

## **Employee Stock Option Plans (ESOPs): Key Insights from Mehta & Mehta Webinar**

Employee Stock Option Plans (ESOPs) have emerged as a cornerstone of modern compensation strategy, enabling organisations to attract, retain, and incentivise talent while aligning employee interests with long-term shareholder value creation. In a recent knowledge sharing webinar organised by Mehta & Mehta, senior professionals and panellists deliberated on the statutory framework, evolving regulatory landscape, structuring considerations, and practical challenges surrounding ESOP implementation in India.

With increasing competition for skilled talent, especially in start-ups, technology-driven enterprises, and growth-stage companies, ESOPs have transitioned from being a human resource tool to a strategic governance mechanism influencing capital structure, dilution, and investor perception.

### **Evolution of ESOPs in India**

Historically, employee compensation in India was largely salary-driven, with limited equity participation. However, the growth of start-ups, private equity investments, and capital markets has transformed ESOPs into a wealth creation instrument and a critical component of executive remuneration.

Corporate expansion, IPO preparedness, and investor scrutiny have further strengthened the regulatory architecture governing ESOPs. Today, ESOPs are designed not merely for compensation but as structured instruments that balance retention objectives, shareholder dilution, and regulatory compliance.

### **Statutory Framework Governing ESOPs**

The primary legal framework governing ESOPs includes:

- ⇒ Section 62(1)(b) of the Companies Act, 2013 read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014;
- ⇒ The SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 (applicable to listed entities)

While the Companies Act mandates shareholder approval and prescribes procedural requirements, SEBI regulations institutionalise governance standards for listed entities through detailed disclosures, oversight by the Nomination and Remuneration Committee (NRC), and stock exchange compliances.

### **Applicability**

Under the Companies Act framework, ESOPs may be granted to:

- ⇒ Permanent employees of the company;
- ⇒ Directors (other than independent directors);
- ⇒ Employees or directors of holding or subsidiary companies.

However, ESOPs cannot be issued to promoters or members of the promoter group (except in limited circumstances as permitted under SEBI regulations for pre-IPO grants meeting specified conditions).

For listed entities, compliance with SEBI SBEB & SE Regulations is mandatory, including shareholder approval by special resolution and adherence to disclosure norms.

Panellists strongly emphasised that even unlisted companies should adopt structured governance mechanisms to avoid future regulatory and transactional challenges, particularly in view of potential IPO plans.

### **Core Structure of an ESOP Scheme**

An ESOP scheme typically consists of the following components:

- ⇒ **Grant** – Offering of options to eligible employees;
- ⇒ **Vesting** – Earning the right to exercise options, subject to time-based or performance-based conditions;
- ⇒ **Exercise** – Conversion of vested options into equity shares upon payment of exercise price;
- ⇒ **Allotment** – Issuance and credit of shares to the employee's demat account.

The webinar highlighted that drafting of the ESOP scheme is the most critical stage. Clear articulation of vesting schedules, exercise timelines, leaver provisions, performance conditions, and corporate action adjustments is essential to prevent future disputes and litigation.

### **ESOP Pool and Dilution Considerations**

The ESOP pool represents the total number of options approved by shareholders for grant under the scheme over a defined period. It determines the extent of potential dilution and must be approved by special resolution.

Panellists observed that investors frequently incorporate ESOP pool creation clauses within shareholders' agreements. The size of the pool is strategically determined based on:

- ⇒ Future hiring plans;
- ⇒ Retention objectives;
- ⇒ Projected capital raising;
- ⇒ Acceptable dilution thresholds.

Proper communication of dilution impact and transparent disclosures are vital for maintaining shareholder confidence.

## **Role of the Board and Nomination & Remuneration Committee**

For listed entities, the ESOP scheme is administered by the Nomination and Remuneration Committee (NRC). The Committee is responsible for:

- ⇒ Framing and modifying the scheme within approved limits;
- ⇒ Determining eligibility criteria;
- ⇒ Approving grants;
- ⇒ Monitoring vesting and exercise;
- ⇒ Ensuring regulatory and disclosure compliance.

The Board retains overall oversight responsibility and must ensure that ESOP implementation aligns with corporate strategy and governance standards.

## **Vesting, Exercise, and Leaver Provisions**

The minimum vesting period under the Companies Act framework is one year. However, vesting may occur in tranches over multiple years, often linked to performance metrics.

Leaver provisions must be clearly defined in the scheme and typically address scenarios such as:

- ⇒ Resignation;
- ⇒ Termination;
- ⇒ Retirement;
- ⇒ Death or permanent incapacity.

Unvested options generally lapse upon cessation of employment, while vested options may be exercised within a prescribed period. Once shares are allotted upon exercise, they cannot ordinarily be clawed back unless specific contractual provisions exist prior to exercise.

## **Accounting and Valuation**

Companies must recognise employee compensation expense in accordance with applicable accounting standards (Ind AS 102 or relevant AS). Valuation of options is commonly undertaken using recognised option pricing models.

The accounting impact of ESOPs affects profitability, earnings per share (EPS), and financial disclosures. Therefore, ESOP design must consider financial statement implications alongside legal compliance.

## **Tax Implications**

Taxation arises at two stages:

1. **At Exercise** – The difference between the fair market value and exercise price is taxed as a perquisite under the head “Salaries”.

2. **At Sale** – Capital gains tax applies on the difference between sale price and fair market value considered at exercise.

Companies must ensure timely withholding and compliance with tax deduction obligations.

### **Trust Route vs Direct Route**

ESOPs may be implemented either:

- ⇒ Through the **Direct Route** – Fresh issuance of shares upon exercise; or
- ⇒ Through the **Trust Route** – Where a trust acquires and holds shares for transfer to employees.

Each structure has distinct compliance, funding, and disclosure implications. Listed entities must comply with SEBI-prescribed limits and disclosure norms where the trust route is adopted.

### **Practical Insight**

Panellists emphasised that ESOPs must be carefully drafted to ensure clarity, fairness, and enforceability. Scheme documents should comprehensively address:

- ⇒ Exercise price determination;
- ⇒ Corporate action adjustments (bonus, rights, split, consolidation);
- ⇒ Change in control scenarios;
- ⇒ Authority of the NRC;
- ⇒ Disclosure and reporting obligations.

Regulators and investors increasingly assess governance quality based on the design and administration of ESOP schemes rather than on the existence of the scheme alone.

### **Conclusion**

Employee Stock Option Plans play a pivotal role in fostering ownership culture and long-term value creation. Their effectiveness depends on strategic structuring, regulatory compliance, financial prudence, and transparent governance.

As Indian companies continue to scale and access capital markets, a robust and well-documented ESOP framework is indispensable for balancing employee motivation, investor expectations, and statutory compliance.

To stay informed or access the webinar recording, visit the YouTube channel:

 “Decoding Corporate Laws with Mehta & Mehta”