
ESOPS AS A FUNDING TOOL FOR STARTUPS

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I. Introduction

The number of startups rose from 471 in 2016 to 72,993 in 2022 and created more than 7,00,000 jobs by March 2022 while reaching an all-time high of 90,000 startups in 2023.¹ India has become the third-largest startup ecosystem in the world after the US and China, as per the Economic Survey 2021–22.²

Finding, inspiring and retaining exceptional people is one of the largest potential challenges for startup founders. By encouraging employees to own stock in the company they work for and providing them with an incentive to stay with that company while also engaging more in its ongoing operations and future plans, granting of ESOPs could tackle the issue.

II. What are ESOPs?

ESOP is a type of employee benefit plan which is intended to encourage employees to acquire stocks or ownership in the company.³

Under the Employee Stock Ownership Plan, employers offer their employees the stock of the company at a low or no additional cost that they can encash after a specified period at a specific price.

Until an employee leaves the company or retires, the shares for an employee stock ownership plan are retained in a trust unit for security and growth. Following their departure, the corporation buys the shares back and distributes them to more employees.

¹ IndiaTimes, <https://timesofindia.indiatimes.com/india/number-of-startups-in-india-grows-to-72993-in-2022-from-471-in-2016/articleshow/93077040.cms> (last visited July. 10, 2023).

² Livemint, <https://www.livemint.com/economy/economic-survey-india-becomes-third-largest-startup-ecosystem-in-the-world-11643626506129.html> (last visited July. 8, 2023).

³ The Economic Times, <https://economictimes.indiatimes.com/definition/esop> (last visited July. 10, 2023).

In conclusion, as the firm grows, the founders who initially decided to work without any significant pay start to feel the strain as the company expands and investors come on board and seek more help to supplement the time and effort they are investing in building the business from its very genesis.

However, the Companies Act of 2013 explicitly prohibits the award of ESOPs to a company's promoters/founders/co-founders.

III. Laws Governing ESOPs

- Companies Act, 2013⁴
- SEBI (Share Based Employee Benefit) Regulations, 2014⁵ (In case of listed entities only)
- ICDR Regulations, 2018⁶ (In case of listed entities only)
- SEBI (Prohibition of Insider Trading) Regulations, 2015⁷ (In case of listed entities only)
- Income Tax Act, 1961⁸
- Foreign Exchange Management Act (FEMA), 1999⁹
- Department of Public Enterprise (DPE) Guidelines

IV. ESOPS can be a value add to Start-ups

As stated above, given that workers must remain with the company for a set amount of time (the “vesting period”) to receive the benefits, ESOPs provide employees with a sense of ownership. Start-ups must keep their talented and competent employees during the early stages. Making the employees feel like a vital part of the business is the greatest method to do this.

⁴ Companies Act, 2013, § 2 (37), The Gazette of India (August 30, 2013).

⁵ SEBI (Share Based Employee Benefit) Regulations, 2014, The Gazette of India (October 28, 2014).

⁶ ICDR Regulations, 2018, The Gazette of India (September 11, 2018).

⁷ SEBI (Prohibition of Insider Trading) Regulations, 2015, The Gazette of India (January 15, 2015).

⁸ Income Tax Act, 1961, The Gazette of India (September 13, 1961).

⁹ Foreign Exchange Management Act (FEMA), 1999, The Gazette of India (December 29, 1999).

Subsequently, employees voluntarily and collectively work hard towards the growth of the company on the leverage of ESOPs. Employees also understand that if the business goes poorly, the market value of their shares could fall below what they paid for under the ESOP during the company's inception. Therefore, ESOPs ensure that employees actively contribute to the development and success of the business. Along with the aforesaid, ESOPs shares are provided as compensation and typically serve as an alternative to bonuses or liquid cash. In the early stages of their companies, start-ups are unable to offer competitive salaries or financial incentives. Offering ESOPs to deserving employees enables the business to manage cash flow and retain them over the long term. *Finally, it is believed that the issuance of ESOPs will give start-ups an advantage in upcoming investment rounds because investors are frequently more likely to invest in a company that has a strong incentive program in place for its employees as it suggests and ensures that employees are committed to the company's long-term success and are aligned with the interests of investors.*

V. ESOPs under the Companies Act, 2013

ESOPs have proven to be very successful in providing a sense of belonging to the employees by rewarding them for their dedication and commitment to the company from its nascent stages by making them essential stakeholders. However, the Companies Act 2013 prevents the award of ESOPs to promoters since they are excluded from the definition of the term "employee" given in Rule 12(i).¹⁰

"Employee means-

(a)

(b)

(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 but does not include-

(i) an employee who is a promoter or a person belonging to the promoter group; or

¹⁰ Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999, The Gazette of India (September 03, 2009).

(ii) a director who either himself or through his relative or through anybody corporate, directly, or indirectly, holds more than ten percent of the outstanding equity shares of the company.”

However, the said rule does not apply on startups that are registered with the Department of Industry and Internal Trade(DPIIT) as long as the grant of such ESOPs is within five years from their incorporation. This exemption followed the 2016 report of the Companies Law Committee, which recommended that startups be permitted to grant ESOPs to promoters as they may be working as employees or whole-time directors. The granting of ESOPs would allow start-ups to compensate them adequately without impacting cash flows.¹¹

The Companies Law Committee was established for the aforementioned purpose and made the recommendation that, to support startups, the restriction imposed by the Companies Act, 2013, be relaxed to allow the issuance of ESOPs to promoters who may be working as employees, employee directors, or full-time directors. This would allow the promoters to benefit from increases in the company's future valuation without hurting the finances of the company in its early years. As a result, a proviso to Rule 12 of the Share Capital Rules was carved out as an exception to a startup company registered with the DPIIT, stating that the conditions mentioned in sub-clauses I and (ii) of explanation to Rule 12 (i) of the Share Capital Rules will not apply to a startup company for 10 years from the date of its incorporation or registration.¹²

VI. Issues of ESOPs faced by start-up companies

Start-ups being unlisted companies whose shares are not readily available have a hard time convincing their employees of future growth. Correspondingly, this makes employees mistrust their ability to realise the anticipated return from the shares they purchased through ESOPs. For companies (startups), the Finance Bill 2020 has established an eligibility requirement to use the tax deferral programme. Start-ups who are referred in 80-IAC determined by the Inter-Ministerial Board (set up under DPIIT) are eligible for the same.¹³ This announcement will hardly benefit 250 start-ups in India, leaving behind the 40k start-ups which are currently

¹¹ Ministry of Corporate Affairs, https://www.mca.gov.in/Ministry/pdf/Report_Companies_Law_Committee_01022016.pdf (last visited July. 8, 2023).

¹² CAIRR, <https://ca2013.com/rule-12-companies-share-capital-and-debentures-rules-2014/> (last visited July. 10, 2023).

¹³ Startup India, https://www.startupindia.gov.in/content/sih/en/startupgov/startup_recognition_page.html (last visited July. 10, 2023).

operational in India. Subjectively speaking, ESOPs boost employee's productivity and morale. There haven't been any facts that can conclusively demonstrate these advantages though. According to certain studies, ESOPs have a negative impact on the democratic nature of the workplace and employee morale. However, no experimental analysis exists to support the same.

VII. Is there an alternative to ESOPS for Start-ups?

For full-time directors who are also promoters, there are alternative stock-linked remuneration structures available, such as sweat equity and performance-linked incentive plans. However, these structures are less transparent and are subject to legal and tax restrictions.

Just like by way of issuing ESOPs, It is only fair for promoters, founders, or key employees to be rewarded for resolute perseverance. In addition to value creation and monetary benefits, sweat equity is considered a form of compensation.

Sweat equity refers to the non-cash contribution of a person to a business venture or project. It commensurates the physical efforts, mental labour, and time dedicated to value creation. It is important to note that sweat equity and equity capital are distinctly different. Equity capital is the financial commitment of the shareholders whereas sweat equity is the efforts involved with developing a business or a particular activity.¹⁴

For instance, although businesses can pay promoters with sweat equity, this is less desirable than ESOPs. Sweat equity is subject to a three-year lock-in while ESOPs only have a one-year lock-in. While the exercise price for ESOPs can be set by the company in accordance with its accounting principles, the issue price for sweat equity shares must be set at the fair value assessed by a registered valuer. The issue of sweat equity shares cannot exceed the higher of 15 per cent in a particular year or shares to the existing value of Rs, 5 Crores, whichever is higher; there is no such limit on the issue or granting of ESOPs.¹⁵

VIII. Conclusion

From the standpoint of the investor, providing ESOPs to promoters is advantageous since it

¹⁴ India Infoline, <https://www.indiaonline.com/knowledge-center/share-market/what-is-sweat-equity> (last visited July. 10, 2023).

¹⁵ Clear Tax, <https://cleartax.in/s/esop-vs-sweat-equity-shares> (last visited July. 10, 2023).

encourages the promoters to put out ongoing efforts towards the expansion of the business while reducing their ownership stake. In exchange, giving promoters ESOPs increases their financial security while also maintaining their value to the company. The Government of India has taken a progressive move by allowing new businesses to provide promoters ESOPs as an exemption, helping to develop a thriving investment market and bolster the Indian economy. Giving these businesses the required breathing room in their early years of development is crucial to enable the nascent startups to blossom into major firms. While ESOPs can be a valuable mode of employee compensation, they are not without their own set of challenges. Companies should carefully consider the pros and cons of ESOPs before implementing them, and employees should fully understand the terms and conditions associated with their options before making any decisions. They must consider factors like the rate of ESOPs, voting rights, dividends on stock holding and vesting terms which provide employment stability. From the promoter's perspective, issuing ESOPs may be seen as a useful tool for onboarding a co-founder later on in the company. In a similar manner, the promoters receive financial benefits as well as maintain their value in the startup as a result of receiving ESOP grants in exchange.