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STARTUP FUNDING IN INDIA: LEGAL CHALLENGES AND OPPORTUNITIES

~ DUTTA CHANDRA VARSHINI

“A good idea can start a business, but adequate funding determines whether that business survives.” This statement reflects the reality of India’s startup ecosystem today. Every year, thousands of entrepreneurs enter the reality of India’s startup ecosystem today. Every year, thousands of entrepreneurs enter the market with innovative solutions, hoping to build the next successful company. However, even the most promising ideas require financial support to become commercially viable. Funding enables startups to develop products, hire skilled professionals, expand operations and compete in increasingly dynamic markets.

India has emerged as one of the world’s fastest-growing startup ecosystems. Government initiatives such as Startup India, increasing participation by venture capital firms and angel investors, improved digital infrastructure and a supportive entrepreneurial culture have contributed significantly to this growth. Yet, securing investment is no longer just about convincing investors that an idea is profitable. It also requires founders to demonstrate that their businesses are legally compliant, professionally managed and capable of protecting investors' interests. In today’s investment environment, legal preparedness has become just as innovation itself¹.

Understanding Startup Funding

Unlike established companies that rely on accumulated profits or conventional bank financing, startups generally operate with limited financial resources during their initial years. They often require external funding long before they become profitable. Startup funding therefore acts as

¹ Anamika Baid, Corporate Governance in Startups: Legal Challenges and Framework in India, International Journal of Law Management & Humanities 2961 (Vol. 8 Iss 2; 2961)

the foundation that supports product development, market expansion, technological innovation and business sustainability.

Funding generally progresses through different stages. Most founders begin by investing their own savings or receiving support from family and friends. Once the business demonstrates potential, angel investors provide early-stage capital in exchange for equity. Venture capital firms subsequently invest larger amounts in startups capable of rapid growth and scalability. Businesses that continue expanding may eventually attract private equity investments or even enter the stock market through an Initial Public Offering (IPO).

Although these funding stages appear straightforward, each involves legal documentation, regulatory approvals and contractual obligations that shape the relationship between founders and investors.²

The Legal Framework Behind Startup Investments

Startup funding in India operates within a comprehensive legal framework designed to maintain transparency, accountability and investor confidence.

The Companies Act, 2013³ forms the backbone of startup regulation. Most investment-oriented startups register themselves as private limited companies because this structure facilitates equity investment while offering limited liability protection. The Act governs incorporation, issue of shares, shareholder rights, board responsibilities and corporate governance.

Foreign investments are regulated through the Foreign Exchange Management Act, 1999 (FEMA) and the regulations issued by the Reserve Bank of India. Since foreign venture capital funds contribute significantly to India's startup ecosystem, compliance with FEMA becomes indispensable. Reporting obligations, pricing guidelines and sector-specific investment limits must be carefully followed to avoid regulatory complications.⁴

The Securities and Exchange Board of India (SEBI) further regulates investment vehicles such as Alternative Investment Funds (AIFs), venture capital funds and various institutional investment mechanisms. These regulations aim to encourage investment while ensuring adequate protection for investors.⁵

² Dr. L. Jalaja, Start Up Financing In India – Avenues and Challenges, PalArch's Journal of Archaeology of Egypt / Egyptology 19(2), 727-739. ISSN 1567-214x

³ Companies Act, 2013, No. 18 of 2013 (India)

⁴ Foreign Exchange Management Act, 1999, No. 42 of 1999 (India)

⁵ Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012

Alongside these statutory frameworks, initiatives such as Startup India and recognition by the Department for Promotion of Industry and Internal Trade (DPIIT) have simplified several regulatory procedures. Tax incentives, self-certification under certain labour laws, easier patent filing and access to government-supported funding programmes have strengthened India's entrepreneurial ecosystem⁶.

Legal Challenges That Continue to Affect Startup Funding

Despite policy support and increasing investor participation, several legal challenges continue to influence funding decisions.

The first challenge is regulatory compliance. Many founders devote considerable attention to innovation and customer acquisition but underestimate the importance of statutory filings, tax compliance and corporate governance. During fundraising, investors conduct detailed legal due diligence to identify potential risks. Missing statutory filings, defective share allotments or unresolved compliance issues often delay investments or reduce company valuations.⁷

Another major concern is the absence of well-drafted founder agreements. Numerous startups begin informally among friends without clearly defining ownership rights, decision-making authority, responsibilities or exit mechanisms. While such arrangements may function during the early stages, disagreements frequently emerge once external investments are introduced. Investors generally prefer startups where governance structures are clearly documented because uncertainty regarding ownership can become a significant legal risk.⁸

Intellectual property protection has also become increasingly important. In today's knowledge-driven economy, the true value of many startups lies not in physical assets but in software, business models, trademarks, proprietary technology and innovative processes. Failure to adequately protect these assets through patents, trademarks or copyright registration may reduce investor confidence and expose startups to unnecessary commercial risks.

Foreign investment presents another layer of complexity. Although India welcomes foreign capital in several sectors, startups receiving international investments must comply with FEMA

⁶ Dr. Sukanta Sarkar, Startup Business for Entrepreneurship in India: Government Policy and Challenges, Vidya – A Journal of Gujarat University, (Vol. 4 No. 2 (2025))

⁷ Bhavya Shah, Legal and Ethical Issues Faced by the Start-Ups in India, Jus Corpus Law Journal 844 (2022-2023)

⁸ Dr. Kamala Joshi, Start-Ups in India: Identifying and analyzing Major obstacles to success, A Peer Reviewed Research Journal 78-91 (Vol. 32 Issue II September 2025)

regulations⁹, pricing guidelines and reporting requirements. Regulatory delays or procedural lapses may adversely affect subsequent funding rounds and create avoidable legal complications.¹⁰

One issue that generated considerable discussion within India's startup ecosystem was the Angel Tax. Introduced to prevent money laundering through inflated share valuations, the provision often affected genuine startups raising legitimate investments from angel investors. Several entrepreneurs argued that the tax discouraged innovation and increased uncertainty during fundraising. The government's decision to abolish the Angel Tax has therefore been widely welcomed as a measure capable of improving investor confidence and strengthening India's startup ecosystem.¹¹

Beyond Money: What Investors Actually Examine

Contrary to popular perception, investors do not invest solely because a startup presents an attractive business idea. Modern investment decisions involve comprehensive legal due diligence.

Before investing, venture capital firms typically examine incorporation documents, shareholder agreements, employment contracts, intellectual property ownerships, tax compliance, pending litigation, statutory filings and data protection practices. A startup may possess an innovative product, but poor documentation or unresolved legal issues often become warning signals for investors.

This demonstrates that legal compliance should not be viewed as a burden imposed after investment. Instead, it forms an essential component of investment readiness. Founders who establish transparent governance structures from the beginning often find fundraising smoother and negotiations more favourable.¹²

Opportunities Ahead

Despite these challenges, India's startup funding ecosystem continues to present remarkable opportunities. Government initiatives promoting entrepreneurship, increasing domestic and

⁹ Foreign Exchange Management (Non-Debt Instruments) Rules, 2019

¹⁰ Mohammed Habeebuddin and D Sakriya, Startups In India – Issues and Challenges, Emperor International Journal of Financial and Management Research ISSN: 2395-5929 (SJIF-2016-3.343 | SJIF-2017-4.253)

¹¹ Dr. Kamala Joshi, Start-Ups in India: Identifying and analyzing Major obstacles to success, A Peer Reviewed Research Journal 78-91 (Vol. 32 Issue II September 2025)

¹² Dr. L. Jalaja, Start Up Financing In India – Avenues and Challenges, PalArch's Journal of Archaeology of Egypt / Egyptology 19(2), 727-739. ISSN 1567-214x

international venture capital participation and continuous regulatory reforms have significantly improved access to capital.

Emerging sectors such as artificial intelligence, fintech, clean energy, biotechnology and climate technology are attracting substantial investor interest. Simultaneously, incubators, accelerators and university innovation centres are providing startups with mentorship, networking opportunities and early-stage financial support.

Equally encouraging is the growing legal awareness among entrepreneurs themselves. Founders increasingly recognise that investing in legal compliance during the initial stages ultimately reduces business risks and enhances investor confidence.¹³

Conclusion

India's startup journey demonstrates that innovation alone is insufficient to build successful enterprises. Sustainable growth depends equally upon sound legal foundations, responsible corporate governance and regulatory compliance. Funding is no longer merely a financial transaction; it represents a relationship built on trust, transparency and accountability.

The legal environment surrounding startup investments has undoubtedly become more supportive than it was a decade ago. Nevertheless, founders must continue viewing legal compliance as an investment rather than an expense. Startups that combine innovative ideas with strong governance, protected intellectual property and regulatory discipline will be better positioned to attract investment and sustain long-term growth.

As India aspires to become a global innovation hub, strengthening the relationship between entrepreneurship and law will remain essential. Ultimately, startups that understand both business opportunities and legal responsibilities are the ones most likely to transform promising ideas into lasting enterprises.¹⁴

¹³ Tarkeshwar Pandey, Challenges and Opportunities of Startup India, *International Journal of Scientific and Innovative Research* 120-125 (2017;5(1) P-ISSN 2347-2189, E-ISSN 2347-4971)

¹⁴Dr. L. Jalaja, Start Up Financing In India – Avenues and Challenges, *PalArch's Journal of Archaeology of Egypt / Egyptology* 19(2), 727-739. ISSN 1567-214x