

Stock Options and Acquisitions

What options do employees
have?

August 2020

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About NDA

We are an India Centric Global law firm (**www.nishithdesai.com**) with four offices in India and the only law firm with license to practice Indian law from our Munich, Singapore, Palo Alto and New York offices. We are a firm of specialists and the go-to firm for companies that want to conduct business in India, navigate its complex business regulations and grow. Over 70% of our clients are foreign multinationals and over 84.5% are repeat clients.

Our reputation is well regarded for handling complex high value transactions and cross border litigation; that prestige extends to engaging and mentoring the start-up community that we passionately support and encourage. We also enjoy global recognition for our research with an ability to anticipate and address challenges from a strategic, legal and tax perspective in an integrated way. In fact, the framework and standards for the Asset Management industry within India was pioneered by us in the early 1990s, and we continue remain respected industry experts.

We are a research based law firm and have just set up a first-of-its kind IOT-driven Blue Sky Thinking & Research Campus named Imaginarium AliGunjan (near Mumbai, India), dedicated to exploring the future of law & society. We are consistently ranked at the top as Asia's most innovative law practice by Financial Times. NDA is renowned for its advanced predictive legal practice and constantly conducts original research into emerging areas of the law such as Blockchain, Artificial Intelligence, Designer Babies, Flying Cars, Autonomous vehicles, IOT, AI & Robotics, Medical Devices, Genetic Engineering amongst others and enjoy high credibility in respect of our independent research and assist number of ministries in their policy and regulatory work.

The safety and security of our client's information and confidentiality is of paramount importance to us. To this end, we are hugely invested in the latest security systems and technology of military grade. We are a socially conscious law firm and do extensive pro-bono and public policy work. We have significant diversity with female employees in the range of about 49% and many in leadership positions.

Accolades

A brief chronicle our firm's global acclaim for its achievements and prowess through the years –

- **Benchmark Litigation Asia-Pacific:** Tier 1 for Government & Regulatory and Tax
2020, 2019, 2018
- **Legal500:** Tier 1 for Tax, Investment Funds, Labour & Employment, TMT and Corporate M&A
2020, 2019, 2018, 2017, 2016, 2015, 2014, 2013, 2012
- **Chambers and Partners Asia Pacific:** Band 1 for Employment, Lifesciences, Tax and TMT
2020, 2019, 2018, 2017, 2016, 2015
- **IFLR1000:** Tier 1 for Private Equity and Project Development: Telecommunications Networks.
2020, 2019, 2018, 2017, 2014
- **AsiaLaw Asia-Pacific Guide 2020:** Tier 1 (Outstanding) for TMT, Labour & Employment, Private Equity, Regulatory and Tax
- **FT Innovative Lawyers Asia Pacific 2019 Awards:** NDA ranked 2nd in the Most Innovative Law Firm category (Asia-Pacific Headquartered)
- **RSG-Financial Times:** India's Most Innovative Law Firm 2019, 2017, 2016, 2015, 2014
- **Who's Who Legal 2019:**
Nishith Desai, Corporate Tax and Private Funds – Thought Leader
Vikram Shroff, HR and Employment Law- Global Thought Leader
Vaibhav Parikh, Data Practices - Thought Leader (India)
Dr. Milind Antani, Pharma & Healthcare – only Indian Lawyer to be recognized for 'Life sciences-Regulatory,' for 5 years consecutively
- **Merger Market 2018:** Fastest growing M&A Law Firm in India
- **Asia Mena Counsel's In-House Community Firms Survey 2018:** The only Indian Firm recognized for Life Sciences
- **IDEX Legal Awards 2015:** Nishith Desai Associates won the “M&A Deal of the year”, “Best Dispute Management lawyer”, “Best Use of Innovation and Technology in a law firm” and “Best Dispute Management Firm”

Please see the last page of this paper for the most recent research papers by our experts.

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1. Employee Stock Options

I. Introduction

Employee stock options (“**ESOPs**”) provide employees an opportunity to acquire a share in the wealth that they have helped create for the company by having an option to purchase stocks/shares of the company at a concessional rate. Companies use stock options as a tool to retain and reward their rainmakers and incentivize potential employees to join the company.

An option under the ESOP is a right (but not an obligation) granted to an employee to apply for the shares of the company at a future date at a pre-determined price. ESOPs are generally issued to employees pursuant an employee stock option plan which details out the mechanism for grant of options and conditions attached to them. Employees are provided a grant letter with respect to the options issued which inter alia contain terms and conditions in relation to exercising such options, requirements for vesting, the vesting period and exercise price.

II. Legal framework for issuance of ESOPs in India

The (Indian) Companies Act, 2013 (“**Companies Act**”) along with the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 allow an Indian company to grant options to its directors (excluding independent directors), officers, permanent employees of the company (working in India or outside India) or of its holding company or its subsidiaries or joint ventures¹ in India or overseas.² The Companies Act specifically excludes promoters or persons belonging to the promoter group and directors who directly or indirectly hold more than 10% of the outstanding equity shares of the company from being issued options.³ The Companies (Share Capital and Debentures) Rule, 2014 further lists down the terms and conditions for structuring and implementation of ESOPs by an Indian unlisted company.⁴ ESOP plans floated by public listed companies must be in compliance with Securities and Exchange Board of India (Employee Share Based Payments) Regulations, 2014.

The Companies Act inter alia mandates a minimum period of 1 (one) year between the grant of options and their vesting.⁵ Vesting may be subject to time or performance linked conditions. Options whose vesting period is complete are termed as ‘vested options’. Employees can pay the pre-determined exercise price and be issued shares against options which are vested. Until the options are vested they are termed as ‘unvested options’.

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1. While the Companies Act and the rules thereunder, does not specifically provide for issue of stock options to employees of joint ventures, the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 provides for the same.
 2. Section 2 (37) of the Companies Act, 2013 read with Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014 and Rule 8 of Foreign Exchange Management (Non-debt Instruments) Rules, 2019
 3. As per Rule 12 (c) of the Companies (Share Capital and Debenture) Rules, 2014, the restriction on issuing of options to the promoter and directors holding more than 10% of the outstanding equity share capital of the company does not apply to ‘Startups’ recognised by Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry Government of India, Government of India for a period of 10 (ten) years from the date of their incorporation.
 4. Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014.
 5. Rule 12 of the Companies (Share Capital and Debenture) Rules, 2014.

II. ESOPs in share acquisitions

When a company which has issued options to its employees is being acquired by another company, the acquirer may want to replace the options issued by the target with options of the acquirer entity. Typically, intimation about an acquisition may trigger concerns in relation to integration and changes in terms of employment amongst employees. Considering the commercial, legal and tax implications of ESOPs and apprehensions of employees, structuring the treatment of existing ESOPs issued by the target company is one of the key considerations in an acquisition.

At the time of acquisition of a company, the options granted to employees may either be vested and exercised or vested and unexercised or unvested. Depending on the nature of the options, the acquirer may choose to structure them:

- i. **Cash-out of options in lieu of exercise:** The acquirer may choose to cash out the options held by the employees of the target in lieu of the employees exercising the options and being issued shares. Cashing out would involve termination of the options and payment of a sum equal to the fair market value of the shares of the target or the price at which the shares are being acquired by the acquirer less the agreed exercise price. Some ESOP plans may even provide for accelerated vesting of options in case of occurrence of certain events (such as change in control of the target company, acquisition, liquidation etc.), in which case the company may be able to accelerate vesting of all or some of the unvested options depending on the commercials agreed with the acquirer and then cash them out. An important consideration in case of accelerated vesting is to ensure that the cliff / vesting period of 1 year under the Companies Act is adhered to. Further, some ESOP plans may not necessarily provide for a cash out or even accelerated vesting in which case the ESOP plan will need to be amended prior to such events to allow for such actions. While the Companies Act allows companies to vary the terms of their ESOP plans (where options have not been exercised yet), they must ensure that such variation is not prejudicial to the interests of the option holders.⁶

The payouts made to employees as a result of cash-outs should be taxable as salary income in the hands of the employees and consequently, subject to tax deduction at source by the target company.

- ii. **Surrender of unvested options and replacement with options of the acquirer:** Another option that the acquirer may consider is cause the employees to surrender the unvested options and replace it with options of the acquirer post the acquisition of the target company i.e. when the target has become a subsidiary of the acquirer. This option would be available only in the case of employees who continue to be employed with the target even after the acquisition. In the event the acquirer is an Indian resident entity, then the acquirer will only need to ensure compliance with the Companies Act (and SEBI ESOP Regulations in case it is a listed entity) for issuance of options to the employees of the entity being acquired.

If the acquirer is a foreign entity, then the acquirer will need to ensure compliance with Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 issued by Reserve Bank of India ("**RBI**") for issuance of ESOPs to employees or directors of the Indian target ("**ODI Regulations**"). Under the ODI Regulations, Indian residents are permitted to acquire shares under a cashless ESOP scheme issued by a company outside India (provided it does not involve any remittance from India).⁷ Further, an individual resident in India who is an employee or a director of a subsidiary in India of a foreign company or of an entity in India in which the foreign company has direct or indirect equity stake is allowed to purchase shares offered by the foreign

6. Rule 12 (5) (a) of the Companies (Share Capital and Debentures) Rules, 2014

7. Regulation 22 (1) of the ODI Regulations.

company under its ESOP scheme, provided that the shares under the ESOP scheme are being offered by the issuing company globally on a uniform basis and an annual return is submitted by the Indian company to the RBI through the AD bank giving details of remittances / beneficiaries, etc.⁸ In other words, in case of issue of options for cash, it may be difficult for the acquirer to issue options under a ESOP policy / scheme which is applicable only to the entity being acquired and will need to ensure that the scheme applies globally across all its entities in various jurisdictions.

The terms of surrender will need to be mutually agreed by the target company and the employee. Instead of causing employees to surrender the options, the company may also choose to terminate the unvested options. Again, it is important that the ESOP plan of the target company provides for such termination at the instance of the company. It may be difficult to vary the terms of the ESOP plan to provide for termination as that may be construed to be a variation prejudicial to the interests of the option holders. Further, issue of new options under an entirely new plan of the acquirer may result in new vesting periods, exercise price and even performance linked conditions. All the employees of the target company who were option holders may not even be considered eligible to receive options under the ESOP plan of the acquirer. Therefore, acquirers may face resistance from employees in the case of a requirement to surrender the options they hold.

While surrender of options and replacement with options of the acquirer should not have any tax implication, under Indian tax laws, the fair market value⁹ of any securities allotted or transferred, directly or indirectly, by the employer, or former employer, free of cost or at a concessional rate to an employee is treated as the taxable salary income of the employee. Therefore, while the issue of options should not trigger a taxable event, any allotment of shares to an employee resident in India pursuant to exercise of options should be considered as a perquisite and will trigger perquisite (or salary) taxation in the hands of the employee on the fair market value of the shares (as on the date of allotment).

iii. Acquisition of vested and exercised options: If any of the employees of the target have exercised their vested options and converted them into shares, the acquirer will need to purchase the shares held by such employees along with the remaining shareholders of the target company to ensure that it has complete control over the company. The shares held by existing employees of the target can be purchased by the acquirer at the same value at which the acquirer is purchasing the remaining shareholders to incentivize the employees to sell the shares held by them.

In this situation, any gains made by the employee shareholder by way of transfer of their shares to the acquirer may be subject to capital gains tax at the hands of the employee shareholder.

III. Conclusion

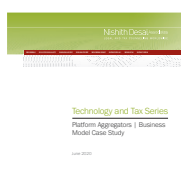


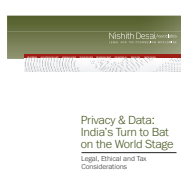
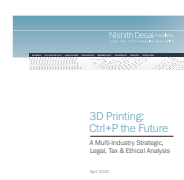



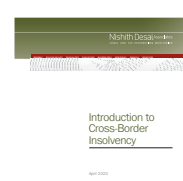
ESOPs play a crucial role in corporate acquisitions from a commercial, legal as well as regulatory perspective. While devising ESOP plans, companies must consider any possible challenges that may arise at the time of an acquisition such as ensuring there is an ability to cash out vested options and provide for any issues that may arise in case of employees who may have exercised their options and are no longer with the target. In order to protect the interest of the target company and the other shareholders of the target, the ESOP plan may prescribe for a power of attorney to be executed by the employee shareholder wherein the promoter/board appointed representative will have the power to vote on behalf of the employee shareholder in relation to specific matters such as amendment to the charter documents of the company, issuance of further shares, raising of debt etc. The ESOP plan and the

8. Regulation 22 (2) of the ODI Regulations.

9. The FMV must be calculated in accordance with the rules prescribed in this regard.

charter documents of the company often contain restrictions on the transfer of shares by the employee shareholders, such as restriction on transfer to competitors of the company, a right of first refusal in favor of the promoters before the employee shareholders sell their shares to a third party or a right to drag along the employee shareholders in case of a change in control or acquisition of the company. Companies may however, face challenges when the employees who are no longer employed with the company are untraceable or are not satisfied with the price offered by the acquirer.

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TITLE	TYPE	DATE
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Bombay High Court quashes 197 order rejecting Mauritius tax treaty benefits	Tax	May 2019
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Research @ NDA

Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Our dedication to research has been instrumental in creating thought leadership in various areas of law and public policy. Through research, we develop intellectual capital and leverage it actively for both our clients and the development of our associates. We use research to discover new thinking, approaches, skills and reflections on jurisprudence, and ultimately deliver superior value to our clients. Over time, we have embedded a culture and built processes of learning through research that give us a robust edge in providing best quality advices and services to our clients, to our fraternity and to the community at large.

Every member of the firm is required to participate in research activities. The seeds of research are typically sown in hour-long continuing education sessions conducted every day as the first thing in the morning. Free interactions in these sessions help associates identify new legal, regulatory, technological and business trends that require intellectual investigation from the legal and tax perspectives. Then, one or few associates take up an emerging trend or issue under the guidance of seniors and put it through our "Anticipate-Prepare-Deliver" research model.

As the first step, they would conduct a capsule research, which involves a quick analysis of readily available secondary data. Often such basic research provides valuable insights and creates broader understanding of the issue for the involved associates, who in turn would disseminate it to other associates through tacit and explicit knowledge exchange processes. For us, knowledge sharing is as important an attribute as knowledge acquisition.

When the issue requires further investigation, we develop an extensive research paper. Often we collect our own primary data when we feel the issue demands going deep to the root or when we find gaps in secondary data. In some cases, we have even taken up multi-year research projects to investigate every aspect of the topic and build unparalleled mastery. Our TMT practice, IP practice, Pharma & Healthcare/Med-Tech and Medical Device, practice and energy sector practice have emerged from such projects. Research in essence graduates to Knowledge, and finally to *Intellectual Property*.

Over the years, we have produced some outstanding research papers, articles, webinars and talks. Almost on daily basis, we analyze and offer our perspective on latest legal developments through our regular "Hotlines", which go out to our clients and fraternity. These Hotlines provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our Lab Reports dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research articles and disseminate them through our website. Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with much needed comparative research for rule making. Our discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged. Although we invest heavily in terms of time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

As we continue to grow through our research-based approach, we now have established an exclusive four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug-Raigadh district. **Imaginarium AliGunjan** is a platform for creative thinking; an apolitical ecosystem that connects multi-disciplinary threads of ideas, innovation and imagination. Designed to inspire 'blue sky' thinking, research, exploration and synthesis, reflections and communication, it aims to bring in wholeness – that leads to answers to the biggest challenges of our time and beyond. It seeks to be a bridge that connects the futuristic advancements of diverse disciplines. It offers a space, both virtually and literally, for integration and synthesis of knowhow and innovation from various streams and serves as a dais to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear your suggestions on our research reports. Please feel free to contact us at research@nishithdesai.com

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