TiE RAJASTHAN
FOSTERING ENTREPRENEURSHIP

ESOP Roundtable

By Chirag Patel

WHAT IS THE DIFFERENCE BETWEEN THESE ANNOUNCEMENTS?

Announcements	Your View Points or Understanding
HDFC Bank announced that it has issued over two million equity shares to its employees, the lender said in a stock exchange filing. "We wish to inform you that the Bank has allotted today 20,56,400 equity shares to the employees of the Bank pursuant to exercise of options under its Employees Stock Options Schemes (ESOS)," said the bank in a stock exchange filing on Thursday morning. The paid up share capital of the Bank will accordingly increase from Rs. 516,79,93,234 equity shares of Rs. 2 each to Rs.517,21,06,034 equity shares of Rs. 2 each.	
ICICI Bank has allotted 1,91,117 equity shares of face value of Rs. 2 each on Monday under the employees stock option scheme, (ESOP), the bank informed the stock exchanges in a stock filing on Wednesday. As per the stock price on Wednesday at 1.40 pm, the shares were valued at Rs. 6.07 crore.	

WHY?

- Objectives of an ESOP Scheme - ARAR Framework: Attract, Retain, Align & Reward
- What do ESOPs Do – Ownership, Risk Sharing, Skin in the Game, Better Performance
- Stakeholder perspective

WHO?

General applicable rules and types of employees that can be covered in a ESOP Scheme

- a permanent employee working in or outside India
- a whole-time or part-time director of company
- an employee of a subsidiary (*whether in India or abroad*), holding company or an associate company, can claim benefits under an ESOP scheme.

It is absolutely important to note that neither a 'promoter' nor a director holding more than 10% of the equity shares of the company is entitled to take part in this scheme.

WHAT?

Mechanics of an ESOP Scheme

- Grant
- Vesting
- Exercise
- Sale/Exit

1. VESTING

Types	Description	Benefits	Drawbacks
Graded Vesting	Graded vesting, also known as graduated vesting, is when an employee gradually becomes entitled to full benefits over several years. Under a graded or graduated vesting plan, an employee might receive full ownership of 20 percent of their potential shares after two years. After three years, they receive 40 percent, after four years 60 percent, after five years 80 percent, and after six years they have 100 percent. After five years, the employee would be fully vested. If the employee leaves in year four, they still retain their vested benefits.		
Cliff Vesting	Cliff vesting is when an employee only becomes entitled to benefits once they're fully vested. If the vesting period isn't completed, the employee loses all of the benefits. For example, under a cliff vesting plan, an employee might gain 20 percent vesting benefit each year. But, if they leave the company before they work for five years and are fully vested, they lose everything.		
Accelerated Vesting	An accelerated vesting offer might be made if a company makes an acquisition. What this means is that a company might offer their employees accelerated vesting of six or 12 months.		

2. EXERCISE CONSTRUCT

Key Construct	Benefits	Drawbacks
Options can be exercised only on listing or sale (Tag Along)		
Options can be exercised anytime after vesting		

PRE LISTING SCENARIO	**VESTED OPTIONS**	**UNVESTED OPTIONS**
While in Employment	All Options Vested prior to listing can be exercised from the date of listing of shares of the Company on a Recognized Stock Exchange but not later than two years from such date.	The Options would continue to vest as per the original Vesting schedule.
Resignation / Termination (Other than due to misconduct or breach of Company Policies / Terms of Employment)	Vested options which were not exercised as on the date of submission of resignation / date of termination shall stand cancelled.	All Unvested Options on the date of submission of resignation / date of termination shall stand cancelled with effect from that date.
Termination due to misconduct or breach of Company Policies / Terms of	All Vested Options, which were not exercised at the time of such termination, shall stand cancelled with effect from the date of such	All Unvested Options on the date of such termination shall stand cancelled with effect from that date.

Employment	termination.	
Retirement / early Retirement approved by the Company	All Vested Options on the date of Retirement can be exercised from the date of listing of shares of the Company on a Recognized Stock Exchange but not later than six months from such date.	All Unvested Options will stand cancelled as on the date of Retirement, unless otherwise determined by the Board whose determination will be final and binding.
Termination due to Permanent Disability	All Vested Options as on the date of termination due to Permanent Disability may be exercised by the Option Grantee or, in case of his demise, the nominee or legal heirs*, from the date of listing of shares of the Company on a Recognized Stock Exchange but not later than six months from such date.	All the Unvested Options as on the date of termination due to Permanent Disability shall vest immediately and can be exercised by the Option Grantee or, in case of his demise, the nominee or legal heirs* from the date of listing of shares of the Company on a Recognized Stock Exchange but not later than six months from such date.
Death	All Vested Options as on the date of demise of the Option Grantee while in employment may be exercised by the Option Grantee's nominee or legal heirs* from the date of listing of shares of the Company on a Recognized Stock Exchange but not later than six months from such date.	All the Unvested Options as on the date of demise of the Option Grantee while in employment shall vest immediately and may be exercised by the Option Grantee's nominee or legal heirs* from the date of listing of shares of the Company on a Recognized Stock Exchange but not later than six months from such date.

Abandonment	All Vested Options shall stand cancelled. The Board, at its sole discretion shall decide the date of cancellation of Options and such decision shall be binding on all concerned.	All the Unvested Options shall stand cancelled. The Board, at its sole discretion shall decide the date of cancellation of Options and such decision shall be binding on all concerned.
Separation due to reasons other than those mentioned above	The Board will decide whether the Vested Options on the date of separation can be exercised by the Option Grantee or not, and such decision shall be final.	All Unvested Options on the date of separation shall stand cancelled with effect from that date.

POST LISTING SCENARIO	**VESTED OPTIONS**	**UNVESTED OPTIONS**
While in employment	All Options Vested after the Company gets listed can be exercised within a period of two years from the date of Vesting.	The Options would continue to vest as per the original Vesting schedule.
Resignation / Termination (Other than due to misconduct or breach of Company Policies / Terms of Employment)	All the Vested Options as on the date of submission of resignation / date of termination shall be exercisable by the Option Grantee before his last working day with the Company or before the expiry of the Exercise Period, whichever is earlier.	All Unvested Options on the date of submission of resignation/ date of termination shall stand cancelled with effect from that date.
Termination due to misconduct or breach of Company Policies / Terms of	All the Vested Options, which were not exercised at the time of such termination, shall stand cancelled with effect from the date	All Unvested Options on the date of such termination shall stand cancelled with effect from that date.

Employment	of such termination.	
Retirement / early Retirement approved by the Company	The Option Grantee can exercise all Vested Options immediately after, but in no event later than six months from the date of the Retirement.	All Unvested Options will stand cancelled as on the date of the Retirement, unless otherwise determined by the Board whose determination will be final and binding.
Termination due to Permanent Disability	All Vested Options, as on the date of Permanent Disability, may be exercised by the Option Grantee or, in case of his demise, the nominee or legal heirs*, immediately after, but in no event later than six months from the date of termination of the Option Grantee, or before the expiry of the Exercise Period, whichever is later.	All the Unvested Options, as on the date of Permanent Disability, shall vest immediately and can be exercised by the Option Grantee or, in case of his demise, the nominee or legal heirs* immediately after, but in no event later than six months from the date of termination of the Option Grantee.
Death	All Vested Options as on the date of demise of the Option Grantee may be exercised by the Option Grantee's nominee or legal heirs* immediately after, but in no event later than six months from the date of demise of the Option Grantee, or before the expiry of the Exercise Period, whichever is later.	All the Unvested Options as on the date of demise of the Option Grantee shall vest immediately and may be exercised by the Option Grantee's nominee or legal heirs* immediately after, but in no event later than six months from the date of demise of the Option Grantee.
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3. KEY LEGAL CONDITION - TAG ALONG & DRAG ALONG RIGHTS

	Benefits	Drawbacks
Example: If prior to listing Current Shareholders (Promoters) intend to sell such number of equity shares being not less than 51% of their share holding in the Company, then, Option Grantee who is in employment as on that date (Resigned employees not entitled) can exercise a proportionate number of the vested options & shall be bound to sell all the Equity Shares arising out of such exercise		
In case of any sale by the Current Shareholders to an Intended Purchaser, The Board of Directors may, at its discretion, vest all or part of the unvested options in an accelerated manner & require all Option Grantees to exercise all such vested options & subsequently, sell all the Equity Shares arising out of such exercise at the same price, terms and conditions as the sale by Current Shareholders provided the selling price of shares is not less than the exercise price of options		

HOW?

ESOP Scheme Design Perspective

	Design Perspectives	What is you Design Principle
1	Most employees have employment contracts that allow termination upon giving some notice. How will a startup want to tackle a situation where some options have vested upon an employee but now he wishes to quit?	
2	What happens if he is willing to work but the startup wants to terminate the employee's employment for 'cause' or even otherwise by simply giving the notice period?	
3	What if the employee has exercised some of his options and is a shareholder in the company but now wishes to resign or is asked to leave?	
4	A startup would definitely not want an ex-employee to hold equity in its venture when such employee could very well be working for, say, a competitor	

Accordingly, terms of an ESOP scheme have to be carefully thought out and discussed with the legal advisors.

Key Steps

- Get an ESOP scheme drafted and approve it in a shareholders' meeting.
- Once an ESOP scheme is approved, a Letter of Grant should be issued to the employee informing him
    a. how many options are being granted
    b. what the vesting period would be
    c. how the exercise price will be determined, should employee exercise the vested options.

- In the event an employee wishes to exercise any of his vested options, he should make an Exercise Application to his employer company pursuant to which his options would be converted into equity.
- ESOP schemes are audited and are referred to by auditors in their audit report. Accordingly, they cannot be back dated, especially when an audit report for the previous financial year has been prepared. Therefore, it is important to understand the legal regulations surrounding ESOPs before granting stock options to any employee

EXAMPLE OF VESTING SCHEDULE

Date of Grant: ___________________

Name: ______________

Number of options: __________

Exercise Price: Rs ___ per option

Exercise period: As mentioned in the EESOP Agreement

Vesting Schedule:

Options will vest over the next ______ years subject to continuous employment with the Company and fulfillment of performance parameters as follows:

Part A: _________ Options
(Basis of vesting: Continued Employment – 50%)

Date of Vesting	Number of Options
TOTAL	

Part B: __________ Options
(Basis of vesting: Performance – 50%)

Performance Matrix

Date of Vesting	Maximum options that can vest	Based upon
		Performance matrix below
TOTAL		

Options will vest, based on the Performance Matrix below:

Performance rating criteria*	Percentage of options that would vest
4 – Excellent	100% of Maximum
3 – Good	75% of Maximum
2 – Average	25% of Maximum
1 - Poor	NIL

*Based on achievement of the Annual Targets set by the management at the beginning of the Financial Year

OTHER USEFUL TOPICS TO CONSIDER

- **WHAT IS THE OPTIMUM SIZE OF THE ESOP PLAN**
- **HOW DO YOU ALLOCATE ESOPS AMONGST EMPLOYEES**
- **HOW ARE TAXES CALCULATED ON ESOP?**
    - There can be two stages with respect to levy of tax on shares allotted under ESOP:
    - First levy occurs when shares are allotted to the employee after he has exercised his option on completion of the vesting period and
    - Second levy occurs when the employee opts to sell the allotted shares under the ESOP.
- **HOW SHOULD ESOP BE REFLECTED IN A SHARE CAP TABLE?**
- **HOW DOES DILUTION AT A STARTUP FOR FOUNDERS WORK WITH ESOP AND INVESTMENT FROM VC**

THANK YOU

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