

# Cross-border ESOPs: Challenges to earn-out acquisition structures under the new overseas investment framework in India

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## 1 Introduction

There has been a marked growth in cross-border business frameworks in recent years, with Indian businesses, both old and new, exerting their presence in offshore markets and vice versa. Foreign entities with wholly owned subsidiaries in India have increasingly started to grant remunerative incentives to their employees in such Indian subsidiaries through restricted stock units or employee stock options (ESOP), with the Indian foreign exchange regulator, the Reserve Bank of India (RBI), making specific allowances for the same through legislative changes over the course of the last few years. This allows for foreign entities to implement an ESOP plan on a globally uniform basis for all its multinational subsidiaries and permits Indian employees of such subsidiaries to enjoy the benefits of the appreciation of equity value of the employer parent entity abroad. However, there has been some ambiguity with respect to the implementation of global acquisition scenarios, wherein a foreign entity with Indian ESOP shareholders (being employees of such foreign entities in India) is acquired by another foreign entity through a share transfer process, merger or restructuring of similar nature.

This update discusses some key challenges arising under the new overseas investment regime in India when providing exits or implementing earn-out structures for Indian residents holding employee stock options in foreign companies.

## 2 Applicable regulatory framework for grant of ESOPs in entities abroad

The acquisition of equity by Indian residents in entities abroad is governed by the Foreign Exchange Management Act, 1999, Foreign Exchange Management (Overseas Investment) Regulations 2022, and Foreign

Exchange Management (Overseas Investment) Rules, 2022 thereunder, along with supplementary notifications and circulars issued by RBI from time to time (collectively, the **FEMA OI Regulations**).

Under the FEMA OI Regulations, the acquisition of capital stock of a foreign company through:

- a. the exercise of ESOPs granted under the employee stock option plan of a foreign company by an Indian resident employee, or
- b. the issue of minimum qualification shares issued for holding a management post in a foreign entity, or
- c. the acquisition of sweat equity shares by a resident individual,

would be classified as an overseas portfolio investment (**OPI**), where such acquisition is less than 10% of the capital stock of the foreign company.

The FEMA OI Regulations specifically draw a distinction between OPI and overseas direct investments (**ODI**) wherein ODI is defined to mean investment in equity share capital of foreign entities by resident or legal entities in India, or investment of 10% or more in a listed foreign entity (with or without control), or investment of less than 10% with control in listed foreign entities.<sup>1</sup>

Investments made under either of these routes would continue to be treated as OPIs or ODIs (as the case may be at the time of investment) irrespective of the shareholding thresholds for qualifying as ODIs and OPIs being breached subsequently, or subsequent loss of control. The financial regulator in this regard seems to have drawn a distinction based on the intention of the initial investment - with ODIs being subject to more restrictive investment conditions, and being treated at par with more sophisticated investors, in comparison to OPIs who might be portfolio investors and/or employees receiving remuneration packages in form of equity investments. Interestingly, in case of founder shareholders (being Indian resident shareholders) who hold significant remunerative packages in foreign holding companies abroad (with a stake of more than 10% of the fully diluted share capital of such foreign entity) such grants would also qualify as ODIs and be subject to limitations and allowances permitted by the RBI under the ODI regime.

### 3 Limitations under the FEMA OI Regulations

The FEMA OI Regulations have run into practical difficulties in providing an exit to employees of Indian entities (who are Indian resident shareholders) holding equity instruments of offshore entities (as a result of the exercise of ESOPs held by such Indian employees). Earn-out structures are tricky to implement in the acquisition space *vis-à-vis* an Indian resident OPI, and issues revolve around the permissibility of payment of deferred consideration and payment of indemnities by the Indian resident shareholders, on the sale of equity instruments held by them in such foreign company.

#### a. *Allowance for payment of deferred considerations and indemnities*

At the outset, the payment of any purchase consideration by a person resident outside India to an Indian resident shareholder would necessitate compliance with the applicable pricing guidelines, i.e., the consideration would be subject to a price arrived on an arm's length basis, taking into consideration the valuation as per any internationally accepted pricing methodology for valuation, and appropriate valuation reports would be required to be obtained in this regard.

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<sup>1</sup> For more information on the applicable framework for investments under the FEMA OI Regulations, please refer to [https://trilegal.com/knowledge\\_repository/new-regime-on-overseas-investment/](https://trilegal.com/knowledge_repository/new-regime-on-overseas-investment/)

While Regulation 7 of the FEMA OI Regulations includes specific provisions for the deferment of purchase consideration to sellers and implementation of related indemnity structures with respect to ODI investors, it leaves a vacuum, whether intentional or unintentional, with respect to OPI investors. The regulations do not expressly permit deferment of the payment of consideration for purchase of equity instruments by a person resident outside India from a person resident in India, where acquisition of such equity instruments is treated as OPI, nor speak of implementation of any indemnity mechanisms in relation to the same. A conservative view may thus be taken that such arrangements are prohibited since they are not expressly permitted, and specific enquiries made with the Indian authorised dealer banks (**AD Bank**) have confirmed this practice. This seems to be aligned jurisprudentially with the intent of the RBI to treat Indian OPI shareholders different from ODI shareholders, with the latter being treated at par with equity investors partaking in the equity risk profile of an investee entity.

b. ***Reporting requirements for pre and post-closing compliance for acquisitions***

What also remains to be considered for the aforesaid acquisition scenarios is the post-closing and pre-closing compliance requirements which are regularly monitored by the RBI through the prescribed Form OPI under the FEMA OI Regulations.

Form OPI has made it compulsory for the Indian subsidiary of a foreign company to disclose relevant information for ESOPs granted within the foreign parent company. This includes disclosures with respect to the amount of ESOP investment held abroad, ESOP investments, re-investments and disinvestments, and remittance and repatriation amounts, during the year. Additionally, the report also requires a declaration by the Indian subsidiary which includes the name of the foreign entity issuing or repurchasing the shares, the percentage interest and the shares or percentage interest allotted or repurchased during the relevant six-month period, and the number of employees/directors who acquired and sold shares during the six-month period.

## **4 Adoption of alternate mechanisms**

Consequently, the ambiguities discussed above along with the absence of specific permissions under the FEMA OI Regulations lead to stakeholders taking recourse to alternate structures to implement the economic objectives of an acquisition scenario of the foreign parent company. These include:

- a. implementing earn-out mechanisms for employee shareholders through additional remuneration packages (with certain tax considerations in mind to preferably route such payments from the Indian subsidiary, given the ambiguities around payment of such deferred earn-out consideration to former employees); or
- b. the deferred buyout of such employee shareholders which might need to be considered from the perspective of desirability of such minority employee shareholders subsisting in the acquired entity and fluctuations in valuations, depending on the timelines involved in the buyout.

## **5 Conclusion**

Considering the above, with respect to both global acquisitions and divestments, it is crucial for foreign companies to ensure that their acquisition structures are in compliance with the FEMA OI Regulations in relation to the reporting obligations of the Indian subsidiaries of target entities post-acquisition, and to analyse

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the limitations imposed under the FEMA OI Regulations in its treatment of capital stock acquired through exercise of ESOPs.

While the introduction of the newly formed overseas investment framework is a welcome move as it streamlines regulations with respect to overseas investments in India, we look forward to the RBI's formal clarifications on the issues discussed above. In the meantime, such structures remain open ended at the discretion of the AD Banks involved, for optimum structuring of employee stock option plans and employee benefit schemes, both pre and post completion of cross border acquisitions, in due compliance with the FEMA OI Regulations.

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