Postlethwaite
EMPLOYEE OWNERSHIP LAWYERS

EMPLOYEE SHARE PLANS IN GROWTH COMPANIES

How UK companies with ambitions to grow are using equity as an incentive and reward for their key employees

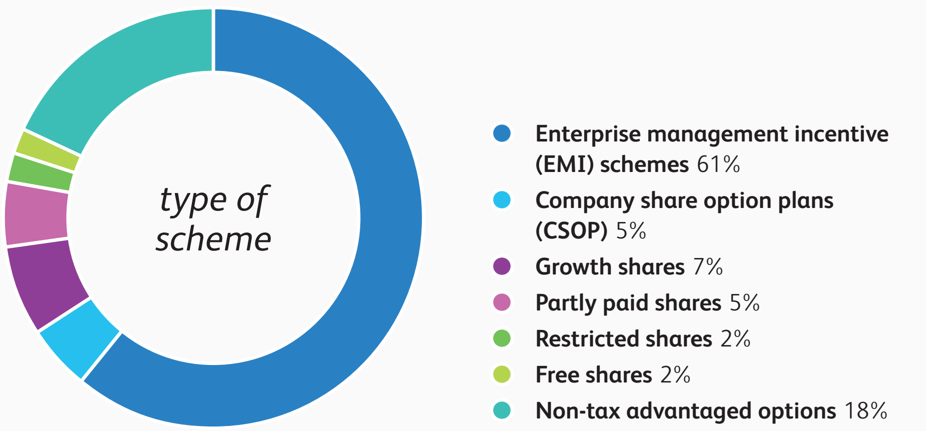
INTRODUCTION

This report summarises the findings of research which looks at how a range of UK-based companies are using equity to incentivise and reward their key employees[1]. The companies reviewed are all ambitious to grow, including a number of fast-developing technology companies but also companies in a range of other sectors, including medical technology, hardware, media and marketing, information technology and retail.

Postlethwaite is a law firm specialising in employee share schemes and employee ownership. Our clients include private and public companies, individuals and other professional advisers. We work with any size of company, from start-ups to more established ventures, and have clients throughout the UK and elsewhere. We are ourselves employee-owned.

WHAT KINDS OF SHARE PLAN ARE COMPANIES USING?

Among the companies reviewed, 61% operate enterprise management incentive (EMI) schemes, 5% have company share option plans (CSOP), 7% have awarded growth shares, 5% partly paid shares, 2% restricted shares and 2% free shares. The remaining 18% have adopted various types of non-tax advantaged option scheme. You will find at the end of this report a glossary which includes an explanation of each of these arrangements and some others.



[1] Our research does not analyse how companies with wider employee ownership are structuring their arrangements. A growing number are extending ownership more widely, and in some cases (for example under an ownership succession plan) a significant or majority interest is created for employees. How companies are approaching this is beyond the scope of this report.

As an illustration of how companies are approaching these issues in practice, we set out below the results of our research into the behaviour of a range of companies operating EMI schemes. EMI allows selected employees to share in future growth in company value with no financial commitment. Tax (capital gains tax – CGT) is only due when shares are sold – 0% on the first £11,000 gains, 18% or 28% on any additional gain (although it will often now be possible to reduce this to 10% through entrepreneurs' relief). It is designed for smaller companies and some types of business are excluded.

COMPANIES OPERATING ENTERPRISE MANAGEMENT SCHEMES 2011–2014

Type of Plan

- Virtually all the companies which satisfied the legislative requirements for EMI have decided to adopt and operate an EMI scheme. Clearly, this has been regarded as by far the most flexible arrangement and the most advantageous from a tax point of view.
- 29% of the companies operating EMI have also adopted non-tax-advantaged option arrangements based on the EMI format in cases where either the option holder did not qualify for EMI treatment (for example, non-executive directors and self-employed contractors) or would derive no tax benefit from it (for example, employees based outside the UK).

Performance target set 25%
No performance target 75%

How much of the company is reserved for options?

- Only 17% of companies formally set a maximum on the percentage of equity available for employee participation. Where a maximum was set, this is typically within the range 5–15% of the company's total issued share capital. Total option awards made by those companies which have not formally set a maximum in practice also fall within the same range.
- The allocation per employee varies hugely, usually depending on the number of participating employees. Where the allocation is targeted at only one or two key individuals, it could be as high as 5% per person, but where the objective is to spread the available equity among most or all employees, the allocation per person is far smaller.

Performance Targets

- Only 25% of the companies set performance targets. In the case of all those, the chosen measure was profit, although this was sometimes combined with a second measure, such as sales.
- The absence of a performance target is usually explained by the fact that most of the option plans are "exit only" plans (where options could be exercised only on a trade sale or IPO rather than after a period of time). In these cases, the company has taken the view that the mere fact of achieving an exit should constitute satisfaction of a performance target.

Vesting periods

- Typically, a company will provide that not all the shares under option can be acquired immediately after the

FEATURES OF OPTION SCHEMES

As over three-quarters of the companies surveyed operated option schemes, it is worth identifying at the outset the key structural features of an option scheme:

GRANT

An unlisted company can grant options at any time of its choosing, but the terms must be set out clearly in the documents issued to the employee. By granting an option, it is giving the employee a right (but no obligation) to acquire shares in the future at a price fixed at the outset.

VESTING

Full rights to exercise an option normally kick in after a time period, or accrue gradually over a period of time (in either case, normally so long as the employee remains in employment).

TIME OF EXERCISE

This can be after a period of time, or on the happening of an event such as a trade sale or share listing (IPO). A performance target might also have to be achieved.

LEAVING THE COMPANY

The treatment of leavers might distinguish between "good" and "bad" leavers and between vested and unvested options, and there might be an overriding discretion exercisable by the board of directors.

25%

of companies set performance targets

date of grant. The right to acquire the shares (by exercising the option) will often accrue gradually in accordance with a vesting schedule so that, on an exercise event (sale or IPO of the company), only those options which have vested can be exercised as of right (although often subject to a directors' discretion to increase this number).

- Some companies chose not to provide a vesting period, usually because the option allocation was characterised as a reward for past performance rather than being linked to future performance.
- Practices vary among the companies which set a vesting period, although more than 60 % have adopted a vesting period of either 3 or 4 years.
- 21% have no vesting period, 4% a 2 year period, 25% a 3 year period, 38% a 4 year period, 8% a 5 year period, and 4% a 10 year period.

79%

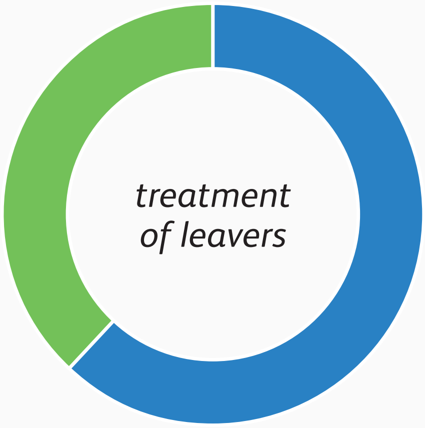
of companies operate a vesting period

Exercise events

- 92% of the companies have expressly linked the exercise of share options to an exit event, being a trade sale or IPO.
- 63% of the companies stipulate that an exit event is the only possible trigger for the exercise of options, while 29% have allowed the directors to permit exercise in their discretion in circumstances other than an exit event.

Option price

- The exercise price of an EMI option can be set at any level (although there will be adverse tax consequences when the option is exercised if it is set below market value at the date of grant – see below).
- 95% of the companies have granted EMI options at market value as agreed in advance with HMRC.
- The remaining 5% chose to grant at nominal value. The reason would usually be to build in an element of reward for past service. The "discount" element would, however, be subject to normal taxation on the exercise of the option.

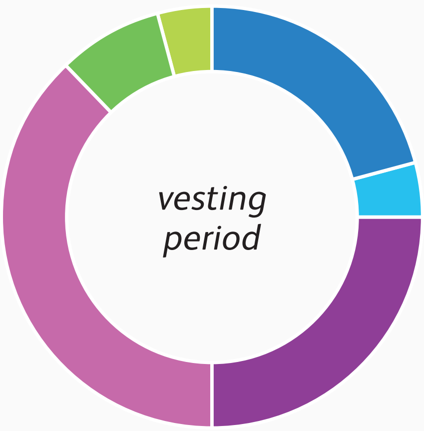


- **Good leavers able to exercise as of right** 62%
- **Directors' discretion required even for vested options** 38%

Treatment of leavers

- In all cases, unvested options will lapse if the optionholder leaves employment.
- Different approaches have been adopted with regard to vested options. In 62% of cases, good leavers may either retain their vested options until an exercise event or (if the option plan allows for exercise before an exercise event) exercise them for a limited period after leaving. In the remaining 38% of cases, even vested options could be exercised only if the directors invoked their discretion in favour of the option holder. If they chose not to exercise discretion, the vested options would lapse.

Companies create their own definition of a "good leaver". For example, this might mean leaving due to long term illness or disability or death, but might also include other circumstances.



- **No vesting period** 21%
- **2 year period** 4%
- **3 year period** 25%
- **4 year period** 38%
- **5 year period** 8%
- **10 year period** 4%

- **Exit is the only circumstance in which exercise is allowed** 63%
- **Directors' discretion allowed in other circumstances** 29%
- **At any time** 8%

92%

of companies link the right to exercise an option to an exit event

ALTERNATIVES TO OPTIONS

Not all companies have used EMI options. We summarise below some of the main alternatives that the companies we have surveyed have used:

CSOP (COMPANY SHARE OPTION PLAN)

Similar to EMI, with much lower financial limits and more constraints on the terms of options (but it can be easier for a company to qualify).

GROWTH SHARES

Here, shares of a special class are created which only have a capital value if the company's value grows beyond its current value. The shares' value when first acquired may therefore be low, so that they can be acquired by an employee with no or minimal initial financial outlay and liability to income tax/NI. Related to hurdle shares (see below). Growth in value is subject to capital gains tax (CGT) when the shares are sold.

HURDLE SHARES

A special type of share in the company is created, which only acquires a capital value once the company's value exceeds a given threshold. By setting that threshold at a level which is higher than the company's current value, these shares will often have low or no initial value, so an employee can acquire them for low or no cost without tax charge.

PARTLY-PAID OR NIL-PAID SHARES

The employee purchases shares but payment of part or the whole of the purchase price is deferred. This can enable an employee to acquire shares with no or minimal initial financial outlay although the outstanding amount will eventually have to be paid, even if the company becomes insolvent. Growth in value is subject to CGT when the shares are sold.

RESTRICTED SHARES

An employee acquires shares but they are initially subject to restrictions (for example: non-voting; no dividends; have to be transferred if the employee leaves). This may reduce their initial value and so the income tax/NI cost to the employee (but in that situation any subsequent value growth due to restrictions being removed will be subject to income tax/NI). Subject to that, growth in value is subject to CGT when the shares are sold.

FREE SHARES

An employee is given shares, and so will pay income tax/NI on their value; but if, as with purchased shares, their value when received is discounted, this significantly reduces any tax liability. Any growth in value is subject to CGT when the shares are sold.

NON-TAX-ADVANTAGED OPTIONS

These are often called unapproved options. There is no tax on grant but when the option is exercised all gains are then subject to income tax/NI.

Other possible arrangements that our surveyed companies have not used include:

EMPLOYEE SHAREHOLDER STATUS

Employee can each receive free shares of up to £2,000 value tax free, if they agree to give up certain rights under employment law, including unfair dismissal. Independent advice must be provided to the employee. There is no CGT on any growth in value, but this arrangement is probably only worth considering if EMI is not available.

JOINT OWNERSHIP PLAN

This is a more complicated arrangement involving an employee benefit trust, and valuation issues will also arise on the receipt of the interest in the shares.

CONCLUSION

This research confirms that there is no "one size fits all" solution for companies which wish to recruit and retain employees by offering them an interest in the equity. There are, however, some trends which can be distilled from these findings. The clearest trend is that EMI is the most popular arrangement if the company satisfies the various conditions, due to its significant tax advantages and ease of operation. Nevertheless, nearly one-fifth of the companies surveyed chose to adopt arrangements which conferred no tax advantages at all, presumably giving flexibility priority over tax efficiency. The key is to analyse each business's circumstances and then try to identify the arrangement which is most likely to deliver its objectives. This research provides a useful indication of how other companies have approached these issues.

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