

NAVIGATING THE ALTERNATIVE: LEGAL AND REGULATORY HURDLES OF REVERSE MERGERS FOR INDIAN STARTUPS

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ABSTRACT

In recent years, startups have emerged as key drivers of economic growth, innovation, and employment generation in India. However, accessing public capital markets remains a significant challenge for many emerging companies due to stringent regulatory requirements, lengthy procedures, and high compliance costs associated with traditional Initial Public Offerings (IPOs). In this context, reverse mergers have gained attention as an alternative pathway for startups seeking quicker access to public markets. A reverse merger typically involves a private company acquiring a publicly listed but dormant or shell company, thereby enabling the private entity to become publicly traded without undergoing the conventional IPO process. This mechanism offers several advantages, including reduced time, lower costs, and immediate market presence, making it particularly attractive for rapidly growing startups. Despite its potential benefits, the reverse merger route presents a range of legal and regulatory challenges within the Indian corporate and securities law framework. Regulatory scrutiny by authorities such as the Securities and Exchange Board of India (SEBI), compliance with provisions under the Companies Act, 2013, and concerns related to corporate governance, transparency, and investor protection complicate the process. Additionally, the emerging phenomenon of "reverse flip," wherein Indian startups restructure their corporate domicile through overseas entities before pursuing reverse mergers or foreign listings, introduces further regulatory complexities, including cross-border legal compliance, taxation concerns, and foreign exchange regulations.

This article examines the evolving landscape of reverse mergers as an alternative route to public listing for Indian startups. It explores the attractiveness of reverse mergers, analyses the growing reverse flip trend, and critically evaluates the legal and regulatory hurdles that startups may encounter while pursuing this strategy. Furthermore, the article discusses strategic approaches that startups can adopt to navigate these complexities while ensuring regulatory compliance and corporate accountability. Ultimately, the study highlights the need for a balanced regulatory framework that fosters innovation and capital access while safeguarding market integrity and investor interests.

Keyword: *Reverse Merger, Indian Startups, Reverse Flip, Corporate Regulation*

1. INTRODUCTION

The conventional Initial Public Offering (IPO) has traditionally been the preferred method for high-growth firms to acquire public funding, markedly increase their market visibility, and offer vital liquidity to their early-stage investors. This traditional route has historically been regarded as a marker of firm success and maturity, providing a significant entry into the public financial markets. Nonetheless, the intrinsic attributes of the IPO process—specifically, its laborious, protracted, and costly nature—often serve as significant obstacles. This is especially applicable to nimble Indian startups, which frequently

function with few resources and a compelling drive for swift expansion and market infiltration. The comprehensive regulatory compliance, intricate disclosures, and considerable financial obligations linked to an IPO can markedly deplete a startup's resources and distract from its primary business goals.

In recent years, the reverse merger, widely known as a "backdoor IPO," has gained substantial prominence in the Indian startup environment. This novel concept provides a uniquely different method for a private corporation to convert into a publicly traded organization. The private corporation attains public status by merging with

an existing publicly listed shell company rather than conducting a new public offering. This method circumvents the lengthy procedures and substantial expenses usually linked to a conventional IPO, offering an appealing option for businesses eager to access public markets more rapidly and economically. Although the allure of speed and cost-efficiency is evident, it is essential to acknowledge that reverse mergers for Indian startups present a distinct and intricate set of legal and regulatory hurdles that require meticulous and strategic navigation. These issues require a comprehensive awareness of the complex legal framework and a proactive strategy for compliance.

2. REVERSE MERGERS AS AN ALTERNATIVE ROUTE TO PUBLIC LISTING FOR STARTUPS

The allure of a reverse merger for Indian entrepreneurs is complex. A notable benefit is the expedited time to market. In contrast to a conventional Initial Public Offering (IPO), which may be a laborious and protracted procedure lasting 12 to 18 months or more, a reverse merger provides a significantly expedited route to public trading, potentially concluding within a few months. This swift access to public markets enables businesses to accelerate their growth and expansion strategies without experiencing extended durations of uncertainty.

Moreover, reverse mergers offer a significant possibility for cost reduction. Conventional IPOs are generally linked to significant costs, including underwriting fees, legal and accounting expenses, and major marketing expenditures. By bypassing numerous traditional procedures, reverse mergers can substantially reduce the total financial expenditure, rendering them an especially appealing choice for businesses with limited funds.

A significant advantage is the improved access to public capital. A public offering via a reverse merger facilitates access to a broader spectrum of investors, encompassing substantial institutional funds and individual retail investors. The expanded investor base enhances liquidity for a company's current shareholders and creates a solid foundation for future fundraising efforts. A

public listing not only provides funding but also enhances the startup's legitimacy and visibility. Transitioning to a publicly traded firm can substantially enhance a startup's brand visibility, augment its market credibility, and fortify its capacity to attract premier talent, new clientele, and advantageous strategic alliances.

Ultimately, although regulatory oversight is significant during the process, the preliminary regulatory obligations for a reverse merger are sometimes regarded as less onerous than the comprehensive disclosure and promotional requirements of a traditional IPO. This preliminary simplification can render the trajectory to public markets appear more attainable for nimble firms.

3. THE RISE OF THE "REVERSE FLIP": GLOBAL STRUCTURING TRENDS AMONG INDIAN STARTUPS

It is essential to differentiate the traditional reverse merger from the contemporary "reverse flip" phenomenon noted among Indian entrepreneurs. Historically, some Indian software startups "flipped" their corporate structures by establishing holding corporations in foreign jurisdictions such as Singapore or Delaware to attract global financing, capitalize on claimed regulatory advantages, and access international listing opportunities. Nonetheless, a considerable proportion of these firms are currently engaging in a "reverse flip" by re-domiciling their parent entities to India.

The "Gharwapsi" (homecoming) is propelled by multiple factors: the maturation of Indian capital markets, heightened investor trust in domestically-based enterprises, and, crucially, proactive regulatory reforms. For example, *The Firms (Compromises, Arrangements and Amalgamations) Rules, 2016*¹, were revised in September 2024 to establish an expedited process for inbound mergers, particularly permitting international controlling firms to merge with their wholly-owned Indian subsidiaries.² This efficient approach markedly diminishes the durations usually linked to the National Company Law Tribunal (NCLT) approval pathway, which may

¹ Companies (Compromises, Arrangements and Amalgamations) Rules, 2016, G.S.R. 114(E) (Jan. 29, 2016)

² Website team 05, *India's IPO door opening for fast-track*

"reverse flips," Law.asia (2025), <https://law.asia/india-fast-track-reverse-flip-ipo-mergers/> (last visited Jun 13, 2025).

exceed one year. This modification largely advantages foreign-domiciled firms seeking to return, while indicating a wider policy objective to streamline corporate reorganizations and enhance India's appeal as a listing location.

4. LEGAL AND REGULATORY BARRIERS GOVERNING REVERSE MERGERS IN INDIA

Notwithstanding the evident benefits and the changing regulatory environment, reverse mergers for Indian startups entail a distinct array of legal and regulatory challenges:

1. SEBI Scrutiny and Disclosure Requirements:

A reverse merger circumvents the conventional IPO process, however the Securities and Exchange Board of India (SEBI) enforces rigorous supervision. *The SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR Regulations)*³, along with other pertinent SEBI circulars, are applicable to firms pursuing a public listing, including through a reverse merger. The consolidated entity must adhere to stringent disclosure standards, frequently akin to those mandated for an IPO, to guarantee transparency and safeguard investor interests.

- **Public Shareholding Norms:** The post-merger entity must meet SEBI's minimum public shareholding requirements.
- **Promoter Lock-in:** SEBI mandates lock-in periods for promoter shareholding, typically 20% of the post-merger paid-up capital for three years, with remaining shares locked-in for one year. This can impact liquidity for early investors and founders.
- **Valuation Challenges:** Accurately valuing the private startup and ensuring a fair exchange ratio with the public shell company is critical and subject to intense scrutiny. Independent valuation experts and fairness opinions are often required, and any perceived unfairness can lead to regulatory challenges or shareholder disputes.
- **Due Diligence:** Thorough due diligence of the public shell company is paramount. Startups

must meticulously investigate the shell's past liabilities, litigations, tax history, and compliance track record to avoid inheriting unforeseen burdens. Hidden liabilities or past regulatory non-compliance of the shell company can have severe repercussions for the merged entity and its management.

In *M/s Keynote Corporate Services Ltd. v. SEBI (2014)*⁴, the Securities Appellate Tribunal (SAT) underscored the rigorous due diligence mandated for merchant bankers under the SEBI (Issue of Capital and Disclosure Requirements) requirements, 2009, which preceded the 2018 requirements. The Court emphasized that merchant bankers must provide comprehensive and precise disclosures in offer documents, underscoring the regulatory authority's commitment to transparency and investor protection in public offerings, including reverse mergers affecting public holdings.

2. Companies Act, 2013 Compliance: The *Companies Act, 2013*⁵, governs corporate mergers and amalgamations in India.

- **Sections 230-232**⁶: These sections outline the detailed procedure for schemes of arrangement, including mergers. This process typically involves obtaining approvals from the NCLT, shareholders, and creditors. While the September 2024 amendments to Rule 25A (under the Companies (Compromises, Arrangements and Amalgamations) Rules) streamline inbound mergers for foreign holding companies, other types of reverse mergers involving unlisted Indian startups and listed Indian shell companies may still necessitate the NCLT route, which can be time-consuming.⁷
- **Shareholder and Creditor Approvals:** Obtaining the requisite majority approvals from shareholders and creditors of both the private startup and the public shell company can be a significant hurdle. Minority shareholder protection is a key concern for regulators, and any dissenting voices or

³ Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, No. SEBI/LAD-NRO/GN/2018/31, Gazette of India, (Sept. 11, 2018)

⁴ *Keynote Corporate Services Ltd. vs. The Securities and Exchange Board of India* (19.02.2014 - SEBI / SAT) :

MANU/SB/0012/2014

⁵ The Companies Act, 2013, No. 18 of 2013, (India) (Aug. 29, 2013).

⁶ The Companies Act, 2013, §§ 230–232, No. 18 of 2013, (India) (Aug. 29, 2013).

⁷ Website team 05, *Supra* note 1

perceived unfairness can lead to prolonged legal battles.

- **Section 232(3)(h) and "Unlisted" Status:** The Companies Act, 2013, through Section 232(3)(h)⁸, stipulates that if a listed company merges with an unlisted company, the resulting entity will be treated as unlisted unless it meets the criteria for a public listing. This provision acts as a safeguard, preventing private entities from simply acquiring a public shell to bypass core listing requirements. The merged entity still has to undertake steps to ensure its post-merger listing.

3. Tax Implications: Reverse mergers can trigger complex tax implications for both the merging entities and their shareholders.

- **Capital Gains Tax:** The share exchange involved in a reverse merger can lead to capital gains tax liabilities for shareholders of the private startup. The valuation at which shares are exchanged becomes critical for tax purposes.
- **Carry Forward of Losses:** While Section 72A of the Income Tax Act, 1961⁹, allows for the carry forward and set-off of accumulated losses and unabsorbed depreciation in certain mergers, its applicability in specific reverse merger scenarios requires careful consideration and expert tax planning.
- **Indirect Transfer Provisions:** For startups with offshore holding structures undertaking a "reverse flip," the indirect transfer provisions of the Income Tax Act can lead to significant tax payouts, as seen in some high-profile cases where large amounts were paid to re-domicile.

The *Re: Bihari Mills Ltd. and Ors.*¹⁰ is regarded as one of the earliest examples in India of a situation resembling a "reverse merger" under the Companies Act of 1956, the precursor to the 2013 Act. The Gujarat High Court, while approving the merging of a solvent corporation with an insolvent entity (a reversal of the typical norm),

⁸ The Companies Act, 2013, § 232(3)(h), No. 18 of 2013, (India)

⁹ The Income-tax Act, 1961, § 72A, No. 43 of 1961, (India)

¹⁰ In Re: Bihari Mills Ltd. and Ors. (23.02.1983 - GUJHC) : MANU/GJ/0004/1985

scrupulously assessed the scheme to guarantee its equity and commercial feasibility. This decision established fundamental rules for the judicial examination of merger schemes, particularly regarding valuation and the overarching public interest, which continue to be pertinent in modern reverse merger transactions.

4. Foreign Exchange Management Act (FEMA) Compliance: In reverse mergers with cross-border components (e.g., an Indian company combining with an overseas listed shell, or a "reverse flip" of an overseas-domiciled Indian startup), adherence to FEMA requirements and obtaining clearances from the Reserve Bank of India (RBI) are crucial. The **Foreign Exchange Management (Cross-Border Merger) Regulations, 2018**¹¹, govern such transactions. Any non-compliance can lead to severe penalties.

Although not directly a reverse merger case, the landmark Supreme Court judgment in **Vodafone International Holdings B.V. vs. Union of India**¹² significantly influenced the interpretation of indirect transfers of Indian assets and the taxability of offshore transactions. For Indian startups undertaking "reverse flips" where the parent entity is relocated to India, or for any cross-border reverse merger, this case emphasizes the critical need for meticulous planning to navigate the complexities of international taxation and FEMA regulations, particularly concerning the transfer of shares and underlying Indian assets, to avoid unforeseen tax liabilities.

5. Corporate Governance Challenges: Integrating the corporate governance structures of a typically agile startup with a publicly listed entity can be challenging. The merged entity must adhere to stringent corporate governance norms mandated by SEBI (e.g., independent directors, audit committees, related party transaction policies), which may be a significant adjustment for a startup accustomed to a more flexible operational style. The composition of the board and management, potential conflicts of interest, and the protection of minority public shareholders' rights are critical considerations.

¹¹ Foreign Exchange Management (Cross-Border Merger) Regulations, 2018, No. FEMA 389/2018-RB, (India)

¹² Vodafone International Holdings B.V. vs. Union of India (UOI) and Ors. (20.01.2012 - SC) : MANU/SC/0051/2012

5. STRATEGIC AND REGULATORY PATHWAYS FOR NAVIGATING REVERSE MERGER COMPLEXITIES

Indian businesses contemplating a reverse merger to access public markets must adopt a strategic and painstakingly planned approach. Engaging seasoned legal counsel and tax experts with proficiency in company acquisitions, capital markets, and foreign taxation from the onset is essential. This prompt and thorough legal and tax counsel can assist in navigating the intricacies involved. Moreover, comprehensive due diligence is essential; startups must delve deeper and perform meticulous financial, legal, and operational due diligence on the target public shell business to reveal any concealed risks or obligations.

Ensuring a rigorous valuation is essential, necessitating an impartial and equitable assessment of both firms to avert future conflicts and regulatory examination. Proactive stakeholder management is a crucial element, encompassing involvement with all stakeholders, including current shareholders, employees, and prospective investors, to align expectations and obtain requisite approvals.

A compliance-centric approach is vital; although expedience provides a competitive edge, sacrificing regulatory adherence is unacceptable, since even a solitary error can result in significant penalties, reputational harm, and a thwarted public offering. Finally, formulating a comprehensive strategy for post-merger integration is essential, incorporating the operational, financial reporting, and corporate governance frameworks of both businesses to facilitate a seamless transition into a publicly traded corporation.

6. CONCLUSION:

Reverse mergers present a compelling alternative for Indian businesses seeking to circumvent the conventional IPO process, ensuring expedited access to public funding and improved market visibility. The recent regulatory revisions, especially the expedited merger rules for inbound "reverse flips," highlight a favorable policy shift aimed at facilitating business reorganizations. This expedited road entails extensive legal and regulatory difficulties, including SEBI's severe disclosure requirements, compliance with the Companies Act, complex tax ramifications, and

adherence to FEMA regulations. Indian businesses must adeptly traverse this complex landscape by comprehending the legal framework, engaging in painstaking planning, conducting thorough due diligence, and adopting a proactive, compliance-oriented approach. As India's startup ecosystem matures, the development of regulatory frameworks that effectively support novel routes to public markets will be essential for promoting growth and enabling the emergence of the next generation of Indian unicorns.