



There is a provision in the Companies Act, 2013 (the “**Act**”) that a company cannot hold its own shares. This is so because a company is considered a separate legal person distinct from its owners. As per this principle, there may be a paradox if the company becomes its owner or co-owner.

Further, there is a consequential restriction in the Act that any public company cannot give any loan or financial assistance in any form (by way of guarantee or security in connection with a loan given by others) for the purpose of facilitating purchase of its own shares.

However, the Act is not that much rigid. With a view to facilitate certain business transactions, as an exception, the Act allows a company:

- a) to acquire, hold and transact in its own shares through a trust formed for the purpose of administering an Employee Stock Option Plan (“**ESOP**”); and/ or
- b) to lend or provide financial assistance to the trust or employees to facilitate purchase of its own shares by its employees under a scheme approved by the shareholders.

The aforesaid trust should be engaged in administering ESOP or any similar plans as its objects. Given the purpose, it is known as an “ESOP Trust” or an Employee Welfare Trust (“**EWT**”) (collectively referred to as “**ESOP Trust**”).

Before deep diving into an ESOP Trust (as to its nature, constitution, documentation, registration, financial needs, rights, liabilities, duties, forbidden activities, taxation, dissolution, etc.), it may be worthwhile to examine if it is required at all for an ESOP implementing company.

### **ESOP Trust – when adopted**

Busting a myth with some readers, it is important to clarify that a company is not legally mandated to have an ESOP Trust if the ESOP plan contemplates issue of fresh/ primary shares to the employees directly upon exercise.

Then, why an ESOP Trust is still adopted, has two answers:

- (a) when the trust route is desirable in spite of being optional; and
- (b) when the trust route is mandatory.

| When optional  | When mandatory   |
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| Use of primary shares<br><br><i>(Fresh shares issued by a company are known as primary shares)</i>   | Use of secondary shares<br><br><i>(Shares acquired from shareholder/ market are known as secondary shares)</i> |
| Use of primary shares dilutes the equity holding percentage of the shareholders; whereas, secondary shares do not. Use of type of share is decided at the inception of the ESOP plan as a part of structuring. |  |

**Few use cases of ESOP Trust despite being legally optional:**

| Case 1: Use of primary shares with large employee coverage  |  |
|---|--|
| Direct route  | ESOP Trust route   |
| <ul style="list-style-type: none"> <li>Company calling frequent board/ committee meetings to approve share allotment upon each instance of exercise</li> <li>Frequently applying for demat of exercised shares</li> <li>Frequent filings with stock exchange for listing (for listed shares)</li> <li>Company's bandwidth and cost associated with above</li> </ul> | <ul style="list-style-type: none"> <li>All or a part of ESOP pool shares are parked with ESOP Trust in advance</li> <li>Trustees (who are generally readily available) transfer the shares</li> <li>No board/ committee meeting nor there are any requirements to demat/ list the shares (as already in demat/ listed form)</li> </ul> |

| Case 2: Listed company with high price volatility   |   |
|---|---|
| Direct route  | ESOP Trust route  |
| <ul style="list-style-type: none"> <li>It takes ~ 25 to 40 days – causing a delay in shares reaching employees' demat account</li> <li>There may be wide price fluctuation during this processing period</li> </ul> | <ul style="list-style-type: none"> <li>Turnaround time is much lesser, say ~ 8 to 10 days</li> <li>A boon for employees enabling them to sell before a big price fluctuation</li> </ul> |

| Case 3: Facilitation of Cashless exercise   |   |
|---|---|
| Direct route  | ESOP Trust route  |
| <ul style="list-style-type: none"> <li>Broker funding at high interest cost and plethora of paper works; or</li> <li>company's own funding subject to ceilings as per the Act with potential adverse tax impact on employees</li> </ul> | <ul style="list-style-type: none"> <li>Trust sells a part of shares to collect exercise price and taxes; rest of the shares are freely transferred to employees' demat account</li> <li>Employees are required to just authorise and it does not involve much paper work (unlike broker funding)</li> </ul> |

| <b>Case 4: Cap table management &amp; share movement control in unlisted companies</b>  |  |
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| <b>Direct route</b>   | <b>ESOP Trust route</b>  |
| <ul style="list-style-type: none"> <li>• Upon exercise and allotment, all ESOP grantees may come to the Cap table of a closely held unlisted company</li> <li>• After allotment of shares, concerned employees may leave the company creating fear of mis-use of such shares</li> </ul> | <ul style="list-style-type: none"> <li>• Upon exercise and allotment, the ESOP Trust holds the shares for and on behalf of all the ESOP grantees</li> <li>• ESOP Trust becomes a single owner instead of numerous employees</li> <li>• Ensures better control on movement of shares</li> </ul> |

| <b>Case 5: Better Employee Tax management in a high growth unlisted company</b>  |  |
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| <b>Direct route</b>  | <b>ESOP Trust route</b>  |
| <ul style="list-style-type: none"> <li>• Closely held unlisted companies tend to allow exercise and monetization only upon a liquidity event</li> <li>• The whole gain is taxed at salary (i.e. higher) tax rate</li> <li>• In a high growth case, even the tax rate may inflate with Surcharge</li> </ul> | <ul style="list-style-type: none"> <li>• Employees exercise early, but the ESOP Trust holds the shares for and on behalf of the employees</li> <li>• Cash outflow for an employee may not be significant at early stage</li> <li>• Trust sells the shares upon liquidity event and gives benefit</li> <li>• All most the whole gain is taxed under Capital gains with a lower tax rate.</li> </ul> |

There is a long list of cases when an ESOP Trust is considered the only way or best way. For instance, where:

- a) the shareholders negotiate that only identified shareholder(s) shall contribute to the ESOP pool, then their secondary shares are acquired and used.
- b) shares of a listed company are available in the stock market at throw away price, such secondary shares (subject to SEBI ceiling) are acquired for ESOP purpose.
- c) a company (listed or unlisted) for whatever reason including the reason that it has diluted too much for previous ESOP plans, intends to implement a new plan with secondary shares purchased from market.
- d) an unlisted company wishing to create an internal liquidity platform for its own employees (subject to certain structuring in the ESOP plan).

Barring the mandatory cases, in optional cases, a cost - benefit analysis gives the conclusion as to if an ESOP Trust is worthwhile. **Sometimes, trust route gives magical outcomes vis-à-vis direct route. However, this should ideally be evaluated by a professional having holistic experience on all aspects of ESOP Trust.**

*ESOP Trust has many nuances (as to its origin, use cases, nature, constitution, documentation, registration, financial needs, permitted activities, forbidden activities, dissolution, taxation, and other aspects) depending upon listed or unlisted status of the implementing company. Key nuances are dealt with in the ESOP Trust Series 1,2 & 3.*