STARTING A STARTUP: LEGAL ANALYSIS OF A LIMITED LIABILITY PARTNERSHIP AS THE IDEAL BUSINESS STRUCTURE AND AVAILABLE INVESTMENT CHANNELS

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ABSTRACT

Considering the fact that startups are gaining massive popularity these days, it seemed important to understand the legal environment and the legal compliances relating to a startup business. Even the Government of India has a huge focus on the ease of doing business reforms and startup action plans. The reason being that, the Government wishes to simplify the business-related legal environment, in order to give a boost to startups. In this light, this article aims to discuss the structural and financial ease of doing business. Firstly, the article analyses the legal benefits of a Limited Liability Partnership over all other business structures, i.e., a public and a private company by pointing out its less complex and less compliance-seeking nature. Thereafter, the article acknowledges the importance of financial decisions for a business which are the cornerstone for its initial years. It is further understood that most people drift away from the idea of opening a startup because of their concerns over financial hurdles. In this light, the latter half of the article points out multiple funding options

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available with a Limited Liability Partnership, such as Equity and Debt Investment options, Foreign Direct Investment and other unique financing methods, and analyses each method in detail by discussing various legal regulations attached therewith.

1. CHOOSING THE RIGHT BUSINESS STRUCTURE

Choosing an appropriate business structure is one of the most difficult tasks. No business startup can succeed solely on the basis of an idea. Business structure has a very important role to play in its success. And that is why; this decision needs to be taken after a detailed analysis with precision and thought.

A Company is a body corporate having an independent legal identity, with capital divisible into transferable shares carrying limited liability, having a common seal and perpetual succession. A Public Company is one which is owned by the public through freely transferrable shares. The liability of each shareholder, however, stays limited up to the maximum amount of money that remains unpaid on his total number of shares. Another important feature of a public company is the separation of ownership from management. While the ownership lies with the Body of Shareholders, the management power vests in the Board of Directors (BOD). All important decisions are taken by the BOD. Shareholders, too, play a significant role through Annual General Meetings where they cast votes proportional to their number of shares. A Private Company is one which is owned privately by individuals. Therefore, the capital herein remains restricted. Furthermore, shares are not freely transferrable due to the concept of Preemptive Right. The other features that were prevalent in a Public Company, all exist herein as well. Both these business structures are regulated by the Companies Act, 2013.

The process of incorporation is extremely lengthy in case of a Company, beginning with Promoters, to acquiring a Digital Signature Certificate (DSG), to Directors Identification Number (DIN), to preparation of Incorporation Documents (Memorandum of Association MoA, and Articles of Association AoA) to Approval of Name to getting a Certification of Incorporation.

A new form of business structure has gained popularity lately, i.e., One Person Company (OPC). An OPC, treated as a private company[1] is a company which has only one person as a member.[2] While this business structure is suitable for a single entrepreneur wishing to start a business, it is not free from troubles, the biggest hurdles being that membership in an OPC is limited to a maximum of two, so the scope investment expansion even in future stays limited.

A Limited Liability Partnership (LLP) is a business structure that shares characteristics of both a company and an LLP. Herein, the liability of each partner remains limited like a company, the inner flexibilities of management also exist like a partnership. Furthermore, the LLP has a separate legal identity just like a company. But, the ownership and the management are unified and not separate, and exist in the hands of the

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[1] Companies Act, 2013, No.18, Acts of Parliament, 2013, § 3(1)(c).
[2] *Id.* § 2(62).

partners. Further, LLP enjoys perpetual succession and transferability of stake as per the LLP Agreement. Also, interestingly, unlike a partnership, the partners in an LLP are the agents of the LLP, but not of each other[3], as pointed out by Sec. 26 of The LLP Act. It, thus, incorporates the advantages of both a partnership as well as a body corporate. Notably, this business structure is regulated by the Limited Liability Partnership Act, 2008. Herein, at least two partners and two designated partners are required for incorporation as per Sec. 6 of the LLP Act, 2008.[4] There is no maximum limit howsoever.

In case of an LLP, the procedure involves obtaining a Digital Signature Certificate (DSC) and a Director Identification Number (DIN) / Designated Partner Identification Number (DPIN) for the proposed Partners, name approval from Ministry of Corporate Affairs (MCA) and, in the end, filing for Incorporation. Notably, as a result of “Companies (Appointment and Qualification of Directors) Rules, 2018, it is mandatory for any person who wishes to incorporate an LLP to have a DIN, without which incorporation procedure would become very difficult (because in cases of incorporation, DIN cannot be applied for using DIR-3).

The document, like a Memorandum of Association (MoA) and Articles of Association (AoA) in case of company, is an LLP Agreement in case of an LLP, which governs it’s various relationships, and is a very simplified document.

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[3] Limited Liability Partnership Act, 2008, No. 6, Acts of Parliament, 2009, § 26.
[4] *Id.*, § 6.

It is to be further noted that in an LLP, as indicated by Sec. 42 of The LLP Act, the right of a partner to receive profits and share losses of the LLP in accordance with the LLP Agreement is transferable.[5] This transferability would not lead to disassociation of the partner or a dissolution of the LLP. It also does not confer any management rights on the transferee or the assignee.

With the above stated detailed discussion, it can be figured that an LLP is the most ideal business structure for a business startup. It is a new corporate form that provides an alternative to the traditional partnership, with unlimited personal liability on the one hand, and, the statute-based complex governance structure of a company on the other, in order to enable professional expertise and initiative to combine, organise and operate in flexible, innovative, and efficient manner.[6]

LLP, as a structural concept, emerged out of the Naresh Chandra Committee Report on 'Regulation of Private Companies and Partnership' and the Dr. J. J. Irani Committee Report on 'Company law'. The Limited Liability Partnership Bill, tabled in Rajya Sabha on 15 December, 2006 articulated the need for LLPs in the best possible way. It stated that,

> *With the growth of the Indian economy, the role played by its entrepreneurs as well as its technical and professional manpower has been acknowledged internationally. It is felt appropriate that*

[5] *Id.*

[6] Bhavesh Bhatia & Sukhada Wagle, *Limited Liability Partnership Act,* INDIA L.J., *available at* http://www.indialawjournal.org/archives/volume2/issue_2/article_by_bhavesh_sukhada.html.

> *entrepreneurship, knowledge and risk capital combine to provide a further impetus to India's economic growth. In this background, a need has been felt for a new corporate form that would provide an alternative to the traditional partnership, with unlimited personal liability on the one hand, and, the statute-based governance structure of the limited liability company on the other, in order to enable professional expertise and entrepreneurial initiative to combine, organize and operate in flexible, innovative and efficient manner.*[7]

2. FINANCING OPTIONS AVAILABLE TO A LIMITED LIABILITY PARTNERSHIP START-UP BUSINESS

There are multiple hurdles in the path to success of a business. However, getting finance for one's startup business is not as big a hurdle anymore. In this light, this Chapter aims to point out the financial ease of doing business, by discussing various financing and funding options available for a startup business.

2.1. EQUITY FINANCING

Some innovative and new equity financing options that can be used by an LLP are, Venture Capital and Angel Investors.

Angel Investors are real life 'business angels' because they help a startup at the time when even the business plan is not ready comprehensively. They help the startup business by financing their ventures and investing in them, their deep-pocketed pool of resources,

[7] *Id.*

their high intellect and knowledge of the business world, in return for an ownership-stake in the business. Angel Investors may provide a one-time capital in order to propel the business, or may contribute the same at intervals during the difficult stages faced by the business in its initial years. Thus, an ‘angel investor’ is any person who proposes to invest in an angel fund and is an individual investor who has net tangible assets of at least two crores rupees excluding value of his principal residence and who has early stage investment experience or experience as a serial entrepreneur or as a senior management professional for at least ten years; or a body corporate with a net worth of at least ten crores rupees or an Alternative Investment Fund registered under these regulations or a Venture Capital Fund registered under the SEBI (Venture Capital Funds) Regulations, 1996.[8]

Venture capitalists, on the other hand, invest in firms that have both high-growth and high-risk potential. Venture-capital investments mostly come in exchange for ownership stake in the company to ensure that the investors have a say in the future. Also, it is not necessary that all venture capital financing occur in the initial stage of the company only. Funding can be provided throughout various stages of the company’s progression. The fund comes from venture capital firms, which comprise professional investors who understand the intricacies of financing and building companies. The money invested by them comes from a variety of sources, such as private and public pension funds, endowment funds, foundations,

[8] *Id.*, Reg. 19-A.

corporations, and wealthy individuals. At the end, venture capitalists usually sell their shares in the company back to its owners, or to the public, or to whomsoever they believe to be more profitable.

SEBI released the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 by a notification on 21 May 2012. These Regulations govern various alternative funding investments. It shall be relevant to note that an Investee-Company is a company, special purpose vehicle, or limited liability partnership or body corporate, in which an Alternative Investment Fund makes an investment.[9] This shows that an LLP can receive investment from these financing options.

Notably, the said regulations divide various alternative investments funds into three categories.[10] Category 1 covers angel investors (regulated by Chapter 3-A) and venture capitalists, and includes those investments which invests in start-up, early stage ventures, social ventures, SMEs, infrastructure, or other sectors and areas which the government or regulators consider as socially or economically desirable.

However, any scheme launched by Angel Funds will have to comply with certain conditions.[11] Firstly, the scheme memorandum will have to be filed at least ten working days prior to the launch of the scheme with the Board. Such scheme memorandum shall contain all material information

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[9] Securities & Exchange Board of India (Alternative Investment Funds) Regulations, 2012, regulation 2(o).
[10] *Id.*, regulation 3.
[11] *Id.*., regulation 19-E.

about the investments proposed under such scheme. Apart from this, there are various other restrictions imposed on the investments by Angel Funds which have to be complied with, e.g., angel funds shall invest only in venture capital undertakings which have been incorporated during the preceding three years from the date of such investment or have a turnover of less than twenty five crores rupees; investment shall not be less than fifty lakh rupees and shall not exceed five crores rupees; investment has to be locked-in for a period of three years, investments in associates are not allowed and lastly, more than twenty-five per cent of the total investments cannot be made in one venture capital undertaking.[12]

2.2. DEBT FINANCING

Debt Financing refers to the technique of raising money in the form of loans. In return for lending the money, the individuals, or institutions become creditors and receive a promised principal sum and interest thereon at the pre-decided rate. There are broadly three channels of Debt Financing options available to a business, viz., loans from banks, External Commercial Borrowings (ECBs) and Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) Loans.

Banks and Non-Banking Financing Companies (NBFCs) grant loans on interest to startup businesses. This method is not considered very lucrative, because sometimes, banks in exchange for the loan, trade for an

[12] *Id.*, Regulation 19-F.

important managerial position in the firm until the loan is paid, and this way operates actively in the business functioning.

ECBs are commercial loans raised by eligible resident entities from recognised non-resident entities. They have been dealt with in detail in the External Commercial Borrowing (ECB) Regulations and The Foreign Exchange Management (FEMA) Guidelines.[13] ECB framework enables the raising of money in the form of loans, securitized instruments, buyers' credit, suppliers' credit, Foreign Currency Convertible Bonds (FCCBs), financial Lease; and Foreign Currency Exchangeable Bonds (FCEBs).

However, it is to be noted that the option of raising money through ECBs cannot be availed by LLPs, because as per the regulations, only companies are eligible borrowers.

In this context, it is relevant to note that The Department of Industrial Policy and Planning (DIPP), the policymaking body on foreign investment, discussed the business structure of LLPs in its discussion paper in 2011. In that paper, it was suggested that ECBs should be allowed for LLPs as well. However, the Finance Ministry and The Reserve Bank of India opposed these suggestions. It was said, in the context of LLPs, that, "It is a business structure largely aimed at professionals and small

[13] Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000; Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004; Foreign Exchange Management (Guarantees) Regulations, 2000.

businesses, which do not require overseas debt that comes with its own risks".[14]

However, in the opinion of the author, the ECB channel should open for the LLPs, for the following two reasons:

I. Since ECBs are a cost-effective means of financing large capital expenditure and projects, they should be allowed for LLPs, otherwise it would adversely hamper their future prospective of growth and their ability to execute large projects on a sustainable basis; and,

II. Such a restrictive angle for the LLPs would obstruct them from indulging in any capital-intensive activity.

A step towards this direction is already in place, as can be seen from the recent RBI Amendment to schedule 9 of the FEMA Regulations 20/2000. By the same, the provision that specifically barred/excluded LLPs from availing ECBs, i.e., para 9(4) has been deleted.

Coming to the option of The Credit Guarantee Trust for Micro and Small Enterprises (CGTMSE) Loans, The Ministry of Micro, Small & Medium Enterprises (MSME), Government of India launched a scheme to encourage small entrepreneurs as it helps them to get loans up to Rs. 1 crore sanctioned without any collateral or surety. All scheduled commercial banks, specified Regional Rural Banks, NSIC, NEDFI, SIDBI, and NBFCs which have signed an agreement with the Credit Guarantee Trust are covered under the said scheme.

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[14] *LLP News*, LLP ONLINE (2010), http://www.llponline.in/news_detail.php?id=38 (last visited May 21, 2018).

Notably, the scheme also provides rehabilitation assistance upto Rs. 200 lakhs in case a unit covered under CGTMSE becomes sick due to factors beyond its control.[15]

2.3. FOREIGN DIRECT INVESTMENT IN LIMITED LIABILITY PARTNERSHIPS

Foreign direct investment (FDI) is an investment made by a company or an individual of one country in another country by either establishing business operations or acquiring business assets.

FDI in India is undertaken in accordance with the FDI Policy which is formulated and announced by the Government of India. DIPP issues a Consolidated FDI Policy Circular on a yearly basis on March 31 of each year explaining the policy. Apart from this, The Foreign Exchange Management Act (FEMA), 1999 and The Foreign Exchange Management (Transfer or Issue of Security by Person Resident outside India) Regulations, 2000 (FEMA 20/2000) govern and regulate FDI in India.

Broadly, there are two routes for the entry of FDI in India; viz, the automatic route and government route. While under the former, the foreign investor or the Indian company does not require any approval from the RBI or the Government; under the latter, prior approval from the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs (DEA) or Ministry of Finance or Department of Industrial Policy & Promotion, as the case may be, is required.

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15 *Eligibility Criteria, Credit Guarantee Fund Trust for Micro and Small Enterprises*, UDAAN, https://www.cgtmse.in/Eligibility_criteria.aspx (last visited May 15, 2018).

In the context of LLPs, it is pertinent to note that the Master Circular issued by the RBI[16] on 1 July 2014, clarifies that an LLP formed and registered under The LLP Act, 2008 shall be eligible to accept FDI under Government route only, subject to the conditions given in Annex B.[17] Notably, Annex B deals with the Scheme for Acquisition/ Transfer by a person resident outside India of capital contribution or profit share of Limited Liability Partnerships (LLPs) in detail. It may be further noted that, an LLP operating in sectors where 100% FDI is allowed under the automatic route would be eligible to receive FDI. These sectors are provided under The Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000.[18] However, certain sectors are not eligible to seek FDI, e.g., sectors eligible to accept 100% FDI under automatic route but are subject to FDI-linked performance related conditions; those eligible to accept less than 100% FDI under automatic route; those eligible to accept FDI under Government Approval route; agricultural/plantation activity and print media; lottery businesses, gambling and betting, real estate business, manufacturing of cigars, atomic energy, and railway operations etc.;

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[16] Reserve Bank of India, *Master Circular on Foreign Investment in India*, No. 15 /2015-16, RBI/2015-16/96, *available at* https://rbidocs.rbi.org.in/rdocs/notification/PDFs/96MC7984B235BAB249D5ADCD6277CCD68D0D.PDF (last visited May 4, 2018).

[17] Reserve Bank of India, *Master Circular on Foreign Investment in India*, No.15/2014-15, RBI/2014-15/6, ¶ 16(1), *available at* https://rbidocs.rbi.org.in/rdocs/notification/PDFs/06FIC010714FL.PDF.

[18] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000, annex. B sch. 1.

Downstream Investment has also been regulated by the RBI in its Circular. When an Indian company which has FDI further invests in an Indian company/LLP, it is called an Indirect Foreign Investment or a Downstream Investment. An Indian company, having foreign investment, will be permitted to make downstream investment in an LLP only if both, the company as well as the LLP, are operating in sectors where 100% FDI is allowed under the automatic route and there are no FDI-linked performance related conditions. Responsibility of compliance shall be on the LLP.

Certain other conditions pointed out by the Circular are as follows:

I. If an LLP with FDI has a body corporate as a designated partner or nominates an individual to act as one u/s 7 of the LLP Act, 2008, such a body corporate should only be a company registered in India under the Companies Act. Notably, the word 'body corporate' herein does not include an LLP or a Trust. The individual partner would have to be not only a 'resident' in India',[19] but also, a 'person resident in India'.[20] This means that he must be a person who has stayed in India for more than 182 days in the immediately preceding one year. However, certain exclusions lie to the same.

II. If a company with FDI wishes to convert into an LLP, it will have to meet the provided stipulations and take prior approval of FIPB/Government; and

[19] Limited Liability Partnership Act, 2008, No. 6, Acts of Parliament, 2009, § 6.

[20] Foreign Exchange Management Act, 1999, § 2(v)(i).

III. LLPs shall not be permitted to avail External Commercial Borrowings (ECBs).

Notably, the FDI Policy of 2017 has incorporated many aspects of the RBI Master Circular and has dealt with FDI in LLPs extensively. Most importantly, it recognises foreign investment in startups organised as a partnership firm or an LLP, and says that the same can be made through capital or through any profit-sharing arrangement,[21] while also specifying some conditions[22] with which LLPs have to comply with before undertaking FDI.

The Policy also scrutinizes downstream investments[23] by eligible LLPs and subjects them to the following conditions:

I. Mandatory notification to the RBI within 30 days of any downward investment and the modality of investment in any new or existing ventures;
II. Resolution by the Board of Directors and also a support by the shareholders agreement, if any;
III. Compliance with the SEBI Guidelines and the RBI Guidelines; and
IV. Funds for the downstream investments would have to be brought in from abroad and not leveraged from the domestic market.

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[21] Atul Chaturvedi (Department of Indus. Pol'y & Promotion, Ministry of Commerce & Indus., Govt. of India), *Consolidated FDI Policy Circular of 2017*, D/o IPP F. No. 5(1)/2017-FC-1, 2017, *available at* http://dipp.nic.in/sites/default/files/CFPC_2017_FINAL_RELEASED_28.8.17.pdf.
[22] *Id.*, ¶ 3.2.4.
[23] *Id.*, ¶ 3.8.4.2.

In this context, it shall also be relevant to discuss The FEMA (Transfer or Issue of Security by Persons Resident outside India) Regulations (RBI Second Amendment), 2017.[24] These Regulations prescribe certain conditions for permitting FDI in LLPs, compliance with which is mandatory.[25] Pricing, as provided under the Regulations is the same as that under the RBI Master Circular of 2015. Similarly, the Mode of Payment compliances too are the same, with only one point of difference, i.e., they have to be in accordance with Foreign Exchange Management (Deposit) Regulations, 2016. As far as the reporting of foreign investment in LLPs and disinvestment or transfer of capital contribution or profit shares between a resident and a non-resident is concerned, the same has to be done in a manner prescribed by the RBI. Furthermore, a Report titled 'Annual Return on Foreign Liabilities and Assets' has to be annually submitted by all LLPs which have received FDI in the previous year as well as in the current year.

Importantly, the amendments made by the RBI to Schedule 9 of the FEMA Regulations,[26] led to some key changes,[27] and the same may be summarised as:

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[24] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Second Amendment) Regulations, 2017, RESERVE BANK OF INDIA https://rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=10876 (last visited May 10, 2018).
[25] *Id.*, ¶ 3 sch. 9.
[26] *Id.*, sch. 9.
[27] *Foreign Direct Investment in Limited Liability Partnership – Revised guidelines*, *Tax Flash News*, KPMG, http://www.in.kpmg.com/taxflashnews/KPMG-Flash-News-FDI-in-LLP-Revised-guidelines-2.pdf (last visited May 13, 2018).

I. Reporting requirements have been simplified as a result of amendments to Para 7(1), (2) and (3).

II. A clarity has been provided for the conversion of a company with FDI into LLP due to an effect of amendment to Para 9(3). Also, now, an FIPB approval for such a conversion would no longer be required.

III. Amendment to Para. 9(4) signals a ray of hope for the ECB channel to be opened soon for LLPs, provided that suitable amendments are made to the ECB regulations as well.

IV. Para. 9(1) was amended to allow foreign companies to be appointed as DP. Apart from that, the residency test criteria under FEMA to be satisfied by individuals appointed as DP is no longer required.

2.4. OTHER METHODS OF FUNDING

Crowd-funding is a method wherein, a business goes to an online crowd-funding portal and mentions all the details of his business, including the objective, products and line of business, capital requirements, expected profits etc. All those who like the idea can invest and pool in their money to help out the business. This money, given under an online pledge, is essentially a payment made by them for the pre-orders of the products sold by the business. Some investments, however, are in the form of donations. One of the benefits of crowd-funding is that it helps in marketing and promotion of the product, apart from being a financing mechanism. Also, if the entrepreneur is apprehensive about the demand of his product, the same can be assessed by the amount of pre-orders received. This method also cuts out professional brokers, as it puts funding in the hands of common people.

Factoring or invoice advancing is another method through which a service provider lends money on the basis of the invoices that have been billed out already. Once the customer pays back the money on the goods taken on credit and settles the bill, the service provider is paid off.

Business incubators and accelerators help in the funding of hundreds of startups every year and are considered to be a very good option for early stage businesses. A fundamental difference between the two is that while incubators help the business in the infant stage and nurture it like a parent, accelerators come into play at the adolescent stage and help the business to progress and grow. An advantage of this method is that the entrepreneurs make good connections with mentors and business professionals.

Rest apart, 'Pradhan Mantri Micro Units Development and Refinance Agency Limited (MUDRA)', is a Government backed scheme that starts with an initial corpus of Rs. 20,000 crores to extend benefits to around 10 lakhs SMEs. All that has to be done is, submitting a business plan, getting it approved, and thereafter, getting the loan sanctioned.

Another program is that of MUDRA Card, which is like a credit card, which you can use to purchase raw materials, meet other expenses etc.

Further, different states have come up with different programs like, Kerala State Self Entrepreneur Development Mission (KSSEDM), Maharashtra Centre for Entrepreneurship Development, Rajasthan Startup Fest, etc. to encourage small businesses.[28]

3. CONCLUSION

It may be safely concluded that, for the ease of doing business, one must choose the business structure of a Limited Liability Partnership. Not only is it much simplified with minimal compliance requirements, there are multiple financing options available for it too, including equity and debt financing methods as well as Foreign Direct Investment. Thus, investment would not be an issue for an LLP, which is the major concern and reason for resorting to and choosing a company structure. However, startups must take the take the decision as to debt and equity wisely, *i.e.*, a balanced proportion of both the funding options.

[28] Harshal Katre, *Funding Options to Raise Startup Capital for Your Business*, PROFIT BOOKS, http://www.profitbooks.net/funding-options-to-raise-startup-capital-for-your-business/ (last visited May 10, 2018).