



Basic Jurisprudence of ESOPs and other Equity Incentive Plans in India

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Preparedness for the Future

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As India inches towards becoming a developed economy, all her economic enablers are also expected to be developed. Likewise, the ESOPs and other Equity Incentive Plans (“EIPs”) are expected to see many phases of development; one of the significant amongst such developmental aspects is the legal/ regulatory application on the EIPs.

Particularly in last 10 years, the role of EIPs has been explicitly evident in making hundreds of millionaire employees in India. This was possible as the employer companies climbed to a greater (and unprecedented) height in business and valuation. This postulates either an explicit or (at least) an implicit role of EIPs in transforming companies in India.

The legal/ regulatory aspects of EIPs (i) not only seek to deal with the respective economic fates of the employees and the employer, (ii) but also have consequences for other persons in the EIP Ecosystem like the Promoters, Investors, Management, ESOP Trust/ Trustees, etc. to the extent they have committed or omitted in an EIP transaction.

EIP and its practice in India are still naïve which is supposed to be more mature (and unwarrantedly more complex) day by day. When the participation increases, the ecosystem expands with the ever-changing expectations or behaviours of the participants. Suddenly, a thing becomes an issue which was hitherto a normal accepted thing. There are numerous examples of what is happening in developed economies. For example, in the US, the Courts have been ruling on different aspects of EIPs which is taken as a surprise by an affected party in the EIP Ecosystem i.e. questioning a fair market valuation of equity, determining the rights of employees, penalising a company/ ESOP Trust/ founder/ investor [Ref: *Acosta v. Vinoskey* (2019), *Brundle v. Wilmington Trust* (2017), etc.].

There is a need to foresee the future and act accordingly; rather than to worry in a growing economy where every player is supposed to be wiser and more conscious about its/his/her rights. This may create fresh challenges in terms of tug-of-war for restoration or enforcement of legal rights in more creative ways in a Law Court. E.g, an employee may not hesitate to file a suit in coming days for a thing which is not minded as a breach today, or an Investor suing a company trying to prove the grant of ESOPs as fraud to him. This is all about setting the tune for this write-up.

In India, the EIPs are implemented in different forms like Employee Stock Option Plans (“**ESOPs**”), Stock Appreciation Rights (“**SARs**”), Employee Stock Purchase Plan (“**ESPP**”). ESOPs include its articulated variants like Performance Stock Units (“**PSUs**”), Restricted Stock Units (“**RSUs**”), etc. Yet another type of EIP widely adopted is Cash Settled – SARs (“**CSAR**”) or “**Phantom**” which derives value from equity but is settled in Cash.

Most of the persons in the EIP Ecosystem perceive that only following rules/regulations/ laws are applicable:

- (a) For Listed Companies: The Securities and Exchange Board of India (Share Based Employee Benefits & Sweat Equity) Regulations, 2021 read with other relevant SEBI Regulations.
- (b) For Unlisted Companies: The Companies Act, 2013 read with the Companies (Share Capital and Debenture) Rules, 2014
- (c) For SAR-Cash/ Phantom: There is no regulation that applies except application of accounting standard.
- (d) Forex Rules: For cross-border EIP transactions, Foreign Exchange Management Act, 1999 read with relevant rules applies.
- (e) Income Tax Laws: Provisions of the Income Tax Act, 1961 read with Rules apply as a consequence of a transaction.
- (f) Sectoral Regulations: E.g. Executive Compensation Guidelines issued by the Reserve Bank of India, Insurance Regulatory & Development Authority of India, etc.

The afore-referred legal sources may be termed as “**Principal Laws**” that explicitly deal with an ESOP/ SAR/ ESPP/ SAR-Cash/ Phantom case and seek to bind the persons in the ecosystem who has a role in an EIP implementation.

The other laws (“**Aiding Laws**”) which are generally not perceived as linked to any type of EIPs but are applied overwhelmingly for the interpretation of rights/ liabilities under the Principal Laws or for the correct execution of the EIPs. Reference of important Aiding Laws are given as under:

- (a) Indian Contract Act, 1872;
- (b) Bharatiya Sakshya Adhinyam, 2023 (erstwhile Indian Evidence Act, 1872);
- (c) Specific Relief Act, 1963;
- (d) The General Clauses Act, 1897;
- (e) Information Technology Act, 2000;
- (f) Indian Trusts Act, 1882;
- (g) Arbitration and Reconciliation Act, 1996;
- (h) Civil Procedure Code, 1908; and
- (i) Legal/ Regulatory Precedents (**last but not the least**).

These Aiding Laws have direct application linked to almost each and every content of an EIP Plan/ Scheme, Grant Letter, Employee Agreement and Disclosures. To cite a few instances are:

- **“Grant”** is deemed to be a “contract” and is subject to provisions of the Indian Contract Act. Thus, a grant letter that does not specify key inputs like number of Options granted, vesting conditions, exercise price, timing of exercise, etc. may be termed as a void contract or a void grant on the grounds of ambiguity.
- **“Vesting”** is held to be “Earning”/ “Absolute right” in several precedents; though this is not specified in any Principal Law. Accordingly, a Company seeking to forfeit Vested Options unless expressly allowed under the Principal Laws, may be misplaced; or may come as a boomerang in future.
- **Jurisdiction** in a Plan: This is effectively governed under the Civil Procedure Code. Writing place(s) of Jurisdiction in an ESOP Plan casually may be misplaced.
- **Manner of Communication/ Notice:** Basic provisions of the Bharatiya Sakshya Adhiniyam have major role to prove service of communication/ notice between or amongst the persons in an EIP transaction so as to avoid any legal consequence.
- **Making good a wrong ESOP/ equity transaction:** Particularly in case of unlisted companies, in case equities are promised only equities may be insisted (instead of Cash) under the Specific Relief Act. This can be used by an employee or an employer to their advantage as the situation warrants.
- **ESOP/ EIP Database Management:** A third party appointed by employer while processing employee personal data along with ESOP data, provisions of Information Technology Act may apply requiring suitable contents/ disclaimers in an ESOP/ EIP Plan documentation to avoid undesirable situations.
- **Electronic transactions in EIPs:** Certain ESOP/ equity transactions may not be valid if done electronically as per the Information Technology Act, requiring only physical/ print-out transaction. For example, filing an exercise application, amending a Trust Deed, giving authority/ power of attorney to do an equity transaction, etc.
- **Arbitration clause in an EIP:** Arbitration clause needs to be planned carefully in strict compliance with the Arbitration laws.
- **ESOP Trust/ Trustees:** Indian Trusts Act determines all the aspects of Trust and Trustees except the aspects explicitly dealt under the Principal Laws.

A company or a consultant while structuring and drafting an EIP Plan should have precise understanding of all these jurisprudence aspects to ensure that transactions contemplated are carried out in future as originally intended with minimal or no deviation. This adds to the predictability and confidence in an EIP Plan.

Through this write-up, we have focussed only on the jurisprudence aspects of the EIPs as one of the critical aspects. We recommend to be calculative on other critical aspects too in terms of assessment from accounting, tax, valuation, governance, and stakeholders perception perspectives. Our write-ups on other aspects are available in our website and social media.