Paper Tigers: When Startup Contracts Can't Save You

A. The Armour You Think You Have

Every term sheet that graduates to a signed Shareholders' Agreement (**SHA**) arrives loaded with investor protections. They look formidable on paper. They are fought over by lawyers on both sides. And in India, a surprising number of them prove difficult to enforce in practice once a dispute with a founder escalates.

Here is the standard toolkit and the practical limitations that have typically emerged.

Protective Clause	Theoretical Function within the SHA	Practical Limitations in the Indian Legal Context
Reverse / Founder Vesting	Founders earn their shares over 3 - 4 years. Departure before vesting, or termination for 'cause' (including alleged misconduct or gross negligence), results in unvested shares returning at nominal value often INR 1 per share. In theory, a meaningful deterrent.	While theoretically a potent deterrent against founder misconduct, triggering this clause for 'cause' relies entirely on establishing definitive proof of the alleged misconduct. Founders invariably dispute the termination, leading to protracted disputes.
Good Leaver / Bad Leaver	A founder classified as a 'bad leaver' where 'cause' is alleged to include breach of the SHA or serious misconduct may forfeit even vested shares at a discount.	Enforcement of such a clause under Indian law, assuming the SHA is governed by Indian law, depends on the ability to legally establish 'cause' to the satisfaction of an arbitral tribunal or civil court. This means heightened scrutiny of the clause by the Court or the arbitral tribunal to see if the same is reasonable and whether the 'cause' mentioned thereunder has been triggered to justify its enforcement.
Reserved Matters & Board Rights	Investors appoint directors and require consent for related-party transactions, debt, auditor changes, and capex above a threshold.	The primary structural flaw is operational execution rather than legal drafting. Investor directors, who are often VC partners serving simultaneously on multiple portfolio company boards, may lack the bandwidth to audit complex management information systems in

		sufficient depth, allowing management to bypass theoretical board controls.
Audit Committee & Independent CFO	Post-Series B, typically SHAs mandate the formation of an audit committee and require the CFO to report to an audit committee rather than solely to the CEO.	In high-profile governance breakdowns like GoMechanic, BharatPe, and MedikaBazaar, these reporting lines were either structurally compromised from the outset, actively circumvented by dominant founders, or entirely ignored, rendering the audit committee blind to the underlying financial realities of the enterprise.
R&W and Indemnity	Founders provide extensive legal representations regarding the absolute accuracy of the company's financial statements. A material breach of these representations triggers an indemnity claim requiring the founders to make the investors whole for any resulting losses.	Enforcement strictly requires the founder to possess recoverable personal assets. For instance, Series C investors in MedikaBazaar filed an indemnity claim of INR 278.7 Cr on MedikaBazaar; however, successfully recovering such a massive quantum is a highly protracted, multi-year legal endeavour fraught with execution risks.
Drag-Along / Anti-Dilution / Event of Default	Investors possess the contractual right to compel minority shareholders (including the founders) to sell their shares to a third-party buyer to facilitate a complete exit for the investors, often triggered alongside anti-dilution ratchets during an Event of Default.	Drag-along rights frequently face fierce, multi-jurisdictional litigation. As seen in the Shaadi.com dispute, the founder utilized statutory oppression and mismanagement claims under company law to effectively stall a forced drag-along sale to a direct competitor, tangling the exit in years of procedural litigation.
Put options	In an SHA, a put option is a contractual right (not an obligation) that allows an investor to force another party usually the Promoters or sometimes the Company to buy their shares at a pre-determined price or upon the occurrence of specific events.	While in theory the put option construct is clean, the Indian regulatory landscape adds several layers of friction, specifically for non-resident put option holders. RBI has consistently maintained a policy of not permitting non-residents from getting any guaranteed exit price upon exercise of the put option and has always insisted that the exit price should be benchmarked to the fair value of the shares, at the time of exit.

B. Why the Armour Rusts

The inability of investors to seamlessly execute SHA protections in India stems directly from fundamental conflicts between private contractual agreements and overarching public statutes. When the private law of the contract collides with the public policy of the state, the latter invariably prevails, rendering specific clauses unenforceable.

i. Non-Compete

Non-compete clauses which are designed to survive post the termination of the SHA are void as they amount to agreements in restraint of trade under Section 27 of the Indian Contract Act, 1872. A founder, after their exit from the company, can, in principle, establish a competing venture immediately.

The only exception to the non-enforceability of a non-compete clause is when there is a sale of goodwill of the business. When there is a sale of goodwill, the seller is permitted to agree with the buyer to refrain from carrying on a similar business within specified local limits where the buyer carries on his/its business, provided such limits appear reasonable to the court having regard to the nature of the business.

In an SHA there is, typically, no sale of goodwill. Therefore, the non-compete clauses in it, which are, invariably, worded to survive post-termination, would lack enforceability in Indian Courts.

ii. FEMA 1999 and the Prohibition on Assured Returns

Put options are a foundational staple in international VC documentation, granting foreign investors a guaranteed floor price or an assured minimum rate of return upon an exit event. These options are designed to provide downside protection in highly volatile emerging markets. In India, however, these clauses run directly contrary to the Foreign Exchange Management Act (**FEMA**), 1999, and the associated capital control regulations administered by the Reserve Bank of India (**RBI**).

RBI strictly views contractual arrangements that guarantee a minimum return to non-resident investors as impermissible capital account transactions that violate the fundamental tenets of India's foreign exchange policies. Specifically, regulatory guidelines mandate that optionality clauses must allow the foreign investor to exit only at the prevailing Fair Market Value (**FMV**) determined at the exact time of exercise, without any pre-agreed assured return or guaranteed valuation floor. Despite this unambiguous regulatory stance, foreign investors and their offshore counsel continue to draft assured-return put options into Indian SHAs, resulting in clauses that are fundamentally legally unenforceable when triggered, requiring complex compounding proceedings with the RBI to remit any funds.

iii. Important Tax Implications

<u>Good Leaver/Bad Leaver</u>

The execution of penal clauses such as Good Leaver/Bad Leaver provisions may attract prohibitive tax implications under the Indian Income-tax Act, 2025 (**IT Act 2025**). When a founder's shares are forcefully transferred to other investors (sometimes even to the other founders) at a nominal value (for example, INR 1 per share) due to a Bad Leaver event, the anti-abuse provisions of Section 92(2)(m) of the IT Act 2025 [erstwhile Section 56(2)(x) of the Income Tax Act, 1961] become applicable. This specific section stipulates that if any property (expressly including unquoted equity shares) is received for a consideration that is lower than its calculated Fair Market Value (**FMV**) by an amount exceeding INR 50,000 (~USD 530), the entire difference between such FMV and the actual consideration paid (**Shortfall**) is taxed as "Income from Other Sources" in the hands of the recipient of the property. For the purpose of Section 92(2)(m) of the IT Act 2025 [erstwhile Section 56(2)(x) of the Income Tax Act, 1961], the relevant FMV is determined under Rule 57 of the Income-tax Rules, 2026 [erstwhile Rule 11UA of the Income-tax Rules, 1962). The said Rule provides a formula for FMV of unquoted equity shares by aggregating adjusted asset values (i.e. market valuations for specific asset classes, FMV of shares and securities as per the said Rule, stamp-duty values for immovable property and book value for other assets), less liabilities. Such income shall be taxable at the slab rate/ maximum marginal rates (**MMR**), as the case may be, in the hands of the recipient of the shares.

Simultaneously, the exiting founder is also impacted by Section 79 of the IT Act 2025 [erstwhile Section 50CA of the Income Tax Act, 1961]. Under this provision, if shares are transferred below such FMV, the FMV is statutorily deemed to be the full value of consideration for the seller, potentially triggering capital gains tax based on such FMV as full value of consideration rather than the nominal INR 1 actually received.

This creates a double-taxation trap i.e., first, in the hands of recipient of shares towards "Income from Other Sources" for Shortfall and, second, in the hands of seller of shares towards capital gains tax on FMV; that may complicate the execution of bad leaver clauses. For the purpose of Section 79 of the IT Act 2025 [erstwhile Section 50CA of the Income Tax Act, 1961], the relevant fair market value is determined under Rule 57 of the Income Tax Rules, 2026 [erstwhile Rules 11UA and 11UAA of the Income Tax Rules, 1962].

In case of a good leaver, if the consideration received is at FMV, any profits or gains arising from the transfer of a capital asset are chargeable to tax under the head capital gains as per Section 67 of the IT Act 2025 [erstwhile Section 45 of the Income Tax Act, 1961] in the hands of the existing founder.

Capital Gains shall be taxable as below:

#	Nature of Gain	Security	Rate	Threshold / Condition
1	Long Term	Listed equity shares	12.5%	On gains exceeding INR 1,25,000 per annum
2	Long Term	Other than listed equity shares	12.5%	On total gains; no threshold exemption
3	Short Term	Listed equity shares	20%	On total gains
4	Short Term	Other than listed equity shares	Slab rate / MMR	As applicable to the assessee

GAAR Issues

Severe disparities in successive valuation rounds during forced Drag-Along sales can also invoke the General Anti-Avoidance Rules (**GAAR**) under the IT Act 2025, leading to classification of the transaction as an Impermissible Avoidance Agreement followed by potential recharacterization of the entire exit transaction by tax authorities. An impermissible avoidance arrangement is one that, among other characteristics, results in a tax benefit to the participant and lacks commercial substance.

Indemnity

Indemnity payments received from founders present complex classification issues. Depending on the specific nature of the breach, tax authorities may classify indemnity payouts in the hands of recipient of such indemnity as taxable income.

The foundational distinction under the IT Act 2025 is whether an indemnity receipt constitutes a **capital receipt**, which is generally not chargeable to tax unless it falls within a specific charging provision vis-a-vis a **revenue receipt**, which is taxable as income. Judicial precedents have held that compensation received for loss of a capital asset or sterilisation of a capital right is a capital receipt, while compensation for loss of trading profits or recurring income is a revenue receipt. Further, such taxable income may be taxed at various rates depending upon classification of such indemnity receipt under respective heads of income in the hands of recipient.

Where the indemnified party is a non-resident investor, the applicable tax rate and characterisation is further complicated by:

- The requirement to determine whether the receipt has a source in India under Section 9 of the Act, which could trigger withholding obligations on the Indian payer (i.e. the founder)
- Treaty analysis - most DTAAs do not have a specific article for indemnity receipts, meaning the receipt would need to be identified to an existing treaty article (Other Income, Capital Gains, or Business Profits). Each of such article/ classification carries different treaty protection and tax rates.

Such taxation may significantly reduce the net financial recovery for the aggrieved investors.

iv. Practical challenges during enforcement

Even when contractual rights are perfectly drafted and legally sound, exercising these rights is fraught with challenges. While almost all SHAs today have an arbitration clause, that does not, by itself, ensure an ouster of the intervention of the Courts. In many cases, where an investor seeks to exercise its rights, the risk of a founder approaching a civil court for an interim stay under Section 9 of the Arbitration and Conciliation Act, 1996 or filing a petition alleging oppression and mismanagement under Sections 241-242 of the Companies Act, 2013 is significant. However, interim relief is not available on demand, but on the demonstration of a prima facie case, balance of convenience and irreparable harm to the party requesting relief. Nonetheless, the founder may be able to meet these thresholds as the Courts are generally wary of hostile corporate actions. By establishing a prima facie case of oppression and pointing out that if the action proposed to be taken by the investor is allowed to go through, it will result in irreversible damage, a founder may be able to convince a court to grant an interim stay on the investor's exercise of rights pending the completion of the arbitration.

In the Shaadi.com case, when the investor wanted to exercise its exit rights, the founder filed an oppression and mismanagement petition before the National Company Law Tribunal (**NCLT**). When the investor succeeded in securing an anti-suit injunction from a Singaporean court (as the SHA therein provided for a Singapore-seated arbitration) restraining the founder from continuing with the action in the NCLT, the founder managed to secure an anti-arbitration injunction from the Bombay High Court restraining the enforcement of the Singaporean anti-injunction order mainly on the ground that oppression and management disputes are non-arbitrable under Indian law.

To avoid supervisory oversight of Indian Courts in the arbitration process, investors may insist on arbitration clauses which specify the seat of arbitration to be a place outside India, preferably arbitration in jurisdictions like Singapore or London. While choosing a foreign seat, investors must also ensure a stipulation that Section 9 of the Arbitration and Conciliation Act, 1996 would not apply to this foreign-seated arbitration. However, it must be remembered that a Section 9 application need not always be a weapon in the hands of the founder. It may be a weapon even for the investor, especially when the investor wants to restrain the founder from causing any harm to the subject matter of the dispute pending the closure of the arbitration. Therefore, an ouster of Section 9 in foreign seated arbitrations also has to be considered quite carefully after weighing relevant factors.

With respect to foreign-seated arbitrations, investors must also bear in mind that while such arbitrations, particularly through institutions such as the Singapore International Arbitration Centre (**SIAC**) or the London Court of International Arbitration (**LCIA**) may be efficient and provide access to high quality dispute resolution, the costs involved in such arbitrations are significant.

Having said that, one must not lose sight of the fact that the only good option is not a foreign-seated institutional arbitration. Institutional arbitration is picking up pace in India and institutions such as Mumbai Centre for International Arbitration (**MCIA**) are building a strong reputation for themselves for providing parties with efficient and quality platforms for dispute resolution. Therefore, India seated arbitration through institutions like MCIA may be considered as a viable alternative to foreign seated arbitrations.

Oft-cited challenges in India-seated arbitrations are the supervision of the Indian courts and additional grounds such as 'patent illegality' being available as a weapon for attacking the award. To reduce the involvement of courts, investors may make sure that they invoke the jurisdiction of the courts only when absolutely necessary. Further, the investor must ensure that it performs all actions as per the SHA and applicable law. This would ensure that when the counterparty takes a matter to court or another forum such as the NCLT, it would be easier to convince the court that the investor is not at fault, thereby effectively defending the matter.

With respect to the risk of the award being set aside, this risk may be mitigated by opting for arbitration under the aegis of institutions, which ensure that competent arbitrators are appointed to adjudicate the matter. Usually, these arbitrators will follow principles of natural justice, conduct the proceeding in a manner

that is fair to all parties, appreciate evidence appropriately and pass well-reasoned awards. Thus, the chances of an award being set aside by a court are reduced significantly.

In the foreign award enforcement space, most enforcement applications are filed under Chapter I of Part II of the Arbitration Act (New York Convention Awards). When such applications are filed, they, invariably, see a challenge from the award debtor. Even when there is no challenge from the award debtor, the court is empowered to scrutinize the award on, *inter alia*, the public policy of India. While Indian courts generally take a pro-enforcement approach and refuse enforcement only in select circumstances, there are some barriers that a foreign award holder must cross before enjoying the fruits of his award.

With respect to criminal proceedings, they are slow and uncertain. Further, the commercial objective that is sought to be achieved, which may either be recovery of money or the specific performance of a certain clause in the SHA, cannot be achieved by pursuing these proceedings. Criminal proceedings are designed to punish the wrong-doer, not achieve the strategic commercial objective of the person initiating the proceeding.

v. Due Diligence as the First Line of Defence

The Theranos and FTX frauds are a masterclass in what happens when investors skip due diligence, Holmes' investors lost over $600 million and SBF's investors and customers lost a combined $11 billion, simply because no one independently verified what they were told. Holmes falsely claimed validated technology and military contracts, while SBF falsely assured investors that customer funds were fully segregated, basic audits and third-party verification would have exposed both lies immediately. In each case, investors were drawn in by charismatic founders, high-profile co-investors, and compelling narratives, substituting social proof for financial proof. The lesson is unambiguous: the bigger the claim and the higher the valuation, the more rigorous the independent verification of financials, technology, governance, and related-party transactions must be, because fraud scales exactly as fast as unchecked trust does.

vi. Clawback Clauses: Contractual Creatures with Limited Precedent

India has no standalone statute specifically governing clawback clauses for founders. Clawbacks are entirely creatures of contract, structured primarily through SHAs and Founders' Agreements. The BharatPe–Ashneer Grover case is India's most instructive precedent: upon Grover's exit amid governance lapses, BharatPe invoked its SHA to initiate clawback of his ~1.4% unvested stake through SIAC arbitration, eventually settling in 2024 with Grover severing all shareholding ties, demonstrating that while the mechanism works, enforcement is slow, arbitration-dependent, and rarely clean.

vii. Governance Lapses

A structural gap running through the reported cases like BYJU'S, BharatPe, MedikaBazaar is the absence of any contractual mechanism giving investors direct access to the statutory auditor. In each instance, the auditor's relationship ran upward through the CFO and CEO: the board received what management chose to present. Where fraud is suspected, that is precisely the channel that is compromised. The SHA should therefore provide, that upon a written request by any investor director citing reasonable grounds to suspect financial misconduct, the board shall convene a session with the statutory auditor, without management present. The auditor's findings must then be reported directly to the board, not routed through the senior management or the founders. Section 177 of the Companies Act, 2013 already mandates that the audit committee have the power to discuss matters directly with auditors; what is missing from most SHAs is the investor's *contractual* right to *trigger* that process within a defined window, say, seven business days.

C. The Warning Patterns Identified in Reported Cases

A review of publicly available press reports and regulatory filings across the cases referred to in this briefing reveals certain recurring patterns that preceded the governance breakdowns in question. These are not presented as predictors in any individual case, but as indicators that warrant heightened scrutiny when observed:

i. **Delayed or incomplete audited financial statements**: As reported by Business Standard and Inc42 (2023), BYJU'S filed its FY22 audited accounts approximately 18 months after the financial year end. The statutory auditor, Deloitte, subsequently resigned, citing an inability to complete the audit process. Investor response during the delay period was, according to press reports, limited. A delay in excess of 120 days in producing audited accounts is a material governance concern.

   Limited independent access to auditors: Where management controls or filters the flow of information between the company and its statutory auditor, the independence and reliability of the audit process may be compromised.

ii. **Connected persons in financial control functions**: As alleged in the forensic report produced by Alvarez & Marsal and reported by Inc42 (2022), a family member of BharatPe's co-founder was placed in a senior financial control's role. The appointment of connected persons to roles with financial oversight or approval authority is a recognised governance risk factor.

iii. **Sudden CFO departure or vacancy**: As reported by Inc42 and the CapTable (April 2025), MedikaBazaar's co-founder, who had served as CFO, departed in 2023. According to the same reports, an anonymous whistleblower complaint was filed with the statutory auditors approximately six months later. Unexplained CFO turnover at a growth-stage company warrants prompt inquiry.

iv. **Divergence between management information and auditor findings**: Where monthly management reports indicate improving performance while auditors are unable to sign off on accounts, the explanation may not be a reconciliation lag.

v. **Founder secondary sale requests during a primary fundraise**: A request by a founder to sell existing shares at the same time as the company is seeking fresh capital may, depending on the circumstances, indicate a desire to realise personal liquidity ahead of a material development. Such requests warrant careful examination.

vi. **Absence of adverse reporting to the board**: Boards that consistently receive positive reports without challenge or qualification may not be receiving an accurate picture of the company's position.

D. The One Case Where the Governance Response Appeared to Work: The BharatPe Example

Of the companies referred to in this briefing, BharatPe is the only one reported to have navigated the governance breakdown without a terminal outcome for the business. It is worth examining the reported sequence of events.

According to press reports published by Inc42 and Business Standard between March 2022 and September 2024, the BharatPe board received a whistleblower complaint in early 2022 alleging financial irregularities. The board is reported to have suspended the co-founder's operational access within days of receiving the complaint; commissioned an independent forensic investigation by Alvarez & Marsal; and pursued civil proceedings in the Delhi High Court seeking recovery of an alleged sum of approximately INR 88.67 crore. A civil settlement was subsequently reported in September 2024, under which the co-founder is stated to have forfeited his entire equity stake. An Economic Offences Wing (**EOW**) First Information Report (**FIR**) filed in May 2023 remains a separate, ongoing matter.

The reported outcome, a business that continued to operate and grow appears to have been materially assisted by the speed of the board's response, the preservation of operational control, and the decision to pursue civil remedies in parallel with, rather than after, the forensic process.

A consistent observation across the cases in this briefing is that delay between the identification of a concern and board action correlates with worse outcomes for investors and the company alike.

E. Practical Guidance: A Field Reference

The following observations are drawn from the publicly reported facts across the cases referred to in this briefing. They are intended as a practical reference for investors and board members and reflect the lessons that emerge from the published record. This is not legal advice; specific situations require specific legal counsel.

SUBSYSTEM	✓ DO THIS	✗ NOT THIS
Financial Controls & Personnel	Mandate explicit joint sign-off for the appointment of the CFO. Legally ensure the CFO reports directly to the Audit Committee, completely bypassing the CEO for all statutory audit and compliance matters.	Do not allow related parties, family members, or historically connected entities to hold any positions in financial control, treasury management, or vendor approval functions.
Audit Compliance & Deadlines	Insert an explicit, non-negotiable 120-day deadline for the delivery of audited financials in the SHA. If breached, legally classify it as an Event of Default and issue formal legal notices immediately upon expiry.	Do not accept vague, undocumented management assurances that "the auditors are still reviewing." Persistent audit delays are a primary, glaring indicator of systemic financial irregularity, not a mere administrative backlog.
Forensic Oversight & Auditing	Commission independent forensic reviews every 18–24 months proactively, expressly instructing the forensic firm to trace all inter-company flows and scrutinize related-party vendor arrangements.	Do not rely on mere board attendance as governance. An investor-nominated non-executive director who receives MIS reports the night before a board meeting is fundamentally failing their fiduciary duty.
Qualified Personnel	Appoint an independent director with substantive financial expertise, not simply a senior professional whose primary value is reputational.	Do not treat educational or professional pedigree as a proxy for integrity or governance quality. Several of the cases in this briefing involve founders with distinguished prior career records.
Crisis Response Mechanisms	If serious concerns surface, act within 72 hours: suspend system access, preserve documents and communications, and instruct forensic counsel. Invoke SHA Event of Default provisions to restrict promoter rights.	Avoid criminal proceedings. They are unduly protracted and also do not help in achieving commercial objectives.
Exit Strategy and Enforcement	Prioritize civil remedies, share forfeiture mechanics under the SHA, and structured, negotiated settlements to permanently remove the founder from the capitalization table.	Do not rely on post-termination non-compete clauses (which are void under Section 27) or assured return put options (which are violative of FEMA regulations). They offer only false comfort.

Arbitration	Opt for arbitration through a reputed institution instead of ad-hoc arbitration. Seat may be Indian or foreign depending on various factors such as cost, efficiency, convenience in terms of attending the proceeding etc.	Do not blindly choose a foreign seat without assessing the pros and cons of all relevant factors.
Accountability of the fund managers	Ask limited partners to require fund managers to disclose governance concerns as part of routine fund reporting, not merely financial performance metrics.	Do not defer action pending confirmation beyond reasonable doubt. By the time irregularities become undeniable, a significant portion of capital may already be unrecoverable.

F. Conclusion

India's startup governance challenge is not, at its root, a drafting problem. While the SHAs drafted for growth-stage transactions are highly sophisticated, they are often disconnected from Indian ground realities. The real challenge lies in the practical conditions required for enforcement and the commercial incentives that actually drive parties to exercise those rights.

Fund managers face a structural tension: identifying and acting on a governance problem at a portfolio company requires writing down a carrying value, which affects vintage performance, which affects the next fundraise. This tension does not excuse inaction, but it does explain it.

As reported by Inc42 (May 2025), SIDBI, a limited partner in several of the VC funds involved in the GoMechanic matter is reported to have directly questioned fund managers about their governance practices following the transaction. This represents a relatively unusual instance of LP-level scrutiny focused on conduct rather than returns alone.

Until that scrutiny becomes routine, until limited partners treat governance conduct as a performance metric alongside IRR, the contracts that are meant to protect investors will remain, in too many cases, well-drafted paper tigers.

Contributors & Disclaimer

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