fact sheet

Designing Effective Share Incentives

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Preliminary

To design a really effective share incentive, one that will attract, retain and motivate key individuals, the company and its advisers must be able to "tell the right story".

Whenever a professional investor is asked to consider investing in a private company one of his first questions will be: "what is the plan for the exit?"

The investor does not want to be locked into an investment in a company. He wants to know, before he invests, when and how he is going to be able to sell. For the company founders this may be rather disconcerting. Here is an investor being asked to put in his money and one of the first things he asks "when can I expect to get my money out?".

However, it is a shrewd and fundamental question. The owner may regard the lifestyle benefits of owning the company to be more important and the thought of selling "his life's work" to be abhorrent.

Another question the shrewd investor will ask: "is the company going to pay me dividends and what will be the return (or yield) on my investment?"

Now it might be asked, what do these questions have to do with designing an effective share scheme: the answer is everything.

Astute employees may be every bit as sceptical as the investor. What is more they have the insider's knowledge of the real challenges facing the company if it is to be really successful.

Advisers will rightly say that the key is effective communication between the company and those to be awarded share incentives. This is undoubtedly essential but if the exit strategy has not been thought through, there will be no coherent story to tell.

An owner who cannot yet "grasp the nettle" of the exit may be better advised to pay generous cash bonuses as these can be readily understood and appreciated. A share scheme that is not properly thought through can damage a company in a number of ways, including altering the balance of power or creating confusion in the minds of its employees.

The benefits of share incentives

Research by the ESOP Centre (The Employee Share Ownership Centre: a not for profit research and membership organisation that promotes broad-based employee ownership in the UK and Continental Europe) has shown that companies with high levels of employee ownership consistently outperform those with no or lower levels of employee ownership.

This may be because employees who are co-owners behave like owners, which is good for the business. It is likely, though, there is something different at play here.

Anecdotal evidence suggests that those most effective at team building will be those instinctively inclined to share; to reward loyalty and hard work. It may be, therefore, that wider share ownership is indicative of the style and culture of the company founders.

A share scheme conceived simply as a means to celebrate collegiality is no bad thing. The football fan who proudly displays on the wall the share certificate of "his team" is demonstrating an important loyalty which is not to be lightly dismissed.

However, for a share scheme to be truly effective it must go much further than that. The owner must take the time and trouble to think through his exit plans and how these dovetail with the incentive scheme and the rewards to be offered.

The exit starting point

The exit alternatives for the company founder may be:-

1. a sale of the company to a trade buyer (perhaps a competitor);
2. a sale of the company to its management;
3. a transfer of the company to the family of the founder; or
4. the closure of the business.

An IPO (or flotation) is often mentioned as another exit alternative. However an IPO is more typically a partial sale used to build value ahead of a full exit by the founders.

It does not take much imagination to appreciate that each of these future alternatives may be a cause of nothing more than anxiety to management and employees. The sale to a trade buyer may lead to redundancies: a management buy-out may bring unwanted extra responsibilities and a family transfer may lead to very challenging issues of competence and change of culture. Closure of the business will naturally be a worry unless the management/employees are at an age where they too want to retire.

The company founder may be motivated by engineering, innovation or lifestyle, not principally by financial reward and may not be emotionally disposed to facing up to his own retirement and the importance of succession planning for the company.

Considering all of the alternative means of exit ahead of the design of a share scheme will be key to ensure communication is effective.

Target exit price

Having decided on the preferred route to exit the owner must fix his target price (net of tax) and the date to achieve that event. This will require forecasting of future growth in sales and net profits and the fixing of a suitable multiple of those net profits after tax.

If the expected exit is a trade sale the next step will be to determine the desired net of tax capital receipt by the employees who are to be incentivised.

Typically a figure of four times annual remuneration is considered the sort of capital sum that would be very motivational to an employee. The owner must also determine what key roles in the company should attract an equity reward.

The financial modelling described in this section will guide the determination of the percentage shareholding for the employee incentive. It will also allow a check to be made on whether this is consistent with the target exit sum for the founder.

Where a management sale is the preferred method of exit the modelling will need instead to focus on the transfer of ownership to the management team and the payments to be made to the founder. The share incentives for the management are designed here to incentivise the managers to the stage one exit and to give them the opportunity for a tax efficient share acquisition.

It is quite possible for a management sale initially to be the preferred exit but for the founder to conclude at a later date that a trade sale will be better for all concerned. The share incentive then becomes a method to give the employee a cash incentive rather than an equity stake.

Team building and flexibility over share awards

The team dynamic and relationships will likely be as important as the individual talents and hard work of each individual team member. As the company grows it may also be that one or more team members do not have the capability to fill a critical new role that will be required for an exit for the owner to be achieved.

These factors point to the good sense of adopting the following approach:-

- having a "probationary period" (perhaps 12 or 24 months) before a new team member becomes eligible for a share award;
- when awarding share options have the options vest (i.e. become capable of exercise) over a period of time in tranches: for example over three to five years;
- for the option agreement to provide for the automatic lapse of options if an employee leaves, at least so far as unvested shares are concerned;
- include, in the Articles of Association or Shareholders' Agreement, a buy-back provision applying to employee-held shares if the employee leaves. This should exclude founder-held shares. Careful thought should be given as to the price to be paid on any buy-back. Good leaver/bad leaver valuation provisions may be appropriate, so that a 'bad' leaver does not receive as much for each share as a 'good' leaver. The logic here is that the founder wants to lock the team in and reward those who contribute to the company reaching the planned exit.

Where share buy-back arrangements are to be included care must be taken that a tax charge under what is called the *restricted securities regime* will not affect the employee (and the company through employer's NIC costs). Please see our Everyman Legal Fact Sheet "The Restricted Securities Regime", if you would like further details.

Payment for shares by employees and the tax challenge

The price paid for shares once an option has vested can often be an emotive subject; the owner is handing over part of the company which he has worked hard to create. The purist may argue that if employees do not pay the full market price for their shares they will not value them. Furthermore, it is argued if they do not pay the proper market price the founder is himself giving away value.

In practice most employees are not in a financial position to pay for their shares and certainly not full market value. So most share incentives will be dead in the water if this philosophy is accepted.

The astute founder will (or at least should!) be more concerned with the value to be added to his own shareholding by a committed and incentivised management team, rather than the price being paid for their proportion of the shares. This is particularly so if the option or shares are made to vest over three to five years and are earned over that period by lower cash remuneration than might be earned elsewhere.

If the logic of a low/no value payment for shares is accepted then the stumbling block will be tax.

The acquisition of shares at below market value will be deemed an employment benefit, the market value of which will be chargeable to income tax. What is more, if at this point of the acquisition the shares are "readily realisable" (e.g. because the company is being sold) then the company must operate PAYE and pay employer's NIC on the value awarded.

Moreover, if for the reasons stated above the company wishes to award options rather than immediately issue shares then the growth in value of the option shares will be liable to income tax (but see below for qualifying EMI options).

There are two techniques that can be employed to eliminate or mitigate this tax issue:-

- reduce the value of the ordinary shares to be awarded to employees through the creation of founder-held preference shares. If the company is valued at £1m today perhaps the share capital is reorganised and the founders take £1m of Preference Shares that are paid out first on an exit; and/or
- award tax-advantaged share options where the growth in value between the date of grant of the option and the date the option is exercised is not subject to income tax. The most popular form of tax-advantaged option is the EMI (or Enterprise Management Incentive) share option. These could also be directly linked to an exit so that the options only vest (and become exercisable) on a change of control. By using such options the time for paying for the shares is deferred and the exercise price will be paid out of the sale proceeds (i.e. the options are exercised immediately before a sale of the shares). This, though, depends on a cash exit not a management buy-out exit. The alternative could be a company loan to the employee to be repaid out of future dividends.

Types of share scheme

There are, broadly speaking, three different types of employee ownership schemes:

1) A share purchase scheme.

2) A share option scheme either approved by HMRC or with tax advantages from following prescribed rules.

3) An unapproved share option scheme. Sometimes it is not possible to meet the criteria of the HMRC approved or tax-advantaged schemes. In these circumstances, an unapproved share option scheme (without the tax advantages) may be the only alternative.

A brief summary of these schemes is set out below:

Share purchase scheme

Employees are issued shares in the Company immediately at an agreed valuation. The shares are often granted with restrictions relating to matters such as dividends, transfers of shares, voting rights and have compulsory buy-back provisions applying to the shares of leavers. Some or all of these restrictions could fall away after a period of time.

This could be an expensive route if the company has a profitable track record and the company wishes to provide free or low cost shares, but there are ways of addressing this – see the section above on Payments for Shares by Employees.

Tax advantaged schemes

A share scheme approved by HMRC or following tax guidelines has various tax advantages. The approved schemes in place are currently the SAYE (Save As You Earn) sharesave plan, CSOP (Company Share Option Plan) and the SIP (Share Incentive Plan) which are explained in more detail below.

Another scheme, which does not require approval but is recognised by HMRC is the EMI (Enterprise Management Incentive) scheme which is commonly awarded either as a 'standard' EMI Option Scheme or an Exit Based EMI Option Scheme (see below).

Standard EMI Options

In summary this scheme allows tax-advantaged options to be granted to employees: by tax-advantaged we mean that the growth in value of the EMI options will be subject to capital gains tax rather than income tax. A summary of the tax treatment at the various stages in the life of an EMI Option is as follows:

1) Grant of EMI Option – at this point in time there is no tax liability at all for the employee

2) Exercise of EMI Option (once the options have vested) – if market value (at the date of grant) is paid to acquire the shares there is no income tax liability at this stage. If the exercise price is less than the market value when income tax will be payable on the difference between (a) the market value of the shares at the date of grant and (b) the price paid on exercise.

3) Sale of the Shares – Capital Gains Tax will be payable at a rate of 10% with Entrepreneur's Relief.

To maintain the tax-advantages of an EMI Option there are a number of statutory requirements to be met. The maximum value (at grant) of shares to be put under EMI option is £250,000. This high limit gives plenty of scope particularly when the method of valuing shares in private companies is considered (see the next section). Qualifying EMI options cannot be awarded by a company under the control of another company. The maximum duration of an EMI option is ten years.

Please see the Everyman Legal Fact Sheet, "Enterprise Management Incentive Schemes" for further details.

Exit-based EMI Options

Founders, concerned perhaps about dividend complications or a high exercise price that employees may not be able to afford, may choose to award EMI options that can only be exercised when and if there is an exit. These are so called exit-based EMI options.

The advantage of such options in legal terms is that the founders do not need to concern themselves with designing a constitution that reflects wider share ownership i.e. the Articles of Association can stay as they are. This can make these types of options considerably cheaper to implement. In addition the employees to not need to find the funds to acquire the shares – the price to be paid can be taken from the sale proceeds at the time of the exit.

The disadvantage is that the EMI option life is limited to ten years. Where the founders will definitely want to retire and exit within ten years this may not be of concern. However, for the well-advised employee the exit- based EMI option may (rightly) be perceived as an award that has value at the discretion of the founders (i.e. only if they decide to sell).

Please see the Everyman Legal Fact Sheet, "Enterprise Management Incentive Schemes" for further details.

SAYE (Save As You Earn)

SAYE is an all-employee share option scheme. The employee can save up to £500 per month out of taxed income on a 3 or 5 year saving contract.

At the end of the scheme a tax-free bonus is then added to the savings too. Those savings are then used to buy shares in the company.

The bonus and any gains made on the shares are exempt from income tax and NICs. CGT may be payable if the amount exceeds the annual personal allowance unless the shares are put into a pension or personal ISA within 3 months (subject to the usual limits).

Due to the 'all-employee' nature of such schemes, these are typically implemented by larger companies who wish to tie in employees for a period of time.

SIP (Share Incentive Plan)

The SIP is an all-employee share gifting and share purchase scheme. The scheme consists of three modules, the Free Shares Module, the Partnership Shares Module and the Matching Shares Module.

The Free Shares Module is a share gifting scheme under which a maximum value of £3,600 of shares can be awarded to an employee in each tax year.

Under the Partnership Module, an employee can allocate up to £1,800 (or 10% of annual income whichever is lower) of pre-tax salary to be used to buy additional shares.

Matching Shares means that for each share you buy the company can give you up to two free shares.

If shares remain in the plan for 5 years there will be no NIC or Income Tax to pay when they are taken out. If shares remain in the plan until they are sold then there is no tax to pay. The SIP is quite a complex scheme which can be rewarding for companies who wish to build a share owning 'ethos' for its employees. Like the SAYE, due to the 'all-employee' nature of such schemes, these are typically implemented by larger companies.

CSOP (Company Share Option Plan)

The CSOP is a discretionary share option scheme,. Shares options are granted up to an initial market value of not more than £30,000 at no less than market value.

The purchase can be made using the employees' own funds or through a loan arrangement. The employee can sell back as many shares as it takes to repay the loan, creating a 'cashless exercise'. The options can be exercised free of income tax between the third and tenth anniversaries of the date of grant.

Share valuation

For HMRC approved shares and EMI options, HMRC will pre-agree the value of the option shares ahead of an option grant.

For EMI options HMRC will also wish to agree a value for the option shares ignoring any restrictions on the shares (a so called Unrestricted Market Value) and a value taking account of the restrictions (an Actual Market Value). Such restrictions, as mentioned above, might be compulsory transfer provisions for employees who leave.

Unapproved Share Option Scheme

Sometimes it is not possible to meet the criteria of the HMRC approved or tax-advantaged schemes. In these circumstances, an unapproved share option scheme (without the tax advantages) may be the only alternative. An obvious advantage with such a scheme is that they can be very flexible; however the very high tax charge which is triggered on exercise (i.e. even if the shares have not been sold) can make them a difficult 'sell' to employees.

It is likely that an unapproved option will only work if the options are to be exercised at the same time as the company is sold. Employer's NIC on the option gain can also be a concern.

Conclusion

The successful design of a share incentive scheme involves a complex interplay of commercial, tax, valuation and legal considerations.

The Everyman Legal team has extensive experience in designing and implementing share schemes for private companies. We can help you design a scheme that is motivational with clear and simple explanations of the legal documentation. We also help you to communicate the scheme to your key team members to ensure their buy-in and answer any technical questions they may have.

Since engaging Everyman Legal we have put in place an agreed legal framework for ownership succession. My company is now positioned for growth.

Charles Purdy
CEO of Smart Currency Exchange

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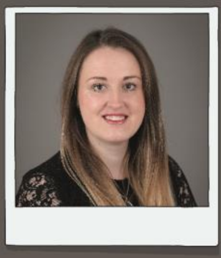

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