



## ESOP Structuring Series 3 / 4

# ESOP Structuring – Exercise/ Sale/ Monetization Parameters

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This write-up is a continuation of our ESOP Structuring Series 2 / 4 on structuring of Vesting parameters. An ESOP (including all its forms) broadly has 4 key stages/ aspects i.e. (i) Grant, (ii) Vesting (iii) Exercise/ Sale/ Monetisation, and (iv) Effective employee communication (“**ESOP Stages**”) which are narrated in separate write-ups.

As the parameters of these ESOP Stages often crisscross/ impact/ influence each other, attempt is made to narrate such linkage at appropriate places in this write-up.

Exercise comes next after Vesting of ESOPs. Exercise of ESOPs means conversion of such vested ESOPs into underlying shares which are then either held or sold for ultimate gain. But in case of Cash-Settled SARs/ Phantoms, exercise shall result in direct payout of cash. Thus, this write-up seeks to cover all these 3 aspects (Exercise/ Sale/ Monetization) succinctly.

### **A. Exercise parameters are generally structured as under:**

Determinants	Details
Exercise period	<ul style="list-style-type: none"> <li>Exercise period is the time period during which the vested ESOPs should be exercised unless which the ESOPs may lapse. Law has not defined any minimum and maximum Exercise period. Thus, it is fixed basis what is reasonable under a company's own circumstance.</li> <li>Exercise requires an employee to pay exercise price and applicable perk taxes. Thus, it is a cash outflow event for employee.</li> <li>Thus, in case of unlisted companies, the exercise period is kept long or linked to a monetization event (like a strategic sale, buy-back, IPO, etc.) so as to minimise/ avoid cash outflow pressure on the employees.</li> </ul>

	<ul style="list-style-type: none"> <li>• In case of a listed company, it may range anywhere between 1 month to 10 years depending upon what discount is given. <i>E.g.:</i></li> <li>• <i>For RSUs (deep discount ESOPs), a short Exercise period is (rightfully) in fashion as reasonable for employees and also good for company due to lower accounting cost.</i></li> <li>• <i>For no discount, the exercise period is kept long so as to give opportunity to grow the value over long time and also to fight against any price fluctuation.</i></li> </ul> <p><b>Linkage:</b> Listed /unlisted status, projected growth rate, Accounting cost optimisation</p>
Exercise price	<p>In addition to exercise price related discussions above, the factors that influence Exercise price are: projected growth rate, investors' wish, market trend in a sector, volatility in share price, ESOP Pool optimisation, Accounting cost optimisation, employee motivation, etc. <i>E.g.</i></p> <ul style="list-style-type: none"> <li>• <i>Where CAGR is reasonably projected at say &gt;50% , probably a discount is not required.</i></li> <li>• <i>Institutional investor may resist a discount unless suitable vesting conditions are prescribed.</i></li> <li>• <i>Discount/ deep-discount may be required in case an Industry from where employees join a company adopts a discounted approach. (like AI professionals of start-ups joining a traditional banking company).</i></li> <li>• <i>Higher is the discount, lesser is the ESOP requirement.</i></li> <li>• <i>Higher discount helps in phases of employee poaching (like that happened in year 21-22 in IT Sector)</i></li> </ul> <p><b>Linkage:</b> As stated above</p>

## **B. Structuring of Sale of shares/ Monetisation:**

### In listed companies

There is no complexity being their shares freely marketable.

### In unlisted companies

The complexity lies particularly when these are privately held or closely held and far from IPO. Giving rights to employees (i) to own shares and be on cap table, and/ or (ii) to sale shares to anybody, may be undesirable. Thus, tailor-made structures are framed for both exercise of ESOPs and sale of shares. Sometimes, both the exercise of ESOPs and sale of shares are linked to a liquidity event. This also offers benefit to the employees as there is no pressure/ hurry to exercise by taking investment risk for unlisted shares.

Liquidity event in this context can be any articulated opportunity created for employees so that their ESOP shares can be sold like (i) scheduled buy-outs by promoter/ investor/ ESOP trust, (ii) Tag-along of ESOP shares with any existing shareholder existing the company, (iii) Drag-along of ESOP shares by any outgoing shareholder with sale of majority stake in the company, (iv) company buy-back, (v) cash settlement of unexercised vested ESOPs, etc.

Transactional structuring of these aspects is validated after testing for feasibility under the corporate laws, measurement of tax impact on all parties involved including an ESOP Trust, feasibility under FEMA regulations for any non-resident (either being an investor or an employee) in the transaction eco-system. This may need understanding and application of few provisions of Shareholders' Agreement ("SHA") in the ESOP transaction with a view to avoid any conflict or to achieve synchronisation.

Understanding and demonstration of these structures may need expertise in multiple fields like corporate laws, taxation, accounting, governance, FEMA, etc. with a long-standing practical experience in ESOP structuring.

**Linkage:** SHA in case of unlisted companies, ESOP primary objectives

### **Employee separations**

Applicable ESOP rules/ regulations specified whether vested ESOPs can be exercised or not without specifying any exercise period in separation cases. Owing this, the only structuring is done is deciding an appropriate shorter Exercise period. However, there are certain tweaks possible which are relevant for companies having monopoly or operating in a highly technological environment, by structuring claw-back of exercised ESOPs, sold shares or even paid benefits. This needs a bit legal expertise for a sustainable claw-back provision.

Basis the Exercise/ Sale / Monetization parameters decided, the subsequent parameters on Employee Communication are structured accordingly. Employee communication is vital as mis-understanding or no understanding of ESOP Plan may be a waste affair.

**It is important to note that 'a predictable ESOP roadmap' can be obtained when all the parameters of the ESOP Stages are pragmatically determined with appropriate analysis and simulations with reference to applicable laws, practice, accounting, tax, resultant business growth/ valuation and last but not the least is ease of administration.**