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Laws and Regulations on Risk Management for Investors in Startup Enterprises in Vietnam

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Abstract. This article analyzes legal issues related to startups and investors, and examines several relevant case studies. After analyzing the limitations and shortcomings of the current Vietnam's legal framework, the authors propose solutions to further improve the investment legal system of Vietnam for the next period.

1. INTRODUCTION

For startups, raising capital from investors in the initial stages is crucial and necessary. However, after the business has started operating, the issue of dividing profits between investors and founders of startups faces many obstacles and legal issues that can lead to disputes and conflicts such as legal status of the parties, ownership and management rights, disbursement schedule, investment dilution prevention, priority order for divestment, valuation at each point in time, founder commitments, limitations on investor rights, access to information, intellectual property, information security, etc.

2. LITERATURE REVIEW

2.1. Startup Businesses

According to Clause 2, Article 3 of the 2017 Law on Supporting Small and Medium-Sized Enterprises: "*Innovative startup small and medium-sized enterprises are small and medium-sized enterprises established to implement ideas based on exploiting intellectual property, technology, new business models and have the potential for rapid growth*." Thus, a startup business is a newly established, small-scale enterprise that implements new business models and ideas, often to exploit intellectual property and new technological inventions. These are usually promising businesses with the potential to grow rapidly and strongly in a very short time.

According to Bill Aullet in his book "Disciplined Entrepreneurship", startup entrepreneurs are those who create a new business sector that did not exist before. Currently, there are two types of startup businesses in the world:

i. Small and Medium Enterprises (SMEs). This type of business is usually founded by a single person to serve the local market and will become a small and medium-sized enterprise operating within that local area. The business is organized within a small, closely related group, possibly a family business, where tight control is crucial. Basically, this type of business does not require a large amount of capital. Investing in these SMEs quickly yields results in increased revenue and job creation. These SMEs are often service businesses or retailers selling products from other companies. The main distinguishing factor from other types of startups is their focus on local markets.

ii. Innovation-Driven Enterprises (IDEs). These businesses are riskier and more ambitious. IDE entrepreneurs aspire to expand beyond local markets to global or at least regional markets. These entrepreneurs typically work in teams to build businesses based on new technologies, processes, business models, or innovations that give them a significant competitive advantage over existing companies. They are more interested in creating wealth and value than controlling the company and often sell company shares to pursue their ambitious growth plans. These IDE businesses initially grow more slowly than SMEs but will achieve exponential growth once they attract customers (as in the case of Facebook, Google, Apple, or Uber). To achieve their ambitions, these companies must grow and mature rapidly to serve the global market.

2.2. Investors

Investors in innovative start-up small and medium-sized enterprises (SMEs) include startup investment funds, domestic and foreign organizations, and individuals conducting business through contributing capital to establish, purchase shares, or acquire equity in innovative start-up SMEs.

Investment in an innovative start-up of small and medium-sized enterprises (hereinafter referred to as innovative start-up investment) is the act of investors contributing capital to conduct business activities through contributing capital to establish, purchase shares, or acquire capital contributions of innovative start-up small and medium-sized enterprises that are not yet public companies. An innovative start-up investment fund is a fund formed from capital contributions of private investors to carry out innovative start-up investments. The fund's capital contribution is the total value of assets contributed by investors to the innovative start-up investment fund. The company managing the innovative start-up investment fund is a company established under the law

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on enterprises, with a specific business line. (Vietnam's Government, 2018, Article 2 of Decree No.38).

Regarding Innovation Startup Investment Funds, the Decree 38 clarifies that Innovation Startup Investment Funds do not have legal personality and are established by a maximum of 30 investors contributing capital based on the fund's charter. Innovation Startup Investment Funds are not allowed to contribute capital to other innovation startup investment funds. Contributed assets can be in Vietnamese Dong, gold, the value of land use rights, and other assets that can be valued in Vietnamese Dong. Investors are not allowed to use borrowed capital to contribute capital to establish innovation startup investment funds.

In addition to investment funds, individual investors can invest in startup businesses. Globally, these individual investors are often called Angel Investors. Angel investors are understood as individual investors who make initial investments in startup businesses. Alongside venture capital funds, angel investors play a crucial role in the development of startup businesses today.

2.3. The Relationship Between Startups and Investors

Investing in innovative start-up small and medium-sized enterprises (hereinafter referred to as start-up investment) is when investors contribute capital to conduct business activities through contributing capital to establish, purchase shares, or acquire equity in innovative start-up small and medium-sized enterprises that are not yet public companies.

According to Decree 38/2018/ND-CP, investors can conduct investment activities in start-up businesses through the following forms:

i. Contributing capital to establish, purchase shares, or acquire equity in innovative start-up small and medium-sized enterprises;
ii. Establishing or contributing capital to an innovative start-up investment fund to carry out investments.

Currently, it is common for investors to require startups to accept them as contributing shareholders (members), with an initial capital contribution of approximately 10% of the company's charter capital. Depending on the agreement between the startup founder and the investor, this capital contribution percentage and how it changes after the company becomes operational, grows, and raises new investment capital from other investors will vary. Typically, in the capital contribution agreement, investors often request a dilution clause to protect their percentage of ownership in the startup when the startup receives additional capital contributions from new investors as it grows and expands in the future.

3. RESEARCH METHODOLOGY

To do this research, the authors use many kinds of methodologies such as method of analysis international and Vietnamese legal documents (laws and regulations) related to startup and investor; method of survey, and the hypotheses developed in the study shows how to use law and regulation to govern the startup and investment. Moreover, the authors also use the questionnaires for survey to get the opinion of related people and statistic data to assess the role and affection of law on the startup and investor in Vietnam. Lastly, the authors also use some hypotheses developed in the study shows how to use law and regulation to govern the activities of startup and investment.

4. RESEARCH RESULTS AND DISCUSSION

4.1. Some Issues Related to the Relationship Between Startups and Investors

In Vietnam, the case of The KAfe failure and its founder - Dao Chi Anh after raising $5 million from investors is a typical financial lesson for startups when raising capital. This failure stemmed from several reasons. Firstly, the reason is the inappropriate choice of investors. There are investors, known as Sharks, whose only goal is to take over, not to partner with. They come to usurp power and aim for short-term profit from controlling and selling the company, rather than long-term investment. Many financial investors aim for this goal. Therefore, the priority order for choosing investors should be Industry Partners, Industry Investment Funds, or Financial Investment Funds. Currently, in reality, some Vietnamese businesses receive investments worth millions of dollars, but also acquire new products from partners, new technologies, management support, and experts from partners to develop the Vietnamese market. This is the ultimate goal. Meanwhile, the nature of financial investment funds is that they have investment timeframes and pressure to divest from their own shareholders, so the investment period for these funds in startups is much shorter. Secondly, many startups lack experience or are not careful in negotiating investment terms, leading to disputes over ownership and management of the startup business. This is the key point in the failure of The KAfe. Receiving investment money comes with a series of conditions from investors, especially the demand for complete control over finances. Founders, however, are often not skilled in this area. Investors will impose takeover targets, and if the founders fail to meet those targets, they will increase their ownership stake and take over the company. Start-ups often don't develop proactive financial strategies from the outset, so when desperate for money, they blindly accept all investor demands. Furthermore, they often forget to negotiate an incentive package (including salary and bonuses) for the founders. Incentive packages are standard practice in any deal, but investors often intentionally overlook this, and start-ups are unaware of the need to request it. Thirdly, because they are start-up businesses, start-ups often lack or haven't yet established a standardized corporate governance mechanism. A startup may not yet understand what corporate governance is. A flawed corporate governance system can cause conflicts between executives and investors, especially purely financial investors. When conflicts arise, unclear mechanisms exacerbate them. As in the case of The KAfe, founder Dao Chi Anh had to leave the company shortly after receiving funding, leading to its collapse. The fourth reason is that startup founders fail to develop viable business plans after fundraising. Incomplete or unreasonable business plans, or even the absence of a well-structured, detailed, and actionable business and development plan, are serious problems for startups. This is especially true for startups with only one founder. When a founder is the sole owner, they can do whatever they want. But with more than one founder, they need to ensure the interests of all are protected. A detailed and feasible business plan is essential, providing a foundation for all parties to work towards and ensuring mutual benefit, or at least a basis for shared responsibility. Conversely, the absence of sound business plans and corporate governance can easily lead to conflicts between founders and investors. Furthermore, founders need to understand the nature and purpose of the investor's funding to maintain a serious work ethic, continuously learn and improve the product, and develop the company. They shouldn't treat it as non-refundable ODA funding, because if investors feel their interests are being affected, they will take action. Poor governance at this point will lead to a dead end for all parties. Additionally, the inability to execute a business plan is one of the reasons for startup failure. Many founders, after receiving funding, need to have a proper understanding of their business's capabilities and realities to develop effective daily business plans and operations. A company must be designed and operated efficiently. These initial successes will help startups build their brand. Furthermore, poor financial and cash flow management is also a major cause of startup failure. For example, tax issues. Previously, selling food and beverages primarily to individual customers resulted in lower tax declarations. Today, having to declare full revenue has led to a surge in tax expenses. Founders see that they spend everything they earn, without realizing the benefits, only seeing that larger scale means more work and lower efficiency. Cash flow suddenly becomes chaotic, and they don't know how to manage it effectively. Moreover, some founders can't even read financial statements and operational reports. After scaling up and running out of money due to low efficiency, founders then consider raising capital again. At this point, the interests of investors are affected, leading to conflicts. Therefore, startups need a sound financial strategy and effective implementation of that strategy. "*Know yourself and your enemy, and you will win a hundred battles*." Startups must clearly understand the legal status of the assets they are about to acquire, including the extent of ownership, ownership percentages, regulations recorded in shareholder registers or legal documents, licenses, and articles of incorporation. Startups must clearly define and understand their internal regulations. This is the best way to protect themselves before engaging with investors. One of the fastest ways to develop resources is to receive investment capital from organizations and individuals. Founders should be clear from the outset about the terms of cooperation and methods of collaboration. Then, they can resolve issues that arise during the business process or as the company grows in the future.

Currently, many founders collaborate in business without establishing a formal company, especially in the technology sector, only considering forming a legal entity after receiving investment. From a legal perspective, simple agreements in the form of civil agreements between founders can easily lead to disputes later on. Disputes between founders and investors often arise when the project is stable and generating high revenue, because the parties did not control issues from the beginning. To avoid this situation, founding members need to have clear shareholder or member agreements right from the establishment of the business and include them in the company's charter. In addition, tax obligations are based on three principles: accuracy, completeness, and timeliness. Receiving large investments without complying with the declaration, reporting, and tax payment process can expose startups to unnecessary risks, causing damage and leading to penalties from state authorities. Regarding intellectual property rights, unique and distinctive product and service ideas must be registered for intellectual property protection right from the project's inception or immediately after the business is established. Regarding the investment funding process, it needs to be planned and negotiated from the outset, with clear regulations on the rights and obligations of the investor and the startup founders. It's also important to understand your investors to ensure the investment funds are legitimate, avoiding becoming a money laundering hub for illegal financial sources. Vietnamese startup projects are generally smaller in scale compared to those in the region and the world. They usually accept funding mechanisms proposed by investors. In the case of startups run by a group of individuals or individuals (not establishing a business), investment follows the capital contribution and profit-sharing mechanism as stipulated in the 2015 Civil Code of Vietnam. If it follows the business formation mechanism, investors purchase capital contributions or shares according to the 2020 (amended in 2025) Enterprise Law. If the investment capital is from abroad, it follows the 2025 Investment Law. To mitigate risks, the general principle is to hire expert consultants for anything unclear. These experts don't necessarily have to be lawyers. They could be strategic capital advisors or experienced professionals. Advisors, lawyers, and experts are all valuable sources of support, helping startups achieve sustainable growth and establish a fairer playing field with investors.

4.2. Crowdfunding and Capital Risk Control

Crowdfunding is a term that is not unfamiliar to the startup community. Simply definition, crowdfunding is a form of receiving capital from the community, specifically the online community, to realize a new idea or product. To encourage contributions, the project owner gives supporters souvenirs or offers discounts when purchasing the product. The support money (pledge) can essentially be considered as pre-orders for the product before its release. Because it's a pre-order and there's a risk of not receiving the product, the pre-order price is usually 30%–50% lower than the market price.

The first benefit of crowdfunding for businesses is capital. This is why this form of fundraising attracts so many startups, especially those that lack access to diverse funding sources, business experience, or the ability to raise capital from investors or banks. With crowdfunding, the fundraiser only needs to convince the online community to open their wallets. Gradually, the number of supporters increases, and the business receives a surprisingly large amount of money, enough to develop and launch the product they promise.

The second advantage of crowdfunding is market research. Startup product ideas are often products that have never appeared on the market before or have unique features. So how do you know if this product or that feature will be accepted by the market? It would be very costly and wasteful to invest a large sum of money to develop a product without knowing whether the market will accept it or not. With crowdfunding, the results and market reaction are the most accurate basis for assessing the product's potential. Consumers may not answer market surveys accurately, but if they are willing to spend money on a product that hasn't been launched yet, that product must certainly be appealing to a certain extent and guarantee a certain level of success when it is released.

Besides its advantages, crowdfunding also faces obstacles and risks. For example, there is no guarantee that after fundraising, the project owner will launch the product and deliver it to the community as promised. Crowdfunding is still largely spontaneous, and the government has not yet implemented any form of management or control over businesses and projects that raise capital through this method. Perhaps because of this, the USA is currently the most developed country for crowdfunding due to its open-mindedness, high risk tolerance, and the online community's fondness for new products and ideas.

In Vietnam, a company can participate in fundraising on an equal footing with companies worldwide due to the openness of global crowdfunding platforms (such as IndieGoGo, or KickStarter). Novel products, not necessarily limited to technology, but also in the arts, handicrafts, and even agricultural products and food, can access not only domestic crowdfunding but also apply broader fundraising methods to reach consumers worldwide.

4.3. Current Legal Regulations in Vietnam Regarding Investor Capital Contributions to Startup Businesses

In addition to complying with investment and business laws, startup businesses will enjoy more favorable conditions and support from the state and society as stipulated in the 2017 Law on Supporting Small and Medium-Sized Enterprises and its implementing guidelines. Vietnam Government's Decree No. 38/2018/ND-CP, guiding the implementation of the 2017 Law on Supporting Small and Medium-Sized Enterprises, has concretized the investment and support model for current startup businesses, initially forming and perfecting the legal framework for the operating model of startup businesses as well as the relationship between startup founders and investors, limiting risks for investors and protecting their rights and interests. According to the founders of the Startup, the Innovation Startup Investment Fund is formed from capital contributions from private investors to invest in innovative small and medium-sized enterprises (SMEs) according to the following principles:

i. Investment in innovative SMEs shall not exceed 50% of the enterprise's charter capital after receiving the investment;
ii. Private investors contributing capital to the fund must meet financial requirements and be responsible for their capital contributions.

Investors in innovative SMEs are exempt from or entitled to a reduction in corporate income tax for a limited period on income from their investment in innovative SMEs, as stipulated by the law on corporate income tax.

Based on local budget conditions, the Provincial People's Committee shall submit to the Provincial People's Council for decision the assignment of local state-owned financial institutions to invest in innovative start-up small and medium-sized enterprises according to the following principles:

i. Selecting qualified start-up investment funds to co-invest in innovative start-up small and medium-sized enterprises;
ii. The investment capital from the local budget shall not exceed 30% of the total investment capital that the innovative start-up enterprise raises from the selected start-up investment funds;
iii. Transferring investment capital to private investors within 05 years from the time of capital contribution. The transfer of investment capital shall be carried out in accordance with the law on the management and use of state capital invested in production and business at enterprises.

Decree No.38/2018/ND-CP provides quite detailed guidance on the operation and activities of these funds. The investment portfolio and activities of the innovative startup investment fund include: (i) Depositing funds in commercial banks as prescribed by law; (ii) investing no more than 50% of the charter capital of innovative startup small and medium-sized enterprises after receiving investment.

All capital contributions and assets of investors in the fund must be accounted for independently from the fund management company; investors contributing capital to establish the fund shall mutually agree on the authority to decide on the investment portfolio, and this must be stipulated in the fund's charter and the contract with the fund management company (if any).

The innovative startup investment fund is organized and managed according to one of the following models:

i. General meeting of investors and the fund management company;
ii. General meeting of investors, the Fund Representative Board or the Fund Director, and the fund management company;
iii. General meeting of investors, the Fund Representative Board and the Fund Director, and the fund management company.

Investors in the fund may establish or hire a company to manage the innovative startup investment fund. The fund management company is responsible for carrying out the fund establishment procedures and notifying the relevant authorities of the law on business registration regarding the addition of the innovative startup investment fund management business to the fund management activities.

The management of innovative startup investment funds as stipulated in this Decree shall be conducted according to the fund's charter, the contracts signed with the fund (if any), and shall not be governed by securities law.

The transfer of shares by founding shareholders in the company managing the innovative startup investment fund shall be carried out in accordance with the provisions of the 2020 Enterprise Law.

Increases and decreases in capital contributions of the innovative startup investment fund shall comply with the following regulations: the fund's charter must stipulate the increase and decrease of capital contributions; and the increase or decrease of capital contributions must be approved by the General Meeting of Fund Investors.

The liquidation and dissolution of a fund shall be carried out in the following cases: the expiration of the operating period specified in the fund's charter; the General Meeting of Investors decides to dissolve the fund before the expiration of the operating period specified in the fund's charter; the company managing the fund is dissolved, goes bankrupt, or has its business registration certificate revoked, and the fund's representative board fails to establish a replacement fund management company within two months from the date of the event.

The mechanism for using local budgets to invest in innovative start-up small and medium-sized enterprises is regulated as follows:

i. Based on the local budget conditions, the Provincial People's Committee shall submit to the Provincial People's Council a proposal to assign a local state-owned financial institution with the function of financial investment to invest in innovative start-up small and medium-sized enterprises.
ii. In the case of a local state-owned financial institution operating under the model of an off-budget state financial fund, the assignment of tasks and provision of charter capital to the off-budget state financial fund must comply with the provisions of Clause 11, Article 8 of the State Budget Law.
iii. In the case of a local state-owned financial institution operating under the model of an enterprise, the addition of charter capital must comply with the provisions of Articles 4, 13, 14, and 15 of the Law on Management and Use of State Capital Invested in Production and Business at Enterprises.

Principles of investment in innovative startups by local state-owned financial institutions. In accordance with Clause 4, Article 18 of the 2017 Law on Supporting Small and Medium-Sized Enterprises, local state-owned financial institutions shall exercise the rights and responsibilities of the owner's representative when investing in innovative start-up small and medium-sized enterprises.

Information on innovative start-up investment activities using local budgets must be publicly available on the electronic portal of the People's Committee of the province where the investment is made. Local state-owned financial institutions shall select a co-investment fund for innovative start-up investments that meets at least the following conditions: Commitment to co-invest in innovative start-up small and medium-sized enterprises with the local state-owned financial institution; at least one year of experience in innovative start-up investment activities; ability to self-finance investment costs; and other conditions (if any). Annually, the local state financial institution evaluates, adjusts, and publishes the list of selected innovative startup investment funds on the electronic portal of the local state financial institution and the Provincial People's Committee.

4.4. Recommendations

For startup founders, before deciding to accept investment capital from investors, a thorough investor assessment should be conducted. Investors need to be thoroughly vetted regarding their financial capacity, reputation, etc., including conducting civil investigations into the investor and their representatives, and clearly stating the investor's commitments in writing. When signing an investment cooperation agreement, clear and detailed clauses outlining the investment cooperation should be included during negotiations. The investment agreement should clearly define the limitations on ownership and management rights of the investor and founders of the startup. This should include provisions for ownership and management after receiving funding for each development stage, and the establishment of intellectual property rights for intellectual property assets created during the early stages of the startup. These agreements should be signed in writing before receiving funding and clearly state the rights to these assets after receiving funding. Startups also need to be cautious in disclosing information. Publicly disclosing information to the media is crucial to avoid problems related to taxes, competitors, creditors, etc. The investment cooperation agreement should clearly define all costs, specifying the amount of capital received – whether it's capital for the founders or capital for business operations; and specifying which party is responsible for expenses such as taxes, brokerage fees, and legal fees, or whether these are deducted from the investment capital. Both parties need to be aware of regulations regarding corporate finance, account transfers, tax payments, and investor capital – ensuring compliance with legal requirements.

Furthermore, the parties should have provisions for investor divestment from the startup. This includes agreements on divestment during the negotiation phase and provisions for unilateral contract termination. Clear regulations outlining each party's obligations in case of divestment risks are necessary.

To avoid risks or disputes, the parties need to reach a unified agreement from the negotiation stage until conflicts arise or divestment occurs, including the termination of investment and cooperation, while still protecting each other's reputation.

During the investment cooperation process between investors and startups, legal documents and procedures need to be standardized. The stages before, during, and after receiving investment capital must be clear and standardized in legal documents, including legal documents with relevant authorities and internal company records.

5. CONCLUSION

Startup business is a new trend of the times worldwide, suitable for many groups, especially young people. Because it is a startup business, it always needs capital from investors. Therefore, building a legal framework to regulate the relationship between investors and startup businesses is extremely necessary in the current period. In general, the Vietnamese legal system on investment and business is quite complete, only needing additional specific regulations to provide more detailed guidance for investors when investing capital in startup businesses.

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