

Transcription

Choosing the Right Legal Structure

Common Legal Mistakes Made by Entrepreneurs



I think the most important factor to business in India is to just make sure you know exactly how to play with the law. So I think it is important to understand the law. A lot of people use consultants and they don't understand, they just start up a business without actually understanding the law.



You just heard Ketan Kadam of Maroosh emphasizing on the importance of understanding the law of the country in which you are operating as well as the law of the country in which you plan to operate. It would be such a pity if a great business idea; the support you receive from family and friends and the worthy level of capital investment received, goes into vain for legal matters that you were not really ready to care about. There are multiple areas in which you can make significant mistakes as an entrepreneur.

These mistakes can then hit back in the long-term, so you should early on create a strong understanding around some critical issues. For example, we keep hearing news about companies having

1. Unclear terms between different stakeholders or shareholders within a company which can lead to significant challenges such as
 - (i) Co-founders leaving the company

This also happens when the cofounders do not have a really watertight agreement between them which clearly sets forth their

- (ii) Rights and obligations in the company including who really controls the company and who calls the shots

So the founders' agreement is something as basic as laying out all these rights and obligations of the parties is something that often gets missed. Secondly, there is also

2. Infringing of trademarks which is another common area for issues in the startup ecosystem. These kind of trademark related cases can cause
 - (i) Reputational damage to companies that lead to
 - (ii) Monetary penalties and
 - (iii) Distract the key founders from daily operations significantly

So how do you really resolve that? That's by thinking of your brand name upfront and making sure that you have protections in place and making sure that your brand name does not violate the third party's IPR. Continuing with the list of legal mistakes, another thing you should be careful about as a founder is the

3. Creation and maintenance of terms of use and privacy policy on your website. A Terms of Use Agreement is meant to set forth the terms and conditions for people visiting your website and a Privacy Policy page specifies the way you use website data of the user

For example, many websites take important sensitive information of the person who visits their website. Whether it is simple information like their name and age, including their address as well. There are laws in India that are very sensitive about privacy protection and data protection where you are required to have a policy that sets forth how you really maintain this confidential information and that you don't sell your customer's sensitive information to other companies and all of these would lead to significant non-compliance issues. Another classical mistake in the early days is to opt for

4. Inexperienced legal counsel within your startup

When you reach a certain scale and commercially you realize that the appointment of legal firms does no longer make sense, then it is recommendable to hire an individual that can help you out in multiple situations, someone with some level of experience to rely on. Finally, another common mistake which entrepreneurs make is by

5. Forming a wrong legal entity which can ultimately lead to
 - (i) Higher taxation and

- (ii) Increased liability, wherein you, at the worst case, even be obliged to put your personal assets such as your house, car and various other assets at risk in the event of a dispute or lawsuit or simply being unable to satisfy debts/liabilities of the entity through which you are conducting business.

In this session, you will first look at different types of legal structures, their incorporation process and the factors which will help you choose the right structure for your business. In addition, we will look into the parameters that you should consider when selecting a lawyer or an expert for your business.

Types of Legal Structure



Now, when it comes to deciding on which legal structure to choose for your venture, you should consider certain basic points:

- a) Your company's Tax liability – where the idea is to constantly seek opportunities to minimize tax
- b) Your personal liability, where you save yourself from risking your personal assets
- c) The ease of raising funds, where certain forms of entities are more common than others and are preferred by investors to protect themselves and facilitate future funding processes
- d) The level of record-keeping obligations, where certain forms of entities' require significant amount of personal collaterals
- e) The cost related to creation of the entity, since certain entity forms are more expensive to register than others. And lastly
- f) Your Future Business goals of the business, say, in terms of scaling up or diversifying, where some forms offer more advantages than others

Let's look into certain types of entities with their respective features. For this, let's especially look into four common types of legal structures:



Features of Sole Proprietorship

1. Single ownership
2. Full decision-making power
3. Least compliance requirements
4. Unlimited personal liability
5. Lacks credibility among investors
6. No provision to add partners

Starting with sole proprietorship, if you ever wondered what kind of legal structure stationary shops, small bakery shops or people who are into small-scale businesses have, the right answer to this is most likely the Sole Proprietorship. Most of these businesses operate as sole proprietorship, generally meant for moderate level risk businesses that are low on financial resources.

Under this form, you have

1. Sole ownership of the business, with
2. Full rights to take every decision on behalf of the entity

In addition to that, you require the

3. Least level of compliance and record-keeping, be it pertaining to the number of registrations you have to make or the norms to meet

As a drawback, you have

4. Unlimited liability, where you would be held responsible for paying up out of your own pocket in case if the business assets are unable to meet the liability

Next, this entity structure

5. Lacks credibility in terms of raising funds from the investors

Finally, there are

6. No provision to add partners here

So as the name suggests, sole proprietorship is where you are the sole guy calling the shots and it's only you running the business and hence the introduction to sole proprietorship lay emphasis on the fact that it is only meant for moderate to small scale businesses which require a family running it informally where it is only one person running the business.



Features of General Partnership

1. Low cost of entity formation
2. Profit sharing ratio
3. Preparation of partnership deed
4. Unlimited personal liability
5. Maximum 20 partners

The next form of legal entity is what is called the general partnership. Now, when it comes to general partnership, you might have seen many professionals in the service industry operating under this structure – namely law firms. As a law office, they might have numerous partners within a single business structure called the general partnership.

The primary motive behind doing so could be the

1. Low formation cost and
2. Profits which can be shared either as per their capital contribution ratio or any other terms that the partners may mutually agree and set forth in the
3. Partnership deed

Like Sole proprietorship, the liability in a general partnership is also

4. Unlimited which can extend to the personal assets of the partners as well as the liabilities of the other partners of the firm

Under this form, the number of partners can start anywhere from

5. 2 and can go up to 20 partners

Once again, as Sole Proprietorship, the key issue here is the question of unlimited liability.



Features of Private Limited Company

1. Limited liability
2. Good for scalable businesses
3. Can have multiple shareholders
4. Good for raising funds
5. Separate legal existence
6. High compliance requirements
7. Few tax advantages
8. Maximum 200 shareholders

So then, that brings us to our third form of entity which is called Private Limited entity which as the name suggests this is where limited liability and hence is the most popular/common form of entity that most companies tend to go under. So, this entity is regarded as one of the most favourites among startup entrepreneurs. There are several advantages of opting for a private limited company. So like we said, what does it mean to limit your liability in a company? So unlike a sole proprietorship, or a partnership, where there is no distinction between you as an owner and the business. In case of a company,

1. Your liability is limited just to the
 - (i) Shares that you hold in the company

So in case things do not function properly under your business and in the event there are liabilities and deaths in the company, then your assets as a shareholder,

- (ii) Your personal assets cannot be attached to make good those liabilities

So, this is why Pvt companies are significantly more popular for businesses that are

2. More scalable and which have
3. Multiple shareholders or rather cofounders in your business when compared to a small sole proprietorship or a general partnership

Having this form of a structure actually facilitates in

4. Raising funds easily and consequently helps in scaling up rapidly

Next, because you have a

5. Separate legal existence, i.e. the owners are different from the entity, which saves them from unlimited liability issue that we keep seeing in other forms of less formative and less regulated industries

On the flip side, given that liabilities are demarcated, you have a

6. Greater level of compliance requirement like statutory audit, annual filings with the RoC, a special entity setup just to regulate companies in India

Then, you have

7. Fewer tax advantages, in which you have
 - (i) No exemption and you have to pay your taxes at the full corporate tax rate of approximately 30% on profits, and as a second level once you have paid that tax, then you want to distribute your profits to the shareholders, there is something called the
 - (ii) Dividend distribution tax (DDT) which is applicable

Now, when it comes to the cost of starting up, the Ministry of Corporate Affairs has removed the minimum paid-up capital requirement for private limited company and that's indeed a great point to save entrepreneurs from blocking their initial money. In case of private limited companies, you need to have a minimum of

8. Can have a maximum limit of 200 shareholders

However, as per the new Companies Act, 2013, the law also now permits private limited companies to operate with just one shareholder too. So, in your formative stages where you haven't identified all your co-founders, and you want to create an entity, it is no longer the case where you need to have a minimum of 2 shareholders to set up the company. You can go ahead with just yourself and setup the company and this has been a more recent relaxation under the company's act.



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Features of Limited Liability Partnership

1. Limited liability benefit
2. Moderate compliance requirements
3. Superior tax advantage

Lastly, we come to what is known as Limited Liability Partnership. This, which is commonly known as an LLP is one of the recent corporate structure that combines the flexibility of a partnership and the advantages of limited liability of a company at a low compliance cost. This is a new form of legal entity under Indian law

and hence people are still in a wait and watch mode before going down this path the reason because while in comparison to the Pvt Ltd company, it has fewer compliances it offers similar protections like

1. Limited Liability, there are several aspects of the LLP regime that are still under evolution and where the regulators are still coming up with amendments periodically to make this a more attractive form of entity

While it is not as flexible as a GP or a Sole Proprietorship, at the end of the day there are still

2. Fewer compliances when compared to a Pvt. Limited company

For example, an LLP requires audited annual returns to be filed only if it has a turnover of more than Rs. 40 lakh or a capital contribution of more than Rs. 25 lakh. So, in the initial stages, when you don't meet these kind of turnover requirements or your capital contribution is significantly lesser, then even these minimum compliance requirements do not exist. At the end of the day,

3. Taxation of LLP is what sets it apart from a Company –

depending on the type of revenue streams earned and sought to be distributed to partners, where in certain circumstances it could be the case that once profits of the LLP have been taxed and paid to the tax department upstream distribution to its partners is no longer taxable, unlike what we discussed in the company structure, where tax upstream to shareholders is subject to DDT.

Entity Registration Process



Registration of Sole Proprietorship

1. No formal registration
2. Decide the entity name
3. Open a bank account

Now that you have learnt about different types of legal structure, it's time to look at the processes which you will have to follow to create your business, be it a sole proprietorship, a general partnership, a limited liability company, or a limited liability partnership. In case of sole proprietorship, there is

1. No formal registration required

To get started with the same, all you need to do is to open a bank account in the name of the proprietorship firm. So, that's as simple as it gets. You think of a

2. Name of sole proprietorship firm,

which could even carry on business in your personal name or you can have a separate name. A sole proprietorship is not a separate legal entity and that brings us to the issue of unlimited liability, so once you think of a name of your sole proprietorship, and

3. Open a bank account, you are good to carry out business in the name of the SP



Registration of General Partnership

1. Create partnership deed
2. Register the deed (optional)

Next, we come to a general partnership. As far as the registration of the partnership firm is concerned, a partnership comes into existence by

1. Creating and signing a partnership deed

Then, whether you want to

2. Register the deed with any regulatory authority, which is the registrar of firms is entirely at the discretions of the partners



Partnership Deed

1. Name of firm
2. Capital contribution ratio
3. Profit sharing ratio
4. Duties and power of partners
5. Nature of business
6. Place of business

So, to create a partnership firm, all you need to do is to get your partnership deed in place which sets out the key commercials between various partners, namely what is the

1. Name of the partnership firm, what is the
2. Capital contribution ratio, are the two partners contributing capital equally, are they
3. Distributing or being entitled to profits equally that is in proportion to their capital or are they separated where capital is, let's say in the ratio of 50:50, , but profits could still be distributed, in the ratio of 60:40, or even 80:20, depending upon the deliverables of each partner

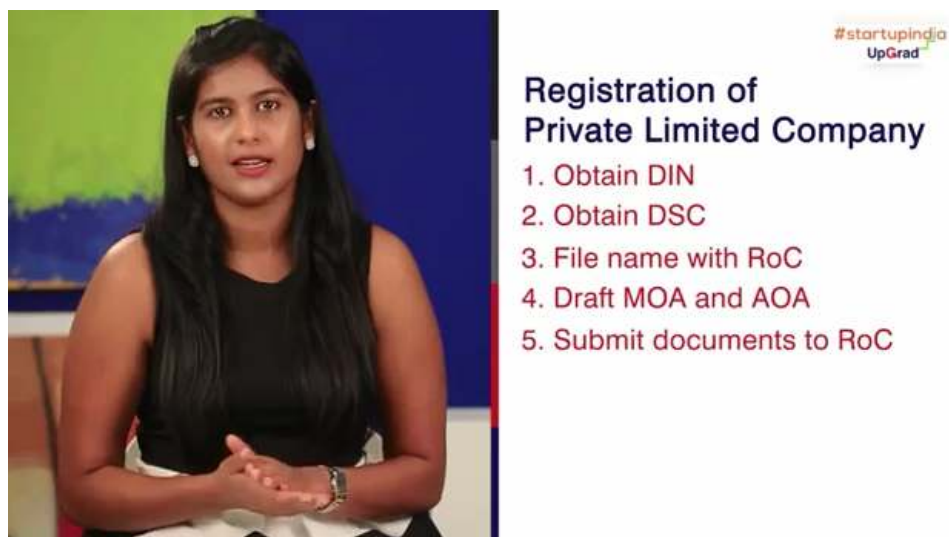
Partnership deed would include all these points and it's very important to set it forth in the deed, including what are the

4. Duties and powers of each partner, and also what is the
5. Nature and
6. Place of business

It may be done before starting the business or anytime during continuance of partnership.



It would be necessary to register your venture before you intend to approach court in case of any legal dispute. So, also for any eligible tax benefits, it is recommendable to register your partnership deed, because unlike a company where registering the ROC entails various periodic compliances, a general partnership at the end of the day, just stops at getting your partnership deed registered, your compliance requirement as such are not as regulated.



Now we come to a Pvt Ltd company. For registering a private limited company, first you need to:

1. Obtain a director identification number or DIN which is a unique identification number is given to an existing or potential director of the company

Next, you need to get a

2. Digital signature certificate or DSC, which is the digital equivalent of a physical certificate

Then you will have to

3. File a proposed name for the company for the Registrar of Companies or RoC, the authority having jurisdiction over the incorporation and get it approved

So, as we go over each of the steps of the Pvt. Ltd. company, you would start to realise that unlike a sole proprietorship or a general partnership, there are various sequence of events that needs to be followed. Not just procedural things like getting a DIN or a DSC or your name approved, but also the level of documents that you need to file.

The most critical filing process or rather the more detail oriented formation is something called its charter documents which is the –

4. MOA and the AOA

So, the memorandum sets forth the objects of the company, what the company plans to do; what is the capital of the company. The AOA is more like setting out like the rules or the by-laws of the company stating what the company can do and what is freely permissible.

So, overall, these are fairly, procedural aspects, where once you decide the type of entity, you can engage a consultant to help you with these formation steps, because whether its obtaining a DIN or even drafting these charter documents, while there are several precedence and access to these kinds of information, these are points of discussions with your consultant, whether your CA or company secretary, to understand what kind of a term should be upfront, so that you don't keep wasting your time amending the articles to carry out the actions. Finally you will have to:

5. Submit the documents we just discussed to the RoC, which is the registrar, the entity which is responsible for regulating the development and management of all companies that are setup either as a Pvt Ltd. Co. or a Public Limited Co.



Registration of Limited Liability Partnership

1. Obtain DIN
2. Obtain DSC
3. File name with RoC
4. Submit incorporation form to RoC
5. Draft an LLP agreement
6. File the deed with RoC

Lastly, we come to LLP, which is the Limited Liability Partnership. The process for registering an LLP is broadly similar to that of a private limited company in terms of all the paperwork and initial steps that you need to follow namely, like

1. Getting DIN,
2. DSC and also applying for the
3. Proposed name to the RoC

Once, the LLP name is approved, you need to

4. Submit incorporation form to RoC

After incorporation of LLP, you will have to

5. Draft an LLP agreement which includes clauses like
 - liability of the partners,
 - their rights and duties, basically all that we saw in the General partnership structure

Once you have all of these set out in the partnership deed, details of designated partners etc. and

6. File the same with RoC to complete the registration process.

How should you choose your base location



A very common road block for most early stage startups is which destination do they choose to register their startup India, US, Mauritius, Bahrain, we hear so many names and it sounds like choosing a holiday destination than a place to register your company, and I think it's very interesting and important for us to know what are the various aspects that an early stage entrepreneur should take into consideration while deciding which destination he chooses to register his company or open his head office.



So now that you have your structure sorted, the next question that you would have though even before you did this was the location. Where are you going to set this up?

Now 2-3 things you need to keep in mind. One is that as far as a company is concerned, location obviously is important but from a legal perspective, you can have offices all over the country. You need to have only one registered office. Generally speaking, the registered office is really going to be where the headquarters. The registered office is where the company is documents etc. are kept. So it's also important that the operations people and the legal people as well as the people who look after finance etc. are based in that office. There is no restriction on the number of offices you can have. The most critical aspect of location is obviously going to be where is your market, right. Obviously if your market is in Mumbai and you don't want to open an office in Calcutta, you'll have to open it in Mumbai.



So your market is very important. That then leaves you to 2-3 considerations. Where are your clients which is part of your market, where are you going to get people? What kind of skillset are you looking for

employees? So I'm asked many times by clients that where should I open an office? I'll say "okay, where is it that you're going to sell your products or services". If it's not really important from a market perspective, was an online venture and you are going to sell it all across the country then it's going to be that where you're going to be easy for you to operate from and where you are going to get people that you need.

For example, if you're a IT-focused company and you think "look, it's all going to be online, I really don't care where my market is but the people I want are in Bangalore" then you need to look at that as your location specific question. Today many entrepreneurs are looking at scaling up very quickly, Then the question comes is it only India? Or can you even look at location outside India?

There are some jurisdictions in the world where it's easier to do business than it is in India, easier to raise money, easier to get access to markets and some investors feel more comfortable investing in an overseas jurisdictions. Singapore is one jurisdictions which is quite popular for simple reasons that there are good tax treaties between India and Singapore and you should ask your advisors to what these tax treaties are and what do they mean.

Their rule of law is very strong. Singapore gives a lot of benefit for intellectual property creation and if you own your intellectual property, you can even get subsidies from the government and then you can in fact, have your main company in Singapore and you can set up a subsidiary in India. So you could have a dual location structure or a single location structure depending on your business and depending on where you think it's going to go.

Choosing a law firm/lawyer



It is extremely important that it doesn't matter from which background you come from. I came from an engineering background I had to do sales, I love coding and I coded the first product but I had to sales, you do it. Similarly, of a very small company you have to also be the lawyer for your own company. So there is nothing you can say no to.

My only suggestion would be that when you are looking at legal documents try to get the best lawyer you can afford because these thing add up and they are going to stay with you through your journey. I think not to over emphasise on anything I think it's very critical that you keep things simple, you optimise for less brain

damage you really do not want legal and other things to come in your way of execution. As a young startup again the two most important things code and sell and things like legal elements try to simplify them as much as you can and keep it to that degree. Focus on getting the best kind of accountants as well as legal teams as possible, try to keep things clean from day one.



You just heard Shashank from Practo, who actually focused on getting good legal advice right from the start. So then the next question on your mind would be 'How do you really go about finding that good lawyer? Someone who has the answer to all the questions you have and someone who will not drain you of your resources. There's this standing joke that lawyers are always charging you by the hour and they are like a running meter in front of you.



So how do you find that good lawyer? So as you evolve with the business, ultimately you realize that in handling your business from a legal perspective, what's more important than having the answers is knowing:

1. Ask the right questions and having the right questions

So as long as, as a founder of the company, you are broadly involved with the

2. Big picture legal issues, any of the advisors today will be able to give you good reliable legal advice

It's only when you leave everything entirely up to your consultant from the form of entity, from what kind of IP protection you need, from what kind of terms should go on to your ESOP schemes to anything. When you rely everything or you place that entire reliance on your consultant, is when things to start, is when things start of go amiss because your consultant

3. Does not have full visibility on your proposal, on your business and where exactly you see your business going

So when you have this big picture understanding, doing so will save you a lot of cost and effort later on in your journey. It is usually fairly confusing and a daunting task to select a lawyer because you may

4. Ask friends and your peers, who have also ventured into a similar space

You may ask lawyer friends to recommend someone but at the end of the day, what you need is the

5. Right legal experience, a right legal expertise on your side,
6. One who can help you deal with legal complications as you get busy settling down to your business

So either it could be a one service law firm which does multiple, has

7. Multiple verticals that can help you in all these aspects or you could then approach a specialised lawyer depending upon the area in which you are having some difficulty

So, depending upon where you are on your journey, is when you will know whether you have to approach a specialised lawyer or whether you can just have a good law firm on a retainer basis that can help you with your day to day operational issues. So as your business evolves is where you can start approaching them on a frequent basis but upfront, it's very important not to ignore legal issues altogether.

Summary – Choosing the Right Legal Structure



So in session we started off with a discussion about why we need to have a proper legal structure in which we discussed the

1. Mistakes each entrepreneur committed in the past

Thereafter, we moved on to discuss the

2. Features and the incorporation process for each types of legal structure,

Namely,

- (i) Sole proprietorship,
- (ii) General partnership,
- (iii) Pvt. Ltd. and
- (iv) Limited liability partnership

Finally, we learnt about the various

3. Factors on which one should select his/her consulting law firm or lawyer

In the next session, you will be looking at the importance of employee's stock options also referred to as ESOPs both from the founder's perspective as well as the employee's perspective.

You will also learn about the process of creating an ESOP scheme along with understanding the various terms involved in an ESOP scheme.

It was great meeting you for this session, and I look forward to seeing you again for the subsequent session.

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