Employee Ownership

Share plans in an EOT-owned business

Your tailor-made hybrid model


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An Employee Ownership Trust (EOT) holds shares, indirectly, on behalf of all the employees, whereas an employee share plan enables individual employees to become actual shareholders in their company.

EOT-owned businesses may also wish to operate direct share ownership arrangements for their staff.

The EOT must own a controlling interest in the company, being a minimum of 50%+ of the equity (which means voting rights, dividend rights and rights to a return on capital). However, provided the EOT's interest does not drop below that amount, the remaining equity can be used to achieve direct share ownership arrangements for employees.

There are a variety of reasons for an EOT controlled business to create a customised hybrid model to deliver direct ownership to individuals.

When people ask us what is the secret of our success, the first answer is always the people …This is our way of saying to the staff: You've stuck with us, you've been fabulous employees, now this is your little bit of luck.

Incentivising key staff

An EOT-owned company, like any other business, will want to incentivise and reward key people, helping with retention and recruitment of skilled individuals, whilst improving productivity.

This will include providing different levels of reward, and hence motivation, according to the roles and responsibilities of identified key individuals. This may be of particular importance where a new management team has been, or is to be, put in place as part of the original owner's succession planning.

A direct shareholding for individuals can deliver the possibility of dividend payments in addition to the all-employee EOT tax-free bonus and profit share that can be paid by the EOT controlled company.

A share plan for key personnel can also provide a route for additional rewards based on specific performance, provided that an internal market is in place to provide a liquidity route for the shares (given that a third-party sale is generally not planned in an EOT environment).

This might be by way of company share buyback or by the creation of a separate employee benefit trust to act as a market maker. An internal market is likely to be essential to ensure the management of direct shareholdings by employees.

It is important that the next generation of key individuals can see a potential for capital-based financial return on their shares in the medium to long term, particularly during the period when the vendors' debt is still being repaid by the EOT. An internal market can also ensure that shares can be purchased for value from employees who leave the business.

Finally, it is possible that some EOT businesses will change their ownership structure in the future. Should a sale occur, direct shareholdings can deliver individuals an additional equity-based reward in the form of sale proceeds at that time.

There are specific rules relating to shareholders who own 5% or more of the EOT-owned company's share capital, so care should be taken when setting up any employee share plan.

Wider direct share ownership for staff

The points detailed above that apply to selected staff, apply equally to the employee group as a whole. Direct share ownership can result in additional dividend payments for employees, and can deliver an additional equity incentive-based reward on an exit, whether as a result of individuals leaving the company, or an exit event for the company itself.

Furthermore, the creation of an internal market for employee shareholders can create liquidity for shares on an ongoing basis. The ability for employees to acquire and sell shares in the company not only provides a financial benefit, but can also help cement the concept of employee ownership.

Some companies find that direct shareholding encourages a greater feeling of ownership and sense of community within the company than the less tangible concept of the EOT holding shares, indirectly, on behalf of all the employees.

What share plans are available to EOT-owned companies?

EOT companies can, in theory, operate any of the HMRC tax-advantaged schemes available. This is the case even if the EOT company is technically under the control of another corporate body, which will be the case if the EOT trust is a company. Tax advantaged share plans all have their own qualifying criteria so it is important to check wider qualification issues.

Enterprise Management Incentives (EMI)

A share option plan suitable for smaller companies with fewer than 250 full-time equivalent employees that undertake certain trading activities. EMI is the most popular share option plan in the UK and is very often used for companies wishing to incentivise key staff. However, it can be used for all employees, with the flexibility to make different levels of award. EMI allows companies to grant options with a value (measured at date of grant) of up to £250K to each individual, but each company is limited to total option grants of £3M.

Company Share Option Plan (CSOP)

An alternative share option plan for companies that don't qualify for EMI (for example, because they have 250 or more full-time equivalent employees, or undertake certain excluded trades). CSOP has a lower individual limit than EMI – up to £60,000 (measured at date of grant) for each individual – but there is no company limit and qualification is easier to establish and maintain than for EMI. Traditionally used for senior executives, but can also be used to reward all employees.

Share Incentive Plan (SIP)

An all-employee share plan, well-suited to the ethos of an EOT controlled business. It allows employees to acquire shares in the company directly, enabling the payment of dividends, although the shares are held in a special SIP trust on their behalf (this will be separate from the EOT trust that holds a majority interest in the company). For a private company, the SIP offers a considerable advantage as the trust can create an internal market in the shares for employees who wish to sell their shareholdings (including if they leave the company): the trust then recycles the shares for future awards to employees.

Other forms of direct share award and share option plans are also available to EOT-owned companies above and beyond the government-backed plans referred to above.

Are there any challenges to using share plans in an EOT-owned company?

There are some specific points that you should be aware of when choosing a hybrid model to suit an EOT-owned company.

Different share classes

It's common for private companies to use different share classes in an employee share plan – for example, shares that carry different dividend or voting rights from the founders' shares. Some companies create share classes that will pay out different values on the sale of the business – this includes growth and hurdle shares.

However, in order for an EOT to meet the controlling interest requirement, the EOT trust must have rights to the majority of the ordinary shares, the votes, the dividends and the assets on a winding up.

It follows that if a different class of shares can pay, for example, a different dividend from that of the shares held by the EOT, then there is a risk that the EOT trustee may no longer be entitled to a majority of the dividends. Similarly, growth shares, unless carefully drafted, could also impact on the percentage of assets on a winding up.

It is possible to use different share classes for a share plan in an EOT-owned business, but there are technical difficulties to overcome and which will require careful design and implementation.

Valuation

The great majority of EOT transactions are paid for by way of an initial payment to the sellers, with the bulk of the consideration paid over a number of years on a deferred basis. Payment is made out of the company's ongoing post-tax profits, which the company undertakes to provide to the EOT trustee. Therefore, immediately following an EOT transaction, the company effectively owes the EOT a significant debt. At this stage, it can be argued that the company, and its shares, carry a lower value, although that value will be rebuilt whilst the debt is being repaid.

Companies establishing share plans are generally advised to make share or option awards to employees at a time when the shares' value is low to maximise potential value growth for participants, so it makes sense for share plans to be implemented as soon as is practicable after the EOT transaction has completed.

However, it should not be assumed that the company's shares immediately post-completion are worthless or only of nominal value. EOT companies often have a strong trading history, and will most likely have calculated future profits with care, so there will be some value in the company's shares.

Excluded participators

Should the EOT company be sold, the proceeds obtained by the EOT trust must be applied for the benefit of all the eligible employees in the business. Note that this can include individuals that were working for the company up to two years prior to any exit.

However, if any employee holds more than 5% of the share capital (or 5% of any class of share capital in the company) – or holds rights to more than 5% of the share capital or any class of share capital – they will be excluded from sharing in any proceeds received by the EOT trust itself.

This may not be a concern to participants in employee share plans as either any onward sale of the EOT-owned company may be too remote a possibility or they would be sufficiently rewarded through direct interest in the EOT-owned company in any event.

Working out how many shares employees should be able to acquire under a share plan will still need careful consideration. If an individual expects to share in part of the EOT trustee proceeds on exit, they will need to be sure their own individual shareholding is not 5% or more. If options are used, it must be clear their options do not give them the right to acquire 5% or more of the share capital (or any class of share capital).

Furthermore, as noted above, if different share classes are introduced, the 5% rule does not apply to the whole of the company's shares, but to that particular share class. So, if there are two directors who have acquired 10 B Shares each, then each director would hold 50% of the B Share class, and they would be excluded from benefiting from the EOT trust's shares on an exit, even though they might hold much less than 5% of the entire share capital.

These issues can be managed through careful equity modelling or by drafting employee share plan and constitutional documentation to ensure shares cannot deliver rights of any type that break the "excluded participators" 5% rule.

Internal share market

As noted above, without an exit route it is hard to create any liquidity in an EOT-owned company's shares (or, indeed, for any private company). To make direct share ownership in an EOT company more meaningful, it may be necessary to create an internal market for shares, enabling employees to sell their shares for value when they cease employment (usually as a "good leaver"), or at an appropriate time.

It is not appropriate for an EOT trust to act as a market maker. The EOT trust may only distribute the shares for the benefit of all the eligible employees on the same terms. It is not possible within the terms of the legislation for the EOT trust to award shares to individual employees, including making option grants. Nor may the EOT use any of its funds to purchase shares from any individual employee, for the same reason.

If an internal market is required, it may be advisable to establish a separate employee benefit trust (EBT), which could also be used to make option grants under tax advantaged employee share plans.

A Share Incentive Plan could be established with a special SIP trust, which would create an internal market for employees. However, once a SIP trust has acquired shares, those shares may only be awarded to employees under the SIP rules (i.e., to all employees, on similar terms).

As well as capital value accruing on employee shares, emplyees may benefit from dividends being paid on the shares they own. Dividends should not, however, be paid on shares delivered under an employee share plan until the EOT debt has been repaid.

Seek specialist advice

If you already have an EOT holding shares on behalf of all your employees and now want to incentivise key personnel through an employee share plan, you will need specific advice tailored to the unique needs of your company.

Here at RM2, we have one of the most experienced employee share ownership teams in the UK and are employee owned ourselves. We do not advise on anything apart from Employee Ownership Trusts and employee share plans. It's all we do. And we do it very well.

Our multi-disciplinary team includes accountants, solicitors and share plans administrators, who work together to deliver the UK's only 'cradle to grave' service, from the initial design of your EOT transaction or share plan, through implementation and ongoing administration to ensure compliance throughout the life of your share ownership arrangements.

We have successfully completed over 100 EOT transactions and designed and implemented more than 2,000 employee share plans, including ongoing maintenance for many of these plans.

For more information and for a no-obligation consultation, contact us on enquiries@rm2.co.uk.

> *The whole EOT/EMI experience has been very positive from our point of view.*

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