

2021/4/25

## Employee Stock Ownership Plan (ESOP): Understanding the basics

### Q. What is Employee Stock Option Plan (ESOP)?

Employee Stock Option Plan (“**ESOP**”) OR Employee Stock Option Scheme (“**ESOS**”) is an incentive scheme used by companies to compensate their employees.

The Companies Act, 2013 defines<sup>[1]</sup> “employees stock option” as ‘*the option given to the directors, officers or employees of the 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.*’

Simply put, the company provides its employees a right to subscribe to specific number of shares of the company at a defined price after certain number of years (“**Option**”). The employee may or may not be required to work with the company for such number of years before an employee could exercise his option. It is part of the compensation offered to the employee. ESOP Plan offers following benefits to the company as well as the employee:

- ensures long term commitment of the employee.
- provides employees with ownership over shares of the company
- makes the compensation package competitive.
- no outflow of cash
- employee to receive any dividends declared by the company

### Q. What are the legal provisions governing ESOPs in India?

There are specific provisions under the Companies Act 2013, SEBI Guidelines and FEMA Regulations which govern the issue of ESOPs by listed and unlisted companies in India.<sup>[2]</sup>

### Q. What are the compliances to be ensured by listed/ public company for issuing ESOPs?

SEBI Regulations will govern the issue of ESOPs by a listed company whose equity shares are listed on a recognized stock exchange.

### Q. What are the compliances to be ensured by unlisted/ private company for issuing ESOPs?

#### A. Pre- grant of ESOP Actions

##### 1. *Shareholders’ approval:*

The issue of the Employee Stock Option scheme shall be approved by the shareholders of the company, by passing a **special resolution**.<sup>[3]</sup> However, private companies are exempted from this requirement and therefore, they can get the approval of its shareholders by way of an **ordinary resolution**.<sup>[4]</sup>

The approval of shareholders by way of **separate resolution** (separate approval) shall be obtained by the company in case of [\[5\]](#):

- grant of option to employees of a subsidiary or holding company; or
- grant of option to identified employees, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option.

## 2. *Explanatory Statement*[\[6\]](#)

The company is required to make certain disclosures, in the explanatory statement annexed to the notice for the passing of the resolution including the total number of stock options to be granted, identification of classes of employees entitled to participate in the Employees Stock Option Scheme, vesting period, exercise price, lock-in period, the method which the company shall use to value its options, and other terms and conditions.

## B. Preparing the ESOP Plan

The company is required to decide the terms and conditions of the ESOP to be granted to the eligible employee like eligibility criteria, number of shares to be offered, exercise price, vesting period, payment mechanisms, and other terms and conditions. Such ESOP Plan will be evaluated in line with Section 62 (1) (b) of the **Companies Act, 2013** and the Companies (Share Capital and Debenture) Rules, 2014 (“**Share Capital Rules**”).

### 1. *Definition of Employee:*

As per Share Capital Rules, ESOPs can be issued only to the "employees" of an unlisted company. Rule 12(1) of Share Capital Rules defines who comes under the definition of "Employee" and who does not:

#### “Employee” means

- a. a permanent employee of the company who has been working in India or outside India; or
- b. a director of the company, whether a whole-time director or not but excluding an independent director; or
- c. an employee as defined in clauses (a) or (b) of a subsidiary, in India or outside India, or of a holding company of the company or of an associate company

#### “Employee” means

- a. an employee who is a promoter or a member of the promoter group; or
  - b. a director who either himself or anybody corporate, directly or indirectly, holds more than 10% of the outstanding equity shares of the company.
- Note: This exclusion will not apply for a period of 10 years.

### 2. *Terms of the ESOP:*

The Share Capital Rules provide for certain requirements with respect to vesting conditions of the Option:

**Not transferable[\[8\]](#)**

The option granted to employees shall not be transferable to any other person of the employee.

**No alienation[\[9\]](#)**

The option granted to the employees shall not be pledged, hypothecated, mortgaged, encumbered or alienated in any other manner.

**Death of employee[\[10\]](#)**

In the event of the death of an employee while in employment, all options granted till such date shall vest in the legal heirs or nominees of the deceased employee.

**Permanent Incapacity[\[11\]](#)**

In case the employee suffers a permanent incapacity while in employment, all options granted to him as on the date of permanent incapacitation shall vest in him.

**Resignation/ Termination[\[12\]](#)**

In the event of resignation or termination of employment, all options granted on that day shall expire. However, the employee can exercise the options vested within the period specified in this behalf, subject to the terms and conditions of ESOP as approved by the Board.

There are other requirements provided for other terms of the ESOP:

**Exercise Price[\[13\]](#)**

The companies granting an option to its employees pursuant to an ESOP shall determine the exercise price in conformity with the applicable accounting standards. There shall be a minimum period of one year between the grant of options and their exercise.

**Grant of Vesting Period[\[14\]](#)**

In case of merger or amalgamation, the period during which the option was held by the employee in the Amalgamating company shall be adjusted to the period of 1 year.

**Lock In period[\[15\]](#)**

The company shall have the freedom to specify the lock-in period for the exercise of an option. Until the shares are allotted, the employee will not have the right to exercise the option.

**No rights till the issue of shares[\[16\]](#)**

- to receive any dividend
- to vote
- in any manner, to enjoy the benefits of a shareholder in respect of the shares

The amount, if any, payable by the employees, at the time of grant of options shall be

**Treatment of amounts received [\[17\]](#)**

- may be forfeited by the company if the option is not exercised within the specified exercise period; or

- the amount may be refunded to the employees if the options are not exercised due to non-fulfilment of conditions relating to vesting of an option as per the scheme.

## **C. Post- grant of ESOP Actions**

### ***1. Disclosures in Board of Directors Report***[\[18\]](#)

The Board of directors, shall, inter alia, disclose in the Directors' Report for the year, the following details of the Employees Stock Option Scheme:

- Options granted/ vested/ exercised;
- The total number of shares arising as a result of exercise of option;
- Options lapsed;
- The exercise price;
- Variation of terms of options;
- Money realized by exercise of options;
- Total number of options in force

### ***2. Register of Employees Stock Options***[\[19\]](#)

- The company shall maintain a Register of Employee Stock Options in Form No. SH.6 and shall forthwith enter therein the particulars of the options granted under Section 62 (1) (b).
- The Register of Employee Stock Options shall be maintained at the registered office of the company or such other place as the Board may decide.
- The entries in the register shall be authenticated by the company secretary of the company or by any other person authorized by the Board for the purpose.

### ***3. Variation of terms of ESOP***

The company may by special resolution, vary the terms of ESOP not yet exercised by the employees provided such variation is not prejudicial to the interests of the option holders. The notice for passing special resolution for variation of terms of Employees Stock Option Scheme shall disclose full details of the variation, the rationale therefore, and the details of the employees who are beneficiaries of such variation.

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*The information contained in this site is provided for informational purposes only, and should not be construed as legal advice on any subject matter. For any ESOP related query or assistance, reach out to us at [help@cornelliachambers.com](mailto:help@cornelliachambers.com) .*

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[1] Sec 2(37) of Companies Act, 2013.

[2] Rule 12 (11) of Companies (Share Capital and Debenture) Rules, 2014.

[3] Sec 62 (1) (b) of Companies Act, 2013.

[4] Notification GSR 464 (E ) dated 5<sup>th</sup> June 2015.

Available at

[http://www.mca.gov.in/Ministry/pdf/Exemptions\\_to\\_private\\_companies\\_05062015.pdf](http://www.mca.gov.in/Ministry/pdf/Exemptions_to_private_companies_05062015.pdf)

[5] Rule 12 (4) of Share Capital Rules

[6] Rule 12 (2) of Share Capital Rules

[7] Definition of Start Up Company is provided vide Notification GSR 127 (E) dated 19 February 2019 issued by DPIIT. Available at

<https://www.startupindia.gov.in/content/dam/invest-india/Templates/public/198117.pdf>

[8] Rule 12 (8) (a) of Share Capital Rules

[9] Rule 12 (8) (b) of Share Capital Rules

[10] Rule 12 (8) (d) of Share Capital Rules

[11] Rule 12 (8) (e) of Share Capital Rules

[12] Rule 12 (8) (f) of Share Capital Rules

[13] Rule 12 (3)

[14] Rule 12 (6) (a)

[15] Rule 12 (6) (b)

[16] Rule 12 (6) (c)

[17] Rule 12 (7)

[18] Rule 12 (9)

[19] Rule 12 (10)