

Ministry of Corporate Affairs Notification relaxing restrictions in respect of Sweat Equity Shares and Employee Stock Options for Start-up Companies

1. Background

- 1.1** Ministry of Corporate Affairs has issued the Companies (Share Capital and Debentures) 3rd Amendment Rules, 2016 ("Amendment Rules") vide Notification no. G.S.R. 704(E) dated July 19, 2016 which has amended specific provisions of the Companies (Share Capital and Debentures) Rules, 2014 ("Companies Rules") with a view relax restrictions on issue of Sweat Equity Shares ("Sweat Equity") and Employee Stock Options ("ESOP") particularly for start-up companies.
- 1.2** The Companies Rules as originally notified had come in to force with effect from April 01, 2014 since more than 2 years from now and used to provide for all unlisted companies including startup companies that:
- a)** In respect of Sweat Equity under Rule 8(4) of the Companies Rules: No company shall issue Sweat Equity Shares beyond limit of 15% of existing paid-up equity share capital during any one year, subject to overall limit of 25% paid-up equity share capital at any time.
 - b)** In respect of ESOPs under Rule 12(1)© of the Companies Rules: ESOPs cannot be granted even to an employee/ director who is a promoter, or a person belonging to the promoter group i.e. a promoter's immediate relative, nor a director who either himself or through his relative or through any body-corporate, directly or indirectly, holds more than 10% of the outstanding equity shares of the company.
- 1.3** Whereas in the meantime, Company Law Committee ("CLC") was constituted with a view to provide its recommendation to deal with issues arising out of implementation of the recently enacted Companies Act, 2013. This was followed by a nationwide start-up movement which was officially launched by the Central Government on January 16, 2016 primarily with a view to encourage entrepreneurship, innovation and sustainable economic growth. The CLC after considering representations of various professional/statutory bodies and Industry Associations, gave its report in respect of Companies Rules on February 01, 2016 with following recommendations among others:
- (a)** "...start-ups, who may require such instruments may be permitted to issue sweat equity shares beyond twenty-five percent and up to fifty percent of the paid up equity share capital."; and
 - (b)** "...in order to encourage start-ups, this rule may be relaxed to enable issuance of ESOPs to

promoters who may be working as employees or employee directors or whole time directors which would help the promoters to gain from increase in future valuation of the company without in anyway impacting finances of the company during its initial years.”

- 1.4 It seems that the Amendment Rules have been notified in due adoption of recommendations of CLC. By way of this newsletter, we wish to highlight and analyze the important aspects of the Amendment Rules particularly on Sweat Equity and ESOPs that would help understanding the benefits and need for action, if any.

2. Amendments to the Companies Rules: As it is

- 2.1 Addition of second proviso to Rule 8(4): “Provided further that a start-up company, as defined in notification number GSR 180(E) dated 17th February, 2016 issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, may issue sweat equity shares not exceeding fifty per cent of its paid up capital up to five years from the date of its incorporation or registration.”
- 2.2 Addition of a proviso to Rule 12(1)(c): “Provided that in case of a start-up company, as defined in notification number GSR 180(E) dated 17th February, 2016 issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry Government of India, Government of India, the conditions mentioned in sub-clause (i) and (ii) shall not apply up to five years from the date of its incorporation or registration.”

3. Analysis

- 3.1 The amended Rule 8(4) stands to carve out an exception for a start-up company facilitating issue of Sweaty Equity to the tune of 50% of its paid-up capital to the employees and directors from time to time, up to a period of 5 years from the date of incorporation. Earlier, there was not only a restriction in term of overall ceiling of 25% of paid-up equity capital but also that any company (including a start-up) could issue Sweat Equity only after expiry of 1 year from the date of commencement of business as per Section 54 of the Companies Act, 2013. This Amendment Rules seems to have relaxed the time period restriction for the maiden issue of Sweat Equity, as well.
- 3.2 It may be noted that there is no special concession contemplated in the said amended Rule for a promoter from Sweat Equity perspective. Also other pre-requisites as to requirement of special resolution, bringing-in of value addition/ know-how/ intellectual property rights by proposed Sweat Equity allottee, valuation, accounting, disclosures, etc. are all intact for a start-up company. Quality/ value of innovation is expected in such a way as to occupy up to 50% of the share capital.
- 3.3 Whereas the amended Rule 12(1)(c) seeks to remove the prohibitions that used to apply up till amendment on a promoter, a person belonging to a promoter group, and a director holding (directly or indirectly) more than 10% in the outstanding equity share capital in case of a start-up company, for a period of 5 years from the date of incorporation. This means ESOPs can be granted up to 5 years from the date of incorporation, irrespective of whether the concerned

ESOP Plan of a start-up company envisages vesting period and exercise period of any length. What is important is 'grant' within this qualifying period.

- 3.4 Even if a promoter of a start-up company seems to be eligible, a meticulous reading suggests that the promoter who is working an employee or director is only eligible. Passive promoters, as the provision states may not be eligible. Care may be taken in this regard.
- 3.5 Another and probably the most significant observation is that all these beneficial amendments are for a company which qualifies to be a "start-up company" as per Notification No. GSR 180(E) dated February, 17 2016 issued by the Department of Industrial Policy and Promotion ("DIPP"), Ministry of Commerce and Industry, Government of India. This DIPP Notification states that a company working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property, can be regarded as a start-up up to a period of 5 years from the date of its incorporation, provided that its turnover does not exceed Rs. 25 Crores in any of the financial years during this 5 year period and that it is recognized as such by DIPP.
- 3.6 To conclude, it can be said that given the limited tenure of retaining status as a start-up company either from DIPP Notification, or from the Amendment Rules perspectives; a start-up company which has either not implemented ESOPs for the only reason that promoters cannot be covered, or that it has implemented an ESOP Plan but promoters were deliberately (lawfully) excluded, or that issue of Sweat Equity was stopped at 25% of equity capital, may act timely. Timely action is also supported by fast growing fair value of shares of start-up companies, as any delay may result in higher purchase price or accounting cost as there is no change in the accounting principles governing issue of ESOPs and Sweat Equity.

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