

Successful fundraising for start-ups: A legal checklist

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The Indian start-up eco-system is dynamic and has evolved over the last few years, giving rise to several creative and commercial business models. However, this year has been a testing time for the start-up space, which is striving to overcome the repercussions of the COVID-19 pandemic.

A report by YourStory states that the funding ecosystem is gradually improving, with start-ups raising close to USD 1.4 billion in November 2022, an **18.1% month-on-month increase** in comparison to October.

Be it comprehending different mechanisms to raise capital or identifying the benefits and loopholes of those methods, in such a precarious situation, start-ups must be circumspect in their funding strategy to avoid legal and business challenges at various stages of the funding lifecycle.

Overview: Legal challenges involved in different stages of fundraising

1. **Pre-seed** – This stage marks the commencement of the start-up lifecycle, where the product is under development and testing. Friends, family and angel investors are typical investors at this stage. Given that this is mainly a 'friends and family' round, founders may be inclined to avoid seeking proper legal advice in order to save costs. This approach may be risky for the company/founders, especially if a subscription or shareholders' agreement (or similar document) is proposed to be signed for the pre-seed investment. Money matters often turn friends and family into tough negotiators and roadblocks in the start-up world. To ring-fence this risk, the start-up and founders should enter into a detailed term sheet to legislate the rights and obligations of the respective parties.
2. **Seed/Series A** – This level of fundraising is for start-ups that have garnered reasonable traction and market share. At this stage, apart from friends, family and angel investors, early venture capitalists show interest in fundraising. Legal advice at this stage is even more important, especially since venture capitalists not only come equipped with adequate legal support, a majority of them have experience of seeing legal documents play out in real life. Venture capitalists, especially institutional investors, have their standard asks of investor rights (such as board rights, reserved matter rights, exit rights, input on business plan, etc) and may also seek a full suite of business representations, warranties and indemnities.

Founders need to understand the implications of these legal provisions and their risks and rewards before they put pen to paper. Founders may also be required to sign employment agreements with the company, under which concepts like termination for 'cause' and consequences thereof need to be paid close attention to. Employment agreements can be crafted to not only act as a ball and chain for the founders, but can easily be turned into a Damocles' sword hanging over the future of the founders. Separate structuring/regulatory advice to align the investment with sector-specific regulations or exchange control requirements may also be required, especially if the institutional investors are foreign entities.

3. **Series B onwards** – In this phase, start-ups often generate a stable revenue stream and build a dedicated user base. While Series A funding is generated when start-ups have proven strategies for creating long-term profit, Series B usually helps a start-up to scale up. In Series C funding, venture capitalists, corporate venture capital funds and private equity funds show interest owing

to a start-up's strong prospects and financial performance. Legal advice at this stage is crucial not only because of the larger fundraise rounds and requirement of coordination/negotiations with multiple sophisticated investors, but also because negotiated and well-balanced investment documents at this stage help set a precedent for future fund-raise rounds.

Specifically, proper legal advice can help the founders exclude their personal assets from the indemnity liability and segregate investors into different categories based on shareholding percentage and corresponding bucketing of rights. Also, better liquidity results in founders gaining greater negotiating capacity. Founders should use this to scale down some of the onerous risks and obligations they might have had to sign up for in the previous rounds.

Additionally, the Indian start-up eco-system and the legal industry supporting it have evolved, and it is possible to have well-balanced legal documentation reflective of 'market standard' in a cost and time-efficient manner. Involving lawyers at an early stage can save valuable time, money, resources and mind space for the founders in the future.

Top five legal considerations for start-ups for successful fundraising

1. **Identify a suitable fundraising strategy:** The fundraising strategy differs as per the business structure, sector and future prospects. Stages like pre-seed involve legal processes like implementing business structures which do not fall foul of existing laws, identifying red flags for future growth and fundraising, drafting detailed term sheets (possibly even investment agreements) and identifying the shares/investment instruments for the fundraise. Ideally, start-ups should aim to issue equity shares with only the statutory rights attached to them at the pre-seed and seed stages. From the Series A round onwards, instruments which rank senior to equity shares may have to be issued, such as compulsorily convertible preference shares or debentures, and robust share subscription and shareholders' agreements (together with other transaction documents such as employment agreements) should be entered into.
2. **Ensure compliance/good governance:** Investors often conduct legal due diligence to assess the level of compliance and good governance practices that the start-up follows. It typically covers corporate secretarial compliance, material contracts, assets, licenses and consents, litigation, indebtedness, insurance, employment, intellectual property and information technology. The prospective investors then evaluate red flags identified during legal due diligence. If these red flags are not deal-breakers, protections such as valuation adjustments or indemnities are sought from the start-up and founders.

Start-ups should ideally engage legal counsel to conduct a 'vendor due diligence' to identify these red flags upfront, and have them resolved before the prospective investors begin their legal due diligence, to minimise valuation adjustment and the founder undertaking onerous indemnity obligations, which can even attach to the personal assets of the founders.

For example, if an e-commerce marketplace is collecting customer data without complying with applicable privacy laws, the start-up can put in place the mandated protocols (such as having a privacy policy for the website, seeking express consent of customers for their data collection). Taking this same example forward, the investor would be well within his right to ask for an indemnity undertaking from the founder/s for any loss caused due to the breach of these data privacy laws.

3. **Pay attention to the legal documentation:** The major challenge for start-ups in fundraising is to appropriately draft term sheets, structure the deal, and determine the right company

valuation, a process that uses complex methodologies. While these aspects are subsequently captured in the term sheet, which is majorly non-binding, it is vital to ensure that it accurately captures what the parties intend to agree to. The definitive documents are then drafted by lawyers taking into account the commercial intent set out in the term sheet, while incorporating nuanced provisions which may not be expressly set out in the term sheet. For instance, if a start-up is an insurance company undertaking a fund-raising round, the requirement of approval from the Insurance Regulatory and Development Authority of India for such fundraise would need to be analysed, and accordingly, a pre-closing condition in the investment documentation would need to be built in.

4. **Ensure specific licensing and compliance with related laws:** Obtaining a license is integral for any start-up. They may need to register their business under various licenses applicable as per various statutes in India. These licences may pertain to aspects such as maintaining the quality of the product and hiring a specific number of employees. Similarly, depending on an entity's structure, compliance with specific laws, such as consumer protection laws and data privacy regulations, is needed. Such compliances establish a positive brand image before investors.
5. **Pick the right legal counsel:** Having a competent legal counsel who is well-versed with start-ups and the fundraising lifecycle enables businesses to assess the potential risks and uncertainties ahead of them and devise a strategy to avert those. The counsel must also have extensive experience in term sheet negotiation, licensing, and IP strategy. Moreover, venture capitalists expect start-ups to be represented by a counsel who is knowledgeable in venture financing. Hence, having a legal counsel whose primary focus is start-up representation can help.

Some key questions to ask include –

- How many start-up fundings has the counsel handled in the last one or two years?
- What kind of legal assistance has the counsel provided to those start-ups?
- Does the law firm have an emerging start-up practice or an established one?
- Does legal counsel have knowledge of the industry in which the start-up operates?

Conclusion

Essentially, every business aspires to build the next best start-up that eventually becomes a unicorn. To materialise this aspiration, an effective fundraising strategy is particularly indispensable. It accelerates the business idea and helps achieve the financial and commercial goals. However, start-ups must understand that external funding opens the door for increased legal risk. But with the right legal guidance at each step of the process, they can leverage the opportunities in India's start-up eco-system, which is recognised as the [third-largest](#) in the world.

This article was first published in [Bar and Bench](#).