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Employee Ownership Planning through ESOP / PSOP

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We sit right in the middle of startups which are looking for affordable and yet reliable legal services and a talented pool of lawyers looking to work for the right clients. We ensure that the pool, including lawyers sitting in interior regions of India secure work and our dedicated team reviews it so that the startups still get high quality work.

So if you are looking for someone to support you with affordable, and yet, high standard contract drafting / compliance services while at the same time contributing to the development of budding professionals in the interior regions of India, drop us a mail at hello@acciolegal.com!

Introduction

Employee ownership planning can be accomplished in various ways - whether it is through shares being issued to employees directly as sweat equity, through employee stock purchase schemes and issue of shares at discounted rates to employees during an IPO, or through grant of options.

The most popular form of employee ownership is an Employee Stock Option Plan (ESOP). However, a Phantom Stock Option Plan (PSOP) can also be an alternative, and this is comparatively lesser known.

In this guide, we have drawn a comparison between the features of an ESOP vs. PSOP. We hope it will be helpful to you!

For every start-up that has chosen to grant options to its employees, there's a choice between adopting ESOP or PSOP. Therefore, it is best to look at both the plans, understanding their pros and cons.

Employee Stock Options

Employee stock options can incentivise the employees by giving them a choice to buy shares in the company. Such choice can be given to directors, key personnel, permanent employees and officers to purchase/subscribe to the shares of the company at a predetermined price at a future date as mentioned in the letter of grant. Such grants are made under the terms of an employee stock option plan, drafted and revised from time to time.

Advantages

1. Universal acceptability – This is the most commonly used plan for employee ownership, and is widely accepted in various countries, including the US and Singapore.

2. Real Ownership – The employees who exercise their options become real shareholders, putting them at the same level as any founder or investor, connecting them strongly with the company.

3. High appreciation – Sometimes, startup valuations can touch the sky, and a stock option granted for a share of Rs.10 can touch the price of Rs.10,000. If it does not, well, it's

still a choice to the employee whether or not to exercise.

Disadvantages

1. If the shares cannot be liquidated (either through buyback or through sale for a long period, employees can start becoming impatient since the benefit is on paper and not liquidated.

2. There is a tax liability on the employee at the time of exercise and for the capital gains at the time of selling the shares.

3. On exercising the options, the employees become shareholders and sit on the cap table of the company, and their signatures are required for any future shareholders agreement.

Phantom Stock Option

Phantom Stock Options can be granted to employees and non-employees, both, and the vested stock options can be liquidated either at the time of the sale of the company or when the company has adequate cash flows to buy these back. The best aspect is the fact that since no real shares are issued, there is no dilution of share capital.

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Advantages

1. Flexibility – It involves only a contractual agreement and no real shares are issued/transferred, hence, it is more like a bonus payment, eliminating some procedural compliances and tax implications.

2. Ease of payments – Employees do not have to wait until an exit or until someone buys the shares. Whenever the company has extra cash flow, it can incentivise the employees by cash settling the options.

3. No shareholding or voting rights - PSOP grantees do not get any voting rights, thus removing any difficulties of coordination in case of a financing transaction and entering into shareholder agreements.

Disadvantages

1. Since the employees do not actually get the shares, it does not give them the same feeling of ownership.

2. It isn't necessary to get a PSOP scheme approved by the shareholders, but it amounts to giving notional rights which are similar to shares without their approval.

3. PSOPs can be granted even to advisors and consultants, and this might result in dilution of more equity than is warranted

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Comparative Analysis in the context of India

Particulars	ESOPs	PSOPs
Meaning	It's a choice given to employees to purchase equity in the company.	It's a choice given to employees to participate simply in the capital appreciation of the shares.
Governed by	Section 62(1)(b) of the Companies Act r/w Rule 12 of the Companies (Share Capital and Debenture) Rules, 2014	The Agreement executed between the Company and the employee/non-employee.
Eligibility	Directors, Key personnel, permanent employees and even the promoters in the start-ups are eligible.	Both employees and non-employees such as promoters, agents, consultants, and advisors

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Effect on dilution	Both Founders' and Investors' equity will be diluted when options are exercised.	While PSOP owners do not sit on the cap table, the PSOP holders may have a share in the amount received on the sale of the company.
Consideration paid	Employees have to pay the exercise price. It is not free.	Employees have to pay nothing. The PSOPs are cash settled at value minus notional exercise price.
Valuation	Ideally, you would need to get a valuation done to determine the correct exercise price.	No valuation is required, because the exercise price is notional and depends on what is agreed between the company and option holder.
Procedural requirement	The plan needs to be approved by the board and the shareholders of the company by passing a	Only a board resolution is required.

	special resolution. Company needs to maintain a register in form of SH-6	No requirement to maintain any register as such.
Dividend and voting rights	ESOP holders become shareholders on exercise and get rights to dividends and also voting rights	PSOP holders do not get any dividends or voting rights normally, but the company can grant profit sharing rights like dividends.
Disclosure	The Board shall disclose the details of the scheme in their report	No disclosure required

Conclusion

ESOPs and PSOPs both offer unique advantages, both to the company and the employee, it is more about knowing when to use, and what to use.

While ESOPs can be an instrument for the companies to secure expensive talent, PSOPs can be a tool to provide cash benefits to employees and others, without getting into the complexities of share capital dilution, procedural formalities, disclosures and compliances.

It is said that knowledge is not enough, without understanding how to implement it. It is not just the knowledge but the timely implementation that makes the difference.

Note: You may choose ESOPs or PSOPs, as per your suitability and objectives or as advised by your legal advisor, but it is very important that the Scheme or the Plan on which such employee participation is based should to be drafted with precision, and due consideration of legal, commercial, compliance and business implications on a long term basis.