

THE LEGAL FRAMEWORK FOR STARTUPS IN INDIA: BUILDING THE FOUNDATION FOR FUNDRAISING

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India's startup ecosystem is burgeoning. As of December 2024, over 1.57 lakh startups have obtained DPIIT recognition, and they have generated more than 17.28 lakh direct jobs.¹ These numbers reflect the confidence in India's innovation potential and the scale of enterprise being built nationwide.

Yet, statistics also tell a harsher story: according to a study by IBM and Oxford Economics, 90% of Indian startups fail within five years of inception.² While many attribute these failures to poor market fit, capital shortage, or competition, one under-appreciated cause is legal and regulatory missteps.

Legal compliance is not merely a box to tick but it is also foundational to sustainable growth. Sound legal frameworks:

- a. bolster investor confidence by reducing risk,
- b. protect consumers and third parties,
- c. maintain fair and ethical market dynamics, and
- d. support credibility and longevity of the enterprise.

However, the Indian regulatory environment is inherently complex. Multiple overlapping statutes, sectoral licensing regimes, evolving frameworks, and jurisdictional nuances make compliance a tough terrain. For resource-strapped startups, especially at early stages, legal obligations often feel like an overhead. As a result, many defer or sideline compliance – only to find later, during fundraising or due diligence, that these “loose ends” become deal-breakers or drag the process into long delays.

This article offers a panoramic overview of the key legal and regulatory compliances that every Indian startup must consider – both in its formative phase and during fundraising rounds. In subsequent sections, we examine entity structuring, corporate law, sectoral licenses, taxation, employment, FEMA, data protection, contracts, and government incentives – showing how legal discipline from the start can prevent pitfalls later.

Key Areas of Compliance for Startups

Before and during fundraising, startups operate within a complex web of legal obligations. These laws collectively shape how a business is structured, governed, financed, and ultimately scaled. A clear understanding of these compliance requirements not only prevents legal setbacks but also strengthens investor confidence.

¹ [Press Release: Press Information Bureau](#)

² <https://www.moneycontrol.com/news/business/90-indian-startups-fail-within-5-years-of-inception-study-2689671.html>

Below is an overview of the key legal areas every Indian startup should focus on both for day-to-day operations and when preparing for investment.

1. Structuring of the Entity

The legal structure of a startup determines its ability to raise funds, issue securities, and attract investors. Most investors prefer a Private Limited Company under the Companies Act, 2013, as it allows share issuance, equity ownership, and corporate governance aligned with global norms. Alternatives such as Limited Liability Partnerships (LLPs) or partnership firms may be simpler to set up but are less suited for equity investment since they cannot issue shares.

From a fundraising perspective, founders should ensure:

- a. Appropriate authorised share capital;
- b. Clearly defined founder equity and cap table; and
- c. Founders' Agreements and ESOP frameworks to align ownership and control.

2. Compliance under the Companies Act, 2013

The Companies Act, 2013 governs incorporation, corporate governance, and share issuance. Startups must comply with:

- a. Section 42 (Private Placement) and Section 62(1)(c) (Preferential Allotment) for issuing shares or convertible instruments;
- b. Board and shareholder approvals, and filings such as PAS-3, PAS-4, and MGT-7; and
- c. Maintenance of statutory registers, board minutes, and annual filings. For investors, these records are a measure of governance quality. Missing filings or informal allotments can become "red flags" during due diligence and delay fund inflows.

3. Employment and Labour Laws

Employees are often the backbone of early-stage growth, yet employment law is one of the most neglected areas for startups.

Key legislations include:

- a. The Code on Wages, 2019, The Industrial Relations Code, 2020, and The Code on Social Security, 2020;
- b. The Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act, 2013 (POSH Act); and
- c. State-specific Shops and Establishments Acts.

Startups must maintain written employment contracts, IP assignment clauses, and ESOP policies under Section 62(1)(b) of the Companies Act, 2013. During fundraising, investors

closely examine HR documentation to verify IP ownership, confidentiality safeguards, and compliance with statutory benefits.

4. Sector-Specific Regulations

Depending on the industry, additional sectoral regulators may apply:

- a. Fintech startups are governed by Reserve Bank of India (RBI) circulars and directions and the Payment and Settlement Systems Act, 2007;
- b. Healthtech and nutraceutical startups must comply with the Food Safety and Standards Act, 2006 (FSSAI) and, where applicable, Drugs and Cosmetics Act, 1940;
- c. Insurtech ventures are subject to the Insurance Regulatory and Development Authority of India (IRDAI) guidelines; and
- d. Edtech and e-commerce are increasingly monitored under the Consumer Protection (E-Commerce) Rules, 2020.

For fundraising, sectoral licences and approvals are often deal prerequisites. Non-compliance can result in investors seeking indemnities or even withdrawing term sheets.

5. Taxation Laws

The Income-tax Act, 1961 and Goods and Services Tax Act, 2017 form the bedrock of tax compliance.

Startups must ensure:

- a. Timely filing of GST, TDS, and income tax returns;
- b. Consistency in valuation under Section 56(2)(viib) of the Income Tax Act, 1961 (angel tax) and Rule 11UA; and
- c. Record-keeping for share premium and convertible securities.

The DPIIT-recognised startup exemption provides relief from angel tax but requires ongoing eligibility maintenance. Tax irregularities discovered during due diligence can stall or devalue funding rounds.

6. Foreign Exchange Management Act, 1999 (FEMA)

When startups raise capital from foreign investors, FEMA and the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 apply.

Key compliance steps include:

- a. Adhering to sectoral caps and verifying if the investment route is automatic or approval-based;
- b. Issuing shares at or above the fair market value; and

- c. Filing Form FC-GPR (for share allotment) and Form FC-TRS (for transfer of shares).

Failure to report or improper pricing can attract compounding proceedings by the RBI, making this one of the most scrutinised aspects during cross-border fundraising.

7. Data Protection and Privacy

With the advent of the Digital Personal Data Protection Act, 2023, startups handling user data must:

- a. Obtain valid consent for data processing;
- b. Limit collection to necessary purposes;
- c. Implement secure storage, breach notification, and deletion protocols; and
- d. Appoint a Data Protection Officer where applicable.

Compliance is especially critical for fintech, healthtech, and SaaS startups. Data governance maturity is now a key metric in investor due diligence.

8. Contractual Arrangements

Contracts are the invisible infrastructure of every startup. Founders should ensure that all relationships – with co-founders, employees, vendors, customers, and investors – are governed by enforceable agreements under the Indian Contract Act, 1872.

Important contracts include:

- a. Founders' Agreement – defines roles, equity, and exit terms;
- b. Vendor and Client Agreements – define scope, payment, and liability;
- c. Investment Documents – Term Sheet, Share Subscription Agreement (SSA), and Shareholders' Agreement (SHA), outlining rights, obligations, and exit mechanisms. A well-drafted contractual framework ensures clarity and reduces post-investment disputes.

9. Government Incentives and Subsidies

The Government of India's **Startup India** initiative, administered by the **Department for Promotion of Industry and Internal Trade (DPIIT)**, offers multiple benefits:

- a. Tax exemptions under Sections 80-IAC and 56(2)(viib) of the Income-tax Act, 1961;
- b. Self-certification for select labour and environmental laws;
- c. Reduced IP registration fees and fast-track patent examination; and
- d. Priority in public procurement and access to the Fund of Funds for Startups (FFS).

Founders should ensure registration on the Startup India portal and maintain compliance to retain these benefits – lapses can result in loss of recognition or subsidy eligibility.

Analysis

1. Legal Compliance as a Long-Term Necessity

For startups, legal compliance should be viewed not as an administrative burden but as a strategic necessity. Early-stage ventures often overlook filings, documentation, or regulatory obligations in the race to scale. However, such omissions tend to surface during investor due diligence, disrupting transactions or affecting valuation. Founders who adopt a compliance-first approach from the beginning establish a solid base for sustainable growth.

2. Protecting Investment and Valuation

Legal compliance is a key determinant of investor trust and company valuation. Investors prefer startups with transparent governance, well-documented share issuances, and up-to-date filings. Conversely, irregularities in corporate records, unresolved regulatory issues, or ambiguous ownership structures can delay funding and invite stricter deal terms. A compliant company not only attracts capital more easily but also commands better terms.

3. Intellectual Property as a Value Driver

Intellectual property protection is directly linked to enterprise value. Patents, trademarks, and copyrights secure a startup's core assets and offer competitive advantage. Investors increasingly assess IP ownership before investing, recognising that unregistered or unassigned IP can lead to disputes and loss of value. A clear IP ownership trail often strengthens valuation and investor confidence.

4. Early Diagnosis and Compliance Framework

Identifying applicable laws—be it under the *Companies Act, 2013*, *Foreign Exchange Management Act, 1999*, or sectoral regulations—helps founders anticipate risks early. Adopting a structured compliance routine, including regular board meetings, statutory filings, and contract reviews, embeds governance into the startup's culture rather than treating it as an afterthought.

5. Governance and Investor Confidence

Strong legal compliance also demonstrates professionalism. Following recent governance lapses in high-profile startups, investors are scrutinising governance standards more closely. A 2024 *Inc42* survey found that over half of Indian founders viewed investor-driven governance mechanisms as only moderately effective, underscoring the need for internal discipline and transparency³. Startups that exhibit legal and regulatory rigour from inception inspire greater investor confidence and long-term credibility.

Conclusion

For any startup, legal compliance is not just paperwork, it's part of the business DNA. Building a legally sound foundation early on helps founders avoid avoidable roadblocks

³ <https://inc42.com/buzz/most-indian-founders-found-investors-corporate-governance-diktat-ineffective-will-2024-see-better-guardrails/?utm>

later and signals to investors that the company takes governance seriously. From choosing the right structure and protecting intellectual property to staying on top of tax and regulatory filings, every step shapes how the business is perceived and valued.

Investors today look for more than just a promising idea; they look for professionalism and preparedness. A startup that keeps its legal house in order naturally earns greater trust and smoother funding conversations.

In the long run, compliance isn't a brake on growth, it's what keeps the wheels turning smoothly. For Indian startups aiming to grow and endure, sound legal practices are not a burden but a quiet competitive advantage.

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