DECODING TRENDS WITH TRIUMVIR LAW

Decoding ESOPs in Indian Private Companies

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I. Introduction

Private limited companies extend a variety of benefits to their employees, ranging from insurance coverage and housing allowances to bonus payments. Among these perks, a notable benefit is the provision of Employee Stock Option Plans ("**ESOPs**"). Through ESOPs, companies grant options to employees, allowing them to convert these options into equity shares in the company upon meeting specific criteria outlined in the relevant regulations governing ESOPs in India. After receiving options, employees hold the opportunity to become shareholders in the company. While this right is exercisable at the discretion of the employee, there is no obligation on the employees to compulsorily exercise their options.

II. Applicable Laws

The laws governing the issuance of ESOPs by private limited companies in India ("**Company**", or "**Companies**") are detailed in the Companies Act, 2013 ("**Act**") and Companies (Share Capital and Debenture) Rules, 2014 ("**Rules**"). In order to issue ESOPs, a company is required to formulate and adopt an Employee Stock Option Scheme ("**ESOP Scheme**") upon passing relevant resolutions and obtaining the necessary approvals from the existing shareholders of the company.

III. Relevant clauses under the Act and Rules

A. <u>Formulating an ESOP Scheme</u>

The "*employee stock option plan*", alternatively called the ESOP Scheme is defined as *'the option given to directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price'*, as per Section 2(37) of the Act[1]. While the definition seems exhaustive, there are a) specific restrictions on the eligibility of class of employees, and b) compliances to be undertaken by a Company, under the Act and Rules.

Section 62 of the Act details the different classes of persons to whom a Company can issue additional shares in order to increase the subscribed capital of the company. Further issuance of shares can be offered to: a) existing equity shareholders; b) employees under the employees' stock option plan; and b) other specified persons, upon receiving authorization by passing a special resolution. This provision in the Act allows and enables the issuance of shares in a Company to its employees, by way of complying with the terms and conditions set out in detail in the ESOP Scheme.

[1] According to Section 2(37) of the Act, the employee stock option plan is defined as the option given to directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.

B. Eligibility of Employees

To understand the scope of "*employees*" eligible to receive options under an ESOP Scheme, the ambit of employees extends to: a) permanent employees[2]; b) directors[3]; and c) permanent employee or directors[4] of a subsidiary company. However, in companies other than a startup company, the promoters[5] and directors holding more than 10 (Ten) percent of the equity shares in the Company[6], shall not be eligible to receive ESOPs. This restriction is temporarily lifted for start-up companies during their initial ten years of operation[7], from the date of incorporation.[8]

C. Compliance requirements for adoption of ESOP

Rule 12 of the Rules outlines a detailed set of regulatory requirements that a Company must fulfill prior to issuance of ESOPs. The key compliance mandates required to be complied are set out below:

(i). **Notice for passing of special resolution:** The notice for passing special resolution to authorize the issuance of options should contain specific disclosures in the explanatory statement[9].

(ii). **Passing of special resolution:** A special resolution has to be passed by the shareholders of the Company to authorize the issuance of options under the ESOP Scheme.[10]

(iii). **Passing of separate resolutions for special circumstances:** Shareholders' meeting to pass a separate resolution[11] is required to be obtained in the event the options are granted to a) Employees of the subsidiary or holding company; or b) Specified employees (where grant is equal to or exceeding 1% (One Percent) of the issued capital of the company.

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[2] Explanation to Rule 12(1)(b) – Permanent employees would include both, employees working in India and outside India.

[3] Explanation to Rule 12(1)(b) – whole time directors are eligible to receive options, whereas, independent directors are restricted from receiving ESOPs in a Company.

[4] Subject to other restrictions placed on independent directors

[5] Explanation to Section 62 and Rule 12(1)(b) of the Rules.

[6] Explanation to Section 62 and Rule 12(1)(b) of the Rules – this includes directors holding more than ten percent either through self, relative or body corporate, directly or indirectly.

[7] According to the earlier position, this was limited to 5 (Five) years from the date of incorporation of the start-up company. However, the extended time frame was included by way of The Companies (Share Capital and Debentures) Amendment Rules, 2019 – refer to Microsoft Word - 4214gi (mca.gov.in)

[8] Proviso to Rule 12(1)(b) of the Rules.

[9] As per Rule 12(2) of the Rules – Disclosures should include the total number of options, class of employees entitled to participate in the ESOP Scheme, vesting requirements, exercise price, exercise period, lock-in period and other details.

[10] Rule 12(1) of the Rules

[11] Rule 12(4) of the Rules

D. Key considerations in an ESOP Scheme:

(i). **Pricing:** Companies offering options to employees under an ESOP Scheme generally have the flexibility to set the exercise price according to their relevant accounting policies.[12]

(ii). **Minimum vesting period:** A minimum of 1 (One) year is required be completed between the date of vesting of options and the date of grant to the employees.[13]

(iii). **Lock-in period:** A lock-in restriction[14] can be imposed on the shares received by the employees.[15]

(iv). **Amendment to the ESOP Scheme:** The terms of an ESOP Scheme can be altered by way of passing a special resolution.[16] Such revisions to the ESOP Scheme is required to be effected prior to exercise of the options by the option holders and such revisions should not be prejudicial to the interests of the option holders.[17]

(v). **Maintenance of register for ESOPs:** Companies issuing options to its employees are required maintain a register of employee stock options in the Form No.SH.6[18], at the registered office of the company[19] or at any other place identified by the board.[20]

(vi). **Transferability of ESOPs:** ESOPs are non-transferable,[21] and cannot be pledged, hypothecated, mortgaged, encumbered or alienated in any manner.[22][23] However, in the event of exigencies, different treatment is observed.

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12 Rule 12(3) of the Rules

13 Rule 12(6)(a) of the Rules

14 Rule 12(6)(b) of the Rules

15 As per Proviso to Rule 12(6)(a) of the Rules - In the case of a merger or restructuring process, the options granted to the employees of the entity (prior to merger) are typically treated by adjusting the options against the minimum vesting period required for the new options granted by the newly formed entity (merged or amalgamated entity).

16 As per Rule 12(5)(b) of the Rules - While circulating the notice for the special resolution, in this case, shall include relevant disclosures regarding: a) nature of the revisions in the ESOP Scheme; b) rationale for necessitating the revisions and c) details of employees benefitting from the revisions to the ESOP Scheme. The disclosure of such details are important in evaluating the fair and equal treatment of option holding employees in the Company, and also ensures transparency of conduct by the Company.

17 Rule 12(5)(a) of the Rules

18 Rule 12(10) of the Rules – *refer to the format of Form No. SH.6 from* NCARules_Chapter4.pdf (mca.gov.in).

19 Rule 12(10)(b) of the Rules

20 As per Rule 12(10)(c) of the Rules - all the entries included in the register are required to be made and authenticated by the company secretary or any other person authorized by the board.

21 Rule 12(8)(a) of the Rules

22 Rule 12(8)(b) of the Rules

23 As per Rule 12(8)(c) of the Rules - only the employees to whom the option is granted shall be eligible to exercise the ESOP.

a) Death of an employee - options granted to the deceased employee shall vest in the legal heirs or nominees of the deceased employee.[24]

b) Permanent incapacity during employment[25]– options granted to the incapacitated employee shall become vested on the day of such incapacitation[26].

c) Resignation/Termination of employment[27]- in the case of resignation or termination of an employee, all unvested options as on the date of resignation or termination shall expire on the same day. However, the vested options can be exercisable by the employees within a certain time period as specified in the ESOP Scheme.

E. Rights of ESOP holders

Typically, the employees holding certain options in a Company can only avail the rights and benefits accrued to shareholders' in the company upon exercising the options and following the issuance of shares in the company. Such converting employees would be required to execute a deed of adherence to the previously executed shareholders' agreement, executed amongst the shareholders of the company. The flow of rights from the shareholders' agreement would award them the right to receive dividends and obtain voting rights – these rights are not extended at the stage where employees are mere option holders in the company.[28]

IV. MECHANISM OF ESOPS

The Company executes a grant letter[29] with each of the employees holding ESOPs in the Company. Upon receiving ESOPs, the options typically undergoes a period of vesting[30]. On completion of the vesting period, the employees can exercise these options to receive shares in the Company. The vested options can be exercised[31] by the employees within the exercise period[32]. On completion of

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[24] Rule 12(8)(d) of the Rules

[25] Rule 12(8)(e) of the Rules

[26] Unlike the requirement to complete the vesting period to exercise the options, the incapacitated employees are eligible to gain access to the full rights to the options without being disadvantaged by their inability to continue working.

[27] Rule 12(8)(f) of the Rules

[28] Rule 12(6)(c) of the Rules

[29] The grant letter is a legal document outlining the rights, obligations, details of the vesting period, vesting schedule, treatment of options among other relevant clauses affecting the employees and the Company.

[30] The vesting period refers to the completion of a specified time period as provided in the ESOP Scheme, while being compliant with the minimum requirements under the Act and Rules. Further, the criteria for vesting may include continued employment for certain number of years in the Company or performance goals or other specific yardsticks. The satisfaction of these criteria conclude a successful completion of the vesting period by the employee. In addition, the terms of the vesting, including the vesting period and vesting schedule explaining the number of ESOPs to vest in an annual basis would be specified in the ESOP Scheme of the Company.

[31] The exercise of an option refers to the process through which a vested option is converted into shares by the payment of an exercise price.

[32] Exercise period refers to the prescribed time frame within which the employee can exercise the ESOP in order to be allotted shares in the Company. Further, as per Rule 12(7) of the Rules, the amount required to be paid by the employee at the time of option grant can be forfeited by the Company if the employee does not exercise the option

the specified pre-requisites, the employees shall be eligible for allotment of equity shares in the Company. Depending on the class of shares being allotted to ESOP holders, these equity shares would rank pari passu with other shares in the same class.

V. PHANTOM STOCKS OPTION PLANS (PSOP) AND MANAGEMENT STOCK OPTION PLANS (MSOP)

A recent trend in issuance of alternative stock option plans is developing in India, by the issuance of MSOPs and PSOPs. Phantom stock in India refers to a form of employee compensation that does not involve actual equity ownership but rather provides employees with a cash bonus tied to the company's performance. In PSOPs, units issued to employees are tied to the company's stock price and upon vesting, employees receive a cash payout equivalent to the appreciation in the company's stock price during the vesting period. Similarly, a line of stock option plans for persons in the management of the company is offered by MSOPs. Similar to PSOP for employees, MSOP is a form of equity compensation used by companies to incentivize and retain management-level employees.

VI. CONCLUSION

The implementation of an ESOP Scheme is recognized as a strategic mechanism that offers advantages to both employees and companies. ESOPs aim to instill a sense of ownership among employees, fostering a personal stake in the company's prosperity. While the emergence of PSOPs and MSOPs have heightened the focus on talent retention within companies, the legal framework surrounding these instruments remains in a phase of ongoing development.

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within the specified exercise period. Conversely, if the option does not vest due to non-fulfilment of conditions related to vesting of options as per the ESOP Scheme, the amount can be refunded to the employee.