

PE/VC - PROMOTER DIRECTORS AND CONSULTANTS – ISSUANCE OF ESOPS

Employee Stock Options (popularly known as ‘**ESOPs**’) are considered as a major source of incentive and monetary compensation not only for employees but also for the directors and founders, for a start up company or a private or a listed company. ESOP structuring can be done by setting up a trust or simply with adoption of ESOP Scheme. Prior to enactment of the Companies Act, 2013 (‘**Act**’), there was no legislation regulating issuance of ESOPs by private companies. Pursuant to the enactment of the Act and the subsequent rules and regulations promulgated therein, there has been a significant increase in the regulatory and compliance requirements for the private companies – one such being governing the issuance of ESOPs. Section 62(b) of the Act read with Rule 12 of the Companies (Share Capital and Debentures) Regulations, 2014 (‘**Regulations**’) sets out in detail the terms and conditions such as eligibility criteria, disclosures, procedure etc. for issuance of ESOPs by a private company.

Some of the key issues pertaining to issuance of ESOPs for private companies are:

- Eligibility Criteria for ESOPs

The Regulations stipulate that only those individuals identified as ‘Employee’ under the definition of ‘Employee’ will be entitled to ESOPs. On the reading of the definition of ‘Employee’ it is clear that a (i) permanent employee of company; (ii) director of the company; and (iii) employee of a subsidiary, associate company and holding company fall within the ambit of definition of ‘Employee’. Further, the definition of ‘Employee’ clearly excludes (a) director (directly or indirectly holding more than 10% of equity shares); and (b) an employee who is a ‘promoter’ and (c) Consultants.

In light of the definition of ‘Employee’ wherein the promoters cannot be issued ESOPs gives rise to the question as to how should the promoters be compensated? As for a start up company the only source of incentive or big money (as its’ called) are the ESOPs, which if cannot be issued to the promoters may pose an issue in terms of compensating the promoters. There are various ways in which the promoter compensation can be structured. However, the structuring of the same would depend upon the commercial objective of the company that have been agreed upon with the investors. Few ways to structure could be (including taking into account a combination of) sweat equity, convertible preference shares, equity shares with lock-in provisions etc.

- ESOP Scheme Mandatory

The Act and the Regulations make it mandatory for every private company to adopt an ESOP scheme for issuance of ESOPs unlike the case prior to enactment wherein there ESOP scheme was not a mandatory requirement. Due to the mandatory requirement to adopt ESOP scheme, there could be an issue wherein ESOP structures are adopted without having an ESOP scheme in place. Such companies without ESOP scheme, would have to regularise their ESOP structures not only by adopting the ESOP scheme. Prima facie, the easiest and the cleanest way forward to regularise the ESOPs would be to adopt the ESOP scheme and issue new ESOPs with a minimum vesting period of 1 year. However, specific ESOP structures will have to be chalked out for each company based on their commercial requirements.

Whilst adopting an ESOP scheme a Company will have to take into account various compliances and conditions that are required to fulfilled under the Regulations. The Regulations require that various disclosures inter alia exercise price, lock-in period, vesting period, method to value its options etc. should be disclosed in the Explanatory Statement annexed to the notice circulated prior to the

shareholders meeting called for approval of the ESOP scheme. Further, the Regulations stipulate a minimum period of 1 year between grant of options and vesting.

- Status of ESOPs that have been promised to the Promoters/Consultants under ESOP Scheme but have not been issued to them

Another issue faced by the start up companies with ESOP plan already in place prior to enactment of Regulations, is whether company can issue ESOPs to promoters/consultants under the ESOP Scheme pursuant to the enactment of the Act and Regulations. It may be contended that prima facie issuance of ESOPs (eventhough permitted under old ESOP scheme) to promoters/consultants should not be issued pursuant to the Act or Regulations. However, one will have to look into legal, tax and commercial objective and deal with this issue on case to case basis.

ARA View

The ESOP Regulations for private companies are a welcome change. The ESOP Regulations are comprehensive and endeavours have been made to bring them in-line with the ESOP regulations for listed companies. However, for a start ups/small companies, the Government should re-examine whether promoters should be excluded from issuance of ESOPs, since it is a major form of incentivising them. Also compliances and disclosures as prescribed under the Regulations look good in theory, however, from a practical point of view, they pose a challenge and are onerous for a start up company.

***Disclaimer:** The information contained herein is of general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.*