirement for special resolution to issue shares to non-members, obtaining a separate certificate for commencement of business and certain provisions relating to statutory meetings and submission of statutory reports.

2. <u>Disadvantages</u>: -

a) The maximum number of members of a private company cannot exceed fifty, whereas there is no such restriction for a public company.

b) A private company cannot raise money from the general public.

c) The directors can refuse to register the transfer of shares at their absolute discretion. This can be an issue of concern if some shareholders wish for their holdings to be liquid.

Generally, it is preferable to incorporate a private company at the initial stages of the business for the above reasons. Prior to an Initial Public Offering, or if the number of members exceeds fifty, it can always be converted into a public company.

Incorporation: Incorporating a company generally takes a week or two (more, if any of the initial shareholders are not resident in India). It is normally prudent to hire the services of a company secretary or incorporation agent as the process of incorporation, though straight forward, required a significant amount of paperwork and co-ordination with the Registrar of Companies.

It is advisable to incorporate a company at the place where you intend to start your business. Changing the registered office from one state in India to another can be procedurally tedious.

Useful information regarding incorporating a company is available on www.mca.gov.in

You will need to finalize the Memorandum and Articles of Association at the time of incorporation. The next section discusses these documents in detail.

B. Corporate Housekeeping

This Section assumes that an entrepreneur has chosen a company (and this is generally the case) as the entity to start his or her business. The discussion below highlights the importance, and various regulations regarding the maintenance, of corporate records and books and conduct of meetings of a company.

Memorandum of Association :: Contents

For all legal purposes, a private company is formed and commences its existence upon the filing of its Memorandum of Association with the Registrar of Companies. The Memorandum sets forth certain basic characteristics of the company such as its name, its purposes, its permitted capital and division thereof into shares, and the location of its registered office. The Memorandum is the constitution or charter of the company and contains the powers of the company. No company can be registered under the Act without the Memorandum of Association.

The Objects Clause of the Memorandum is the most important for the company. It specifies what activities a company can carry on and what it cannot. A company cannot carry on any activity that is not specified in and authorized by its Memorandum. So, make sure that your business is covered under the objects specified in the Memorandum. Do not just adopt any standard memorandum.

In the case of limited companies, the liability clause assumes importance as it is the declaration that the liability of the members is limited.

The capital clause in a company limited by shares specifies the amount of share capital divided into shares, with which the company is to be registered, giving details of the number of shares and types of shares. A company cannot issue share capital greater than the maximum amount of share capital mentioned in this clause without altering the Memorandum. So, every time you wish to issue shares, please ensure that the Memorandum permits such issue of shares and if required, suitably amend it.

Articles of Association :: Effect

The Articles of Association of a company are like the company's bible. It contains the rules and regulations of the internal management of the company. You cannot do anything that is not in the Articles. Your powers regarding the day to day affairs of the company are circumscribed by the Articles.

The Articles are nothing but a contract between the company and its members and also among the members themselves that they shall abide by the rules and regulations of internal management of the company specified in the Articles. They include matters such as: (a) powers, duties, rights and liabilities of the directors of the company, (b) powers, duties, rights and liabilities of the members of the company, (c) rules for meetings of the company (d) dividends, (e) transfer and transmission of shares, (f) calls on shares, (g) borrowing powers of the company, etc. The Articles, when registered, bind the company and the members thereof to the same extent as if it was signed by the company and by each member.

Amendment of Memorandum & Articles

The Articles may be altered by a special resolution passed by the members of the company. However, any alteration to the Memorandum requires a prior approval from either the government or the company law board depending upon which clause of the Memorandum requires alteration. It is, therefore, important to ensure that the Memorandum you register includes all the business that you intend to carry on.

Meetings :: Shareholders' Meetings

The shareholders of a company may hold meetings to discuss and decide upon various issues concerning the company. The shareholders need to compulsorily hold an Annual General Meeting ("**AGM**"). The matters normally under consideration in such an AGM are annual accounts, director's reports, auditors' reports, declaration of dividend, appointment of directors, and appointment of statutory auditors. Besides the AGM, which is a statutory requirement, Extraordinary General Meetings ("**EGMs**") may be called to decide upon urgent business that cannot wait until the next AGM.

Procedures at Meetings; Decision Making

No meeting can be held unless a notice is given to all the persons entitled to attend the meeting, specifying the necessary information. A notice must contain the place, date and hour of meeting and must also state the agenda of the meeting.

If the Articles so authorize, a member may appoint another person to attend and vote at a meeting on his behalf. Such other person is known as a "proxy" and need not necessarily be a member of the company. Corporate shareholders remain personally present at meetings through their authorized representatives. The articles of a company may also provide for a quorum without which a meeting will be construed to be invalid.

A motion means a proposal to be discussed at a meeting by the members. A resolution may be passed accepting the motion, with or without modifications, or a motion may be entirely rejected. A motion, on being passed as a resolution becomes a decision. Resolutions may be Ordinary (simple majority) or Special (seventy five percent majority).

Meetings :: Directors' Meetings

The Board of Directors of a company or committees set up by the Board for special functions may conduct meetings and pass resolutions regarding various aspects of managing the company. The convening of such meetings is normally governed by specific provisions of the Articles in this regard. Rules of notice and quorum stated above in the context of shareholders' meetings shall apply to a Board meeting as well.

Normally, a special resolution of the Board is needed to decide on important matters of the company such as altering the memorandum or articles of association of the company. Besides this, the Articles generally provide for what matters can be decided upon by a simple resolution, and what matters may require a special resolution. In some cases, veto powers may also be granted to some Directors to decide upon certain issues.

While any person can become a director, you should realize that a director has certain obligations under law and may become liable for certain acts and omissions of the company. You should obtain appropriate legal advise in this regard.

Recording the Proceedings

Every company must keep minutes of the proceedings of general meetings and of the meetings of the Board of directors and its committees. The minutes are a record of the discussions made at the meeting and the final decisions taken.

The minute books of the proceedings of general meetings must be kept at the registered office of the company. Any member has a right to inspect, free of cost during business hours at the registered office of the company, the minutes books containing the proceedings of the general meetings of the company. But, the minutes books of the Board meetings are not open for inspection by members.

Other records

A company should have a permanent file in which all of its contracts, tax returns and other important documents are kept. This file should be organized such that it is easy to access the documents.

Why is it important to maintain books and records?

Maintenance of all the records of the company, including the Memorandum, Articles, Register of Members, contracts, minutes book, and other important documents, is of great importance. Where minutes of the proceedings of any meeting have been kept properly, they are, unless the contrary is proved, presumed to be correct, and are valid evidence that the meeting was duly called and held, and that all proceedings have actually taken place, and, in particular, all resolutions passed at the meeting shall be deemed to be valid. Besides this, the other records are also important when a company wishes to obtain financing or enter into any material transactions. Bankers, potential buyers, venture capitalists etc. normally need to review certain basic documents, which should be readily accessible when required. Therefore, for perusal by potential investors, for smooth operation of the regular affairs of the company, as well as for certain regulatory reasons, it is important that these documents / records are well maintained.

Signing on behalf of the Company

All contracts entered into by the company, and other documents that need to be signed, shall be so signed by a representative of the company duly authorized by the company or its Board acting together. A director of the company may be duly authorized by the Board to be that company's authorized signatory. In so doing, it is necessary to highlight that the representative is actually acting on behalf of the company and not personally. This may be done by signing under the seal of the company, and specifically mentioning along with the signature that the individual signing the document is the authorized signatory of the company. For certain transactions, appropriate resolutions may have to be passed by the Board and the shareholders. Directors do not automatically, by virtue only of their position, have the right to enter into contracts on behalf of the company. They need to be duly authorized in this regard by the shareholders or the Board.

E-Governance Initiative

Recently, the Government of India has launched its e-governance initiative in respect of companies. All directors of Indian companies are required to obtain Director Identification Numbers ("**DINs**") as well as Digital Signatures. Such DINs and Digital Signatures are intended to make the process of compliance with the company law and procedures in India much easier by facilitating electronic filing of returns and other forms, online at the Registrar of Companies. Although such electronic filing processes are still being streamlined in practice, there can be little doubt that online processing of compliance filings will make life far easier for Indian companies.

C. Relationship among Founders: Initial Shareholders' Agreement

In starting a company, the founders or the initial members may assume that they are all of like mind. Contributions and commitments may differ over time and a successful resolution of the resulting tensions will depend a lot on how well they were anticipated and addressed in advance. This discussion highlights the issues that the founders may want to consider in structuring the relationship among themselves, by the terms of a shareholders' agreement, and by incorporating necessary provisions in the Articles of the company.

Initial Contribution

Ownership of shares carries with it the attributes of economic and increasingly, non-economic as well, participation in the venture and the right to have a say in the affairs of a company, by participating in the shareholder's meeting. Typically, each founder member is expected to bring a unique skill or property to the venture, for which he is to receive equity. It is important to understand that, unless the members specifically agree otherwise, once a share is issued to a person, he freely and clearly owns the shares. If a member desires to transfer his share in the company, the company and the other founders normally reserve the right to repurchase the departing founder's shares at some price, perhaps the "fair market value" or an agreed value. This would prevent the dilution in ownership that may occur if share are issued or transferred to someone new who is taking over the departing founder's tasks.

Transfer of Shares

It is in the best interest of the company and the founders to restrict the ability of a shareholder to transfer his shares. For example, without such restrictions, a founder could transfer his shares to a competitor. Such restrictions can take the form of a right of first offer / refusal by which the company or the other shareholders have a right to match the price offered by a third party. Careful consideration needs to be given to the events that may trigger this right. If a shareholder is to be allowed to trigger the process by stating his intention to sell his shares at a given price to an unidentified purchaser, consideration should be given as to whether the company and the other members should be allowed to step-back and purchase the shares once the purchaser is identified.

Founders sometimes also agree among themselves that if any one of them finds a purchaser for his or her shares, all the founders will be able to participate in the sale on a pro-rata basis. This is referred to as the tag-along rights of the other shareholders.

A combination of these restrictions provides the existing shareholders with the opportunity to purchase the shares of a departing shareholder if they think the proposed sale price is favourably low, or to sell their own shares if they think the third party price is high.

Value & Valuation of Shares

It may be desirable to specify in advance a process for determining the purchase / sale price of the shares of a departing founder. The price can be determined in a number of ways, including independent appraisals by third party valuers (such as, for example, a bank or an accounting firm of repute) or by the Board of directors in its discretion. If third party appraisal is chosen, the founders should decide on how many appraisers will be required, what their qualifications should be and what valuation guidelines they must follow. There are obvious cost and time considerations and, indeed, constraints here. To prevent this, the founders may instead agree upon an appraisal of the fair market value of the shares, determined by the company's auditors. However, the qualification of such auditors to judge the value of a technology-based business should be considered.

Other Considerations

The founders may also find it worthwhile to agree upon certain other aspects of their relationship with each other and with the company. These may include the following: -

1. Choosing the Board of directors and the powers that can or cannot be exercised by the Board.

2. Setting up of committees for carrying out certain functions of the company, along with an agreement on the powers that can or cannot be exercised by such committees.

3. An agreement on non-disclosure of confidential information. This may be made to last for an unspecified period (as long as the information remains confidential and out of the public domain).

4. An agreement on non-solicitation and non-competition. It may be worthwhile to decide in advance and define the sectors within which such an agreement would be applicable, especially as regards defining the scope of the business of the company as currently or at any time in the future carried out. The agreement is normally made applicable during the course of a founder's involvement, and for a further period of two or three years after the exit of a founder. However, the applicability for such a further period after the termination of

the employment, may be excluded in the event the company goes bust and needs to be wound-up, or if a founder is fired by the company for no apparent reason.

5. A founder may desire to exit the company in the event he is not satisfied with the performance of the company, or if he finds that the initial objects of the company are not being achieved and there is a lack of interest or cooperation being shown by the other co-founders. To handle such an event, it may be useful to agree in advance that unless certain financial or other determinable targets are achieved by the company within a specified period, the non-compete agreement would not apply to any founder who is desirous of exiting the company in consequence of the failure to achieve such targets.

D. Proprietary Information: Intellectual Property Protection

The term "Intellectual Property" covers a range of intangible property rights, including concepts, processes, ideas, methods, formulae, and goodwill. There may be some overlap between various categories of intellectual property, and a particular intangible property right may fall into more than one category.

Legal protection of intellectual property is critical to a technology driven or dependent business. Protection for intellectual property may be provided by private contract as well. The discussion below explores the various options for protecting intellectual property.

Copyright

Copyright protection is governed by the Copyright Act, 1957. The protection is available for any original work of authorship, including computer programmes. The work must be created through an independent effort of the author. However, a copyright protects only the manner in which an idea is expressed, and not the idea itself. Copyright protection is available for original computer programmes, regardless of the language in which they are written.

The company is usually the owner of the copyright on a work created by an employee in the course of his or her employment. This is normally ensured by way of incorporating a suitable clause in the employees' contract of employment.

Ownership of a copyright involves a "bundle of rights" which includes the right to reproduce, distribute, and prepare derivative works from the original copyrighted material. However, copyrights can be transferred, assigned, or licensed, either in whole or in part.

Registration of copyright is only optional.

Trade Marks & Service Marks

The purpose of a trade mark or service mark is to identify the source of a product or service. The major purpose is to prevent confusion among the consumers as to the source of goods or services. The example of a trade mark is a brand name or logo under which a product or service is marketed. Legal protection of marks is governed by the Trade Marks Act, 1999.

Ownership of a mark allows the use of the mark to identify the owner as the source of particular goods or services, and also exclude others from the use of the same or similar mark in connection with goods or services in circumstances which may result in confusion by the consumers.

A trade mark is registered for a period of ten years, and can be renewed from time to time by application to the registrar of trade marks.

Patents

A patent is a legal monopoly granted to an inventor allowing him or her to exclude others from making, using or selling an invention during the life of the patent. The protection is governed by the Patents Act, 1970. Protection is available for any product or process that meets certain requirements of novelty, non-obviousness and utility. India has recently entered the product-patent regime and hence agricultural, pharmaceutical and chemical products that were earlier excluded from patentability, can now be patented.

Patent protection is granted for a period of twenty years from the date of application.

Confidential Information & Non-Disclosure

In India, there is presently no law governing and protecting undisclosed information including trade secrets. While dealing with prospective investors, licensees etc., protection of such information will ordinarily require obtaining an agreement to maintain the information in confidence. This can be either done by incorporating an ideal confidentiality clause in the more comprehensive document signed by the recipient (e.g.; software license agreement or consulting agreement), or by entering into a separate non-disclosure agreement. It may also be worthwhile to get the employees of the company to sign similar confidentiality and non-disclosure agreements.

Non-competition & Non-solicitation

In order to protect the value of your goodwill, it may be necessary to restrict the ability of certain senior employees or technical / marketing personnel to use the customer or other information other than for the benefit of your company, or to compete with your business for a period of time following the termination of their employment.

E. Choosing Legal Counsel

Your lawyers should understand both the business as well as the ideas. So it is important to find lawyers fluent in today's new businesses and ideas. But more importantly, your lawyers should know their own business, the law. There may be legal issues aside from business law and intellectual property, and in legal areas such as corporate financing, securities, taxation, real estate, employment law and litigation. Your team of lawyers must be skilled and experienced in all these areas.

Lawyers with experience in your business sector anticipate your needs. They see opportunities as well as problems on the horizon, and help you navigate through both.

But, it is equally important to educate your lawyers about your business and ensure that they are aware of upcoming events that will require their advice. Foresight and effective communication will ensure that the lawyers have satisfactory resources at their disposal to meet your needs.

Periodic meetings with your lawyers to review the state of the business can be helpful. A good lawyer will help you anticipate and avoid potential legal troubles before you are aware of them. It is not only the potential problems, but also the possible solutions that need to be discussed in a meeting with your lawyers. So, give them sufficient time and information for them to be able to assist you.

§ 2 :: Funding and Equity Incentives

A. The Investment Process; Negotiating the Venture Capital Term Sheet

Choosing a Venture Capitalist

Before selecting a venture capitalist, the entrepreneur should study the particular investment preferences set down by the venture capital firm. It is important to select venture capitalists with whom it is possible to have a good working relationship.

Often businesses do not meet their cash flow forecasts and require additional funds, so an investor's ability to invest further funds if required is also important. When choosing a venture capitalist, the entrepreneur should consider not just the amount and terms of investment, but also the additional value that the venture capitalist can bring to the company. These skills may include industry knowledge, fundraising, financial and strategic planning, recruitment of key personnel, mergers and acquisitions, and access to international markets and technology.

What does the Venture Capitalist expect?

Venture capitalists are higher risk investors and, in accepting these higher risks, they desire a higher return on their investment. The venture capitalist only invest in businesses that fit their investment criteria and after having completed extensive due diligence. It is therefore important for the entrepreneur to maintain good corporate housekeeping. The venture capitalist would normally conduct an initial review of the business plan to determine if it fits with their criteria.

Discussing the Investment; Finalization

The process involves exhaustive due diligence and disclosure of all relevant business information. Valuation is usually a big issue in the mind of an entrepreneur. But, if the term sheet is from an established venture capitalist firm, this issue may have already been resolved. All the information provided over weeks of meetings and discussions has been factored and the investor would have projected future revenue and profits, and reduced it to the present value.

You should have a very clear understanding with your investor as to what business goal the funding is intended to enable you to achieve. The more money you raise the more ownership and control of the company you will have to give up.

If venture capitalists invest based on trust in management, it follows that they want the management to stay. While the co-founders may believe that they will remain with the company for the long haul, there may come a time when a founder leaves. Venture capitalists normally require some restrictions to protect the company from the issues which may arise in the event of the departure of a founder. These restrictions may involve mechanisms of vesting of shares, restrictions on transfer of shares etc.

Your ability to resist or dilute these mechanisms is enhanced to the extent that you have invested cash and not just sweat equity in the company. However, these mechanisms serve to protect not only the venture capitalist firm and their investment, but also the company and its founders, from vindictive ex-founders and from competitors.

Once the final terms are negotiated, an investment proposal is submitted to the board of directors. If approved, legal documents are prepared. A shareholders' agreement is prepared containing the rights and obligations of each party.

B. Forming a Strategic Alliance

A strategic alliance is a common phenomenon in a competitive and free economy and as India integrates into the world economy, there will be several opportunities for such alliances. However, these deals are risky because the integration of two companies may not succeed, and the combined entity may end up spending too much of its energy on internal strife rather than growth.

The Right Ally

Once you have decided that an alliance is the best way to remain competitive, you will need to find an ally that will add value to the enterprise, not just capital. Understanding what the company is seeking from an alliance is a good starting point to make sure that a decision is not being made solely on "name recognition" or personal preference. The ally may be the same size as the start-up in an analogous market, or it may be a larger company producing the same product or service. Whether the ally is big or small, in the industry or not, the same test applies – whether the ally will be a valued part of a lasting relationship.

Some questions to ask while choosing an ally include: -

1. Does the ally know the market? An ally not knowledgeable in the field may contribute capital, but may also, out of inexperience, lead the emerging company down the wrong path. An experienced ally will realize that not all markets and industries are the same.

2. Is the ally economically viable in the market or industry?

3. What are the ally's motives? If the proposed ally is looking to the emerging company's business or technology solely for exploitation with nothing to offer, the emerging company will come away from the experience with nothing but resentment.

4. What is the quality of the ally's management?

5. Are the cultures compatible? If the attitude of the managers you will be working with is not a good fit with your management group, any potential business advantage may be lost in the resulting friction.

What will the Ally Contribute?

Choosing the right ally is the first step. An emerging company needs to form an outline of the business relationship from which the parties can work. An attractive aspect of the alliance is the flexibility that such a structure brings. Most alliances involve the contribution by one company to the product development of the other company, the use of one company's established distribution system, integration of new features into established products, or the contribution of capital by one party to reduce the other's costs. What is important is what the parties are willing to contribute and whether the combination offers a compelling business advantage. Money alone is not the key to a successful strategic alliance. Alternatives such as technical or manufacturing assistance, marketing assistance, etc. are likely to be equally important to the emerging company's substantial growth.

Making the Relationship Work

When the business advantage is understood and identified and the contributions agreed upon, the next step is to make the relationship work. Although the parties may have agreed upon the terms of the alliance, it is important that a written agreement be put in place. The agreement should address topics such as the terms of the relationship, the targets to be reached by the parties, confidentiality, ownership of any contributed proprietary information, terms of equity, if any, and exit strategies if the alliance does not wok for either party. Putting the agreement in writing clearly delineates each party's role and establishes guidelines for when the relationship does not work. The end of the alliance should not spell the end of the company itself, and it is important to protect the interests of the emerging company in case the alliance fails.

In choosing the strategic alliance approach, an emerging company needs to realize that alliances do not always work, and that if they fail, the smaller company is often the more disadvantaged party. Therefore, careful consideration is required and several hard questions need to be answered with respect to the risks and sacrifices the emerging company is willing to endure to make the relationship work. The emerging company will then have to decide whether an alliance is preferable than other avenues, such as more venture capital, or internal growth.

C. FOREIGN INVESTMENT

Your venture capitalist investor, strategic partner or other shareholders could be a foreign investor. It is therefore important to consider the law regulating foreign investment in India.

Foreign Direct Investment ("**FDI**") into India connotes the investment by way of subscription and / or purchase of securities of an Indian company, by a non-resident investor. The Government of India has recently undertaken a comprehensive review of the FDI policy and associated procedures. It is important for the entrepreneur to consult a lawyer and an authorized dealer (generally a bank) when any foreign investment is being considered. Under the current FDI policy, the treatment of FDI into India can be divided into three broad categories.

1. *Prohibited Sectors* – Sectors in which FDI in India is prohibited are Retail Trading (other than 'Single Brand Product' retailing), Atomic Energy, Lottery business, Gambling and Betting.

2. *Sectors requiring Prior Approval* – Sectors in which FDI in India is subject to prior Government of India approval, and / or the approval of India's Central Bank, the Reserve Bank of India ("**RBI**"), include: (i) activities covered by sector-specific FDI policies, sectoral caps, limitations and other conditions as listed, ***(ii) where the foreign investor in question has an existing joint venture or collaboration or technology transfer / trademark agreement in India in the 'same' field as any new FDI proposed,*** and (iii) where more than 24% foreign equity is proposed to be inducted for the manufacture of items reserved for the small scale sector.

3. *'Automatic' Route* – In all other sectors not falling under the above two categories, FDI up to 100% is permitted under the 'automatic' route, where no prior GOI or RBI approvals are required. Foreign investors in such activities only need to adhere to certain post-FDI reporting requirements to RBI.

§ 3 :: Operational Issues

A. Employment Issues

In India there are a host of employment laws that regulate the employment relation in some form or the other. Generally, only employees earning up to a certain fixed maximum salary are protected by these laws. Employees earning beyond this maximum salary are normally governed and protected by their contract of employment. Some of the statutes that are of general importance are briefly discussed in this section.

Employment Benefits

The Payment of Bonus Act, 1956 is applicable to factories and establishments employing twenty or more persons. Any employee on such an establishment who earns less than a monthly salary of Rupees 3500/- is entitled to payment of bonus. Establishments with more than twenty employees are also required to make contributions towards an employee's provident fund, pension and insurance. Similarly, the Payment of Gratuity Act, 1972 entitles employees with five years of continuous service to gratuity upon termination of employment, provided the establishment is one that employs more than ten persons.

Shops and Establishment Laws

There are separate shops and establishment laws in different states that normally apply to establishments across all sectors and govern the following aspects of employment: -

1. Order of employment indicating terms of the employment,
2. Hours of work within a prescribed maximum,
3. Payment of wages, and
4. Entitlement to paid leave

Since there are different Acts for each state, it might be better to be aware of the law governing a particular state before deciding to set up an establishment there.

Other Employment Laws

The following is a list of a few other employment issues that are important: -

1. Equal remuneration for both genders and non-discrimination during recruitment.
2. <u>Maternity Benefit</u>: Protection of employment and entitlement to leave during pregnancy.
3. <u>Sexual Harassment</u>: Employers are required to take preventive steps, create awareness, and establish complaint mechanisms.

Contract Law Generally the employment of persons in positions of management is governed by the law of contracts. Before entering into a contract of employment, it is important that you are aware of various provisions in contract law, such as issues of coercion and restrictions imposed on termination of employment.

ESOP's Employee Stock Option Plan ("**ESOP**") means a plan under which the company grants stock options to employees. If such a plan is in place, an employee may apply to the company to have the options vested in him issued as shares upon payment of the option price. Normally, a time limit is prescribed within which the option can be exercised.

The guidelines issued in this regard are applicable to companies listed on any stock exchange in India. The shareholders need to pass a special resolution for the ESOP to come into force.

B. Licensing Agreements

A license is a grant of a limited right to use intellectual property. The licensor retains the ownership of the licensed property while the licensee, for a fee or royalty, receives the right to use the intellectual property subject to the terms and conditions of the license agreement.

Licensing intellectual property owned by a third party can aid a start up company by reducing the time and expense needed to research and develop intellectual property of its own. Also, if the emerging company has developed intellectual property whose use is desired by other companies, licensing it to others may provide additional revenues.

When entering into a licensing agreement, an emerging company must consider aspects such as the scope of use, payment terms, representations and warranties, indemnification and confidentiality.

Scope of Use Licenses may either be exclusive or non-exclusive. The licensor must be wary of the possibility that a licensee may want an exclusive license only to prevent its competitors from getting access. For example, this may happen when the licensee himself does not have the capital to produce the product but is nonetheless seeking to deter its competitors from gaining access to the technology and gaining market share. However, an exclusive license is worth considering if the licensee can promise reliable distribution to vast markets.

Normally, license agreements restrict the scope of use to a permitted territory, which may either be a geographic territory or a field of use. Economic factors play an important role in deciding these terms, as broader territory and / or exclusive use may fetch a higher royalty.

Transfer of License

The parties may also have to decide whether the license is to be transferable or non-transferable, and for a limited term or perpetual. Parties must also consider ownership of intellectual property developed through the licensee's use of the licensed product. Usually, the licensor reserves ownership in such modifications, but grants a license in such products back to the licensee.

Duration; Term

The duration of the license can be stated to be for a specified period of time, or as expiring on a particular date. Whether or not the license is automatically renewable, who must provide notice of renewal or termination, terms of the renewal or termination, penalties for breach of the agreed scope of use, etc. are some issues that need to be addressed by the parties.

Payment Terms

Payment for a license can take many forms. Licenses may be granted for a one time lump-sum payment, or they may be offered on a royalty basis. Again, royalty arrangements can be in a number of ways. It may be on the basis of a figure-per-unit produced, or as a percentage of the gross sales. Royalties may be decided to be paid weekly, monthly, quarterly, or annually. Licensors may insist upon a guaranteed royalty which provides a minimum amount irrespective of the sales made by the licensee.

Representations, Warranties & Indemnification

Representations and warranties are forms of promises or guarantees of what the licensee can expect from the licensor. The licensor may warrant that it is the actual owner of the licensed product, has the power to grant the license, and affirm that the intellectual property does not infringe the rights of any third party. A licensor of course will try to minimize his exposure by making as few representations and warranties as possible.

An indemnity clause specifies who will pay for what if something goes wrong. The licensor may seek indemnity from the licensee for third party claims arising out of the conduct of the licensee's business. The licensee may seek indemnification from the licensor with respect to third party infringement claims arising from the use of the licensed product.

Limitation of liability clauses may also be incorporated, limiting the amount of liability that the parties will incur. This may be done by specifying harms and damages for which there will be no indemnification, and / or by placing a monetary limit on the damages that the parties are willing to pay.

C. Entering into a Contract

As stated earlier, all contracts entered into by the company need to be signed by a duly authorized representative of the company. In so doing, it is necessary to highlight that the representative is actually acting on behalf of the company and not personally. A separate register of all the contracts entered into needs to be maintained.

A confidentiality clause is usually a part of any contract that your company may enter into. The scope of this clause is for the parties to consider a prospective business relationship by exchange of information, but you must be aware that the lack of a confidentiality clause may create problems by allowing information that should have been confidential to become public.

This clause can be used to protect the crucial terms of the agreement itself, from being disseminated to competitors and other customers. It may also include protection with respect to confidential treatment of certain information relating to the performance of the contract.

D. Other Issues and Regulatory Compliances

Tax — The following is a brief discussion on the tax structure that companies in India have to deal with. A professional tax consultant would be able to explain to you, the various intricacies involved in the tax structure.

Income Tax — The law relating to income tax has been enacted in the Income Tax Act of 1961. Indian companies are taxable in India on their worldwide income, irrespective of its source and origin.

Tax Treaties — Agreements for avoidance of Double Taxation signed by India with various countries provide a favourable alternative mode for determining taxable business profits, as compared to methods under the domestic tax law. The treaties also provide specifically the mode of taxability of incomes in the nature of dividends, interest, royalty and fees for technical services.

Excise Duties — Excise duties are levied in terms of the Central Excise Tariff Act, 1985. All manufacturers of excisable goods are required to register under the Central Excise Rules, 1944. The registration is valid for as long as production activity continues and no renewals are necessary.

Customs Duties — The Export-Import Policy regulates the import and export of goods. Customs duties are levied as per the terms of the Customs Act, 1962 and Customs Tariff Act, 1975. Customs duties can be levied on all goods which are freely importable.

Sales Tax

Sales tax is a single point tax i.e. tax levied on sale of a commodity which is manufactured or imported, and sold for the first time. Subsequent sale of the product without any process is exempt from Sales tax. Sales tax is levied either under the Central or the State sales tax Acts. There is no Sales tax on services and exports.

Other Taxes

Transfer of assets attracts stamp duty. The quantum of the stamp duty is determined as per the provisions of Indian Stamp Act and varies from state to state. Some states levy octroi on goods entering their jurisdiction. Certain states impose real estate taxes based on assessed value of the property. Service tax on taxable services is also levied.

Software Technology Park Scheme

Under the Software Technology Park scheme, you can establish a 100% Export Oriented Unit ("**EOU**") for developing computer software for export. These are some of the features and benefits of setting up an EOU: -

1. Single Window clearance and approval.
2. Income Tax holiday.
3. Customs Duty Exemption in full on imports.
4. Central Excise Duty Exemption in full on indigenous procurement.
5. Central Sales Tax Reimbursement on indigenous purchase.
6. All relevant equipment / goods including second hand equipment can be imported (except prohibited items).
7. High Speed Data Communication Link provided for the export of software.
8. No separate Import / Export license required.
9. 100% foreign equity investment in the companies permissible.

Environmental Clearance

As a responsible entrepreneur you must understand that industrial pollution due to its nature has potential to cause irreversible reactions in the environment and hence it poses a major threat. An industrial entrepreneur therefore needs to apply for certain clearances.

Any person who is likely to establish or take any steps to establish any industrial plant or process or any treatment and disposal system or any extension or addition which is likely to discharge sewage or trade effluent into any stream or well or sewer or on land has to obtain consent of the Pollution Control Board. This rule is quite wide in its applicability and you may require clearance even if you plan to construct an office space / building.

The clearance is given by the Pollution Control Board, after reviewing your pollution potential and probable impact on the environment.

§ 4 :: Exit Strategies

As soon as you start, you need to have some idea of where you would like to finish. That is what venture capitalists mean when they talk about 'exit strategies' – the plans you put in place to turn your company into an asset.

You might decide to sell your company in a trade sale to a competitor or a complementary partner. Or you might set your sights on an initial public offering on the share market. In either case, you put a financial value on your company and can finally receive a monetary reward for your hard work. Sooner or later, you will come to a point where it makes sense to consider going to the share market or selling part or all of your company to another player.

A. Initial Public Offer

A corporate may raise capital in the primary market by way of an initial public offer. An Initial Public Offer (IPO) is the selling of securities to the public in the primary market. The decision whether or not to "go public" is a challenge filled with differing benefits and burdens.

Advantages of an IPO

1. Raising Capital: Substantial funds can be raised in a public offering. A public offering not only improves the company's net worth, but also raises its visibility in the market place. The management's future financing alternatives are multiplied following a successful IPO. The proceeds can be used for a variety of business purposes such as increasing the work capital, expanding physical plant and equipment, acquiring other businesses, or for diversifying the company operations.

2. Acquisition Strategy: A public company is in a better position than a private company to use its own securities to make acquisitions without depleting its own cash resources.

3. Attract & Retain Employees: A public company gains prestige, becomes better known, and thereby improves its business operations. Moreover, it can improve its ability to attract and retain employees if it can offer them publicly traded stocks or option to purchase such stocks.

Disadvantages of an IPO

a) Mandatory Public Disclosure: Once the public is admitted to ownership, material information relating to a company's operations must be disclosed, which might place them at a competitive disadvantage.

b) Effect on Management: The company may lose some flexibility in management with the introduction of outsiders.

c) Expenses & Administrative Burdens: The very process of completing a public offering is also expensive. Besides, there are many additional expenses and administrative burdens for a public company. Recurring expenses would include routine accounting fees, expenses for preparation and distribution of reports, etc.

Converting to a public company by an IPO is a joint endeavour of a team that includes the company, its accountants, its lawyers, and the underwriters. Each member should be experienced and qualified, and have the time and energy to give the company the attention it needs and deserves.

B. Mergers & Acquisitions

The chances are that your company will not be a candidate for the share market. Only a small proportion of startup companies ever go public. The overwhelming majority of successful companies realize their value through some form of trade sale, merger or strategic alliance. A successful deal is the result of a careful process to find the best possible partner on the best possible terms. This is a process that you must control.

Acquisition By A Larger Company

The start-up company may have developed technology that makes it attractive to a larger player in the industry. The larger company may prefer to purchase the new technology rather than take the time to develop its own. In effect, the newer company has assumed the research and development risk and costs on behalf of the larger company. Similarly, a larger company often desires to purchase a smaller, younger company to acquire its team of talent.

An acquisition can have other advantages. The combined strength of the two companies is normally greater than the sum of the two separately. The two companies may have complementary products, technologies, sale forces and marketing efforts, and together they may have an increased leverage with suppliers and customers. Financially also, an acquisition can provide distinct advantages to both companies. The entrepreneur and his or her company's shareholders are well rewarded as the acquirer is willing to pay a premium. This is so because the costs of acquisition are often much lesser than setting up research, and development of a new product or technology from scratch.

Some entrepreneurs start up with the aim to develop a technology that will attract investment from a specific acquirer. They understand the acquirer's business and develop a product or technology that will precisely meet the business needs of the acquirer.

Merger of Equals

A start-up company may also benefit from a merger with another small company. The combined companies are then able to mature more quickly and effectively than they could individually. This may evolve from a merger between two complementary businesses.

Taking on Liabilities

In a merger agreement, the buyer can shift the ultimate responsibility for certain liabilities to the seller. However, parties often assume or retain liabilities that they incorrectly believe are those of the other party. There is no correct way to allocate these liabilities, and it differs dramatically depending on the business. As a result, each party needs to carefully identify the liabilities for which it will be responsible on a going forward basis.

Representations & Warranties

A seller must sit down and carefully consider the representations and warranties that it is extending. Together with the indemnification provisions, these constitute a kind of post-closing insurance policy issued by the seller for the benefit of the buyer. On the buyer's side, plugging in standard representations and warranties and failing to adjust them to the seller's particular business can create serious gaps in indemnification coverage.

An entrepreneur must understand that mergers and acquisitions are complicated transactions. Many issues must be properly addressed, including maximizing value to the target and its shareholders, minimizing the tax burden, navigating the requirements of accounting procedures and applicable corporate and securities laws, and minimizing post-closing surprises. The entrepreneur must assemble and consult an experienced team of financial advisors, accountants and lawyers early in the process.