ESOPs: favorite tool of Start-ups!

Introduction

Employee Stock Options or ESOPs have, over the years, become a key component of benefits given by India Inc., especially amongst the start-ups. Simply put, they are the options given by a company to its employees to own a certain number of shares in the company at a pre-determined price, but at a later date. The attractive feature is that with ESOPs one gets an option to own company's shares at a discounted price. Say, price of ABC's shares is INR 10 today. It grants an option to X to purchase its share at INR 10 after 1 year. When the price of ABC's shares increase up to INR 100, X will have the right to exercise the option and purchase shares worth INR 100 at INR 10! While this became a lucrative package for X, ABC, which did not have enough funds to pay X's salary, gets successful in luring him to stay back till he becomes eligible to exercise the option.

Traditionally, ESOPs were given to reward a well performing employee and inculcate a sense of ownership towards the company. The concept of the sense of ownership still remains though these days, ESOPs are popular with start-ups as well, largely for two reasons **(a)** start-ups cannot afford to lure their employees with massive pay packages like big corporations; **(b)** once recruited, start-ups want to retain employees for a long time. So, while on one hand, ESOPs act as incentives for employees, on the other hand they double up as anti-attrition tool for the companies.

This newsletter discusses the provisions of Companies Act, 2013 ("**Act**") on ESOPs and procedure of their issue by unlisted companies, including start-ups, and also reflects on the practical problems companies face with respect to their issue.

1. Issue of ESOPs: The Legal framework

The code governing ESOPs is contained in sections 2(37) and 62(1) (b) of the Act and rule 12 of the Companies (Share Capital and Debentures) Rules, 2014 ("**Rules**"). The former defines ESOPs and the latter provides that ESOPs is one of the methods that a company may adopt to increase its subscribed capital. The Rules provide the eligibility conditions, restrictions and procedure for granting ESOPs.

Concept and eligibility norms

Section 2(37) of the Act defines ESOPs as options given by a company to its permanent employees, directors and officers or to the permanent employees, directors and officers of its parent or subsidiary whether in India or outside India, to purchase its shares[1] in future at a pre-determined nominal price. Directors will include managing director, executive director or any whole time director.[2] However, the Rules restrict issue of ESOPs to independent directors,

[1] The law is silent on the class of shares that a company may offer as ESOPs. It is not clear if companies have to necessarily offer equity or preference shares and whether company can exempt the ESOP holders from voting rights. Usually, companies offer equity shares via ESOPs.

[2] See per R. 12(1) of the Rules

promoter directors and directors who hold more than 10 percent shares in the company, either directly or indirectly through relatives, part time employees who are not permanent, promoters and promoters who are employees. The law is silent on eligibility of an employee who is neither a promoter nor a director, but who holds more than 10 per cent of the outstanding equity shares of the company. Hence, the company should address this aspect in the scheme.

Grant procedure

A company which intends to grant ESOPs must draft an ESOP scheme in sync with the provisions of the Act and the Rules. The terms at which an ESOP is granted to an employee, officer or director, must be consistent with the ESOP scheme.

As a first step, the Rules prescribe that the company has to lay down a detailed policy governing ESOPs. The scheme must define and describe the purpose of issuing ESOPs, eligibility criteria, process determined for deciding the eligibility, vesting period, conditions relating to vesting and exercise of the options including the pricing formula and the exercise price, size of company's ESOP pool, tax liability, dispute resolution mechanism etc.[3] Then, the scheme has to be tabled in a board meeting for approval. Once approved, company has to convene a shareholders' meeting to seek their approval for the scheme by way of a special resolution. Notice calling such shareholders' meeting must be accompanied by a statement disclosing the contents of the proposed scheme especially the total number of options to be granted, eligibility criteria, vesting period, formula for determining exercise price of an option, maximum number of options to be granted to an employee, conditions for lapse of option, lock-in period of the shares granted through ESOPs, rights on such shares etc.[4] Once the scheme is approved by special resolution, the company can announce the approved scheme. As a matter of practice, companies usually give a "letter of grant" wherein they acknowledge grant of options and the terms governing the same, along with an "ESOP Exercise Form" in which the ESOP holder is expected to submit the application to convert options into shares once they vest.

From a corporate compliance standpoint, the company must file a copy of the special resolution before the RoC in e-form MGT-14 within thirty days of passing such resolution. In addition, it has to maintain an ESOP register, record details relating options granted, options vested, option exercised, options lapsed etc in its annual directors' report. When an employee exercises its option and shares are allotted, the company has to file a return of allotment with the RoC within thirty days of making an allotment. If ESOPs are issued to non-residents, it is important to ensure that the sectoral caps prescribed under the current foreign direct investment policy are adhered with. Further, RBI reporting with respect to issue of shares to non-residents must also be done within thirty days of the exercise of option.

Key Rules

R. 12(5) of the Rules allows a company to amend its ESOP scheme at any time by passing a special resolution approving such amendment. However, the amendment must not be prejudicial to the existing ESOP holders. So, if the exercise price of an option in INR 1, the

[3] This is covered in R.12 (9) of the Rules
[4] As per R.12(2) of the Rules

company can't modify its policy to make the price INR 2 or say, retain the price as is but decrease the exercise period or increase the vesting period.

Further, both the company and the ESOP holder have to comply with certain conditions before the holder can exercise his option[5] and subscribe company's shares. For instance, R.6 (a) states that there has to be a minimum period of 1 year between grant and vesting of ESOPs. This is to say that if an employee is granted an ESOP on day 1 then the employee shall be eligible to exercise the option only after 1 year from that day 1. Company may link vesting of options with other pre-conditions too such as completion of minimum number of years of continued service after receiving the options, satisfaction of certain performance goals etc. Once all the conditions are satisfied, ESOPs vested in the holder.

A vested option gives the option holder an unfettered right to exercise the options[6] at the price determined at the time of grant of options. However, as per R.8(d) of the Rules, if an employee or officer is terminated or he (or the director) resigns, then the options which are yet to be vested shall lapse.

ESOPs are non-transferable and holders cannot transfer their right in any manner to exercise options unless exercised and subscribed to the shares contained therein. So, ESOPs *per se* can't be gifted, pledged, mortgaged etc. R.6 (b) allows companies to impose a lock-in on the shares issued pursuant to the exercise of the options. Once options are converted, then subject to lock-in conditions of the scheme, an ESOP holder can transfer his shares. Further, as holders they do not have any right to avail any benefits as shareholder(s) which arise only when they have exercised the options and names are recorded as shareholders in the register of members of the company. At that point, holders become shareholders and can vote in shareholder meetings, and receive dividends.[7]

If an ESOP holder dies before the options have vested, they vest in his legal heirs or nominees. The law is considerate in case a holder suffers permanent incapacity during the course of his employment. R.8(e) of the Rules states that in such a case, the vesting period gets preponed and the ESOPs vest on the date of incapacity; regardless whether the person continues with the employment or not.

2. The Flip Side

Granting ESOPs has historically been a mutually beneficial tool for a company as well as the ESOP holder. However, in an increasingly evolving business landscape governed by e-commerce and an even more mobile workforce, options by themselves cannot be the reason for people to stay back. Furthermore, it is not necessary that every start-up will have a success story to tell or will necessarily create another Flipkart. Where a start-up does not take off as anticipated and projected, the ESOP holders may not find the options attractive anymore and

[5] This price is referred to as "exercise price" under the Rules. Companies are free to fix any price for the shares to be allotted through options provide it is not higher than their fair value. Many a times, with a view to lure the employees, the companies fix a nominal exercise price for the shares

[6] Exercise of an option is the process by which a vested option is converted into shares by payment of the exercise price

[7] As per R.6© of the Rules

could exit from the company. Thus, the objective of retaining talent, as intended, does not really get fulfilled.

At the same time, companies will do well to remember that the human resource "risk" will always remain and even after the employee exercises its options theoretically such person could always leave the organization after becoming a shareholder. Hence, the ability to consider ESOPs as a long-term tool for retaining talent may no longer be rooted in today's reality.

Conclusion

ESOP is a great way to retain best of the human resources in a company on an almost non-cash compensation. However, it is not a foolproof way and, as stated, has a flip side. Companies need to be very careful when they grant ESOPs. Care must be taken to ensure that all the options do not get vested in one go as that may encourage an employee to exercise all the options and resign. Further, to avoid fiscal burden, it is necessary to ensure that the exercise period of all the holders does not clash. There should not be a situation where the subscriber base of the company increases at its cost. It is always advisable to burden the shares locked in ESOPs with an obligation of right of first offer to the company in case of transfer. A close knit company should not be in a situation where an unrelated person or a competitor gets rights of an equity shareholder. The objective should be to give an option which is just good enough to ensure good performance and more importantly, inculcate a sense of ownership for mutual long-term benefit!

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