EMPLOYEE OWNERSHIP AND BUSINESS RECOVERY

A new deal for employees

Postlethwaite
EMPLOYEE OWNERSHIP & SHARE SCHEMES

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"What can we do to maximise our chances of survival and bouncing back?"

This is a question you will be asking as a business owner or director.

In this short guide, we look at the role employee ownership can play. By channelling your employees' commitment and building a new relationship in which you all work together in common purpose and for shared reward, it can help you build a stronger and more resilient business as your business navigates towards recovery.

1 Background

A 20.4% reduction in UK GDP in April 2020 shows the depth of economic damage caused by Covid-19. Fortunes vary from sector to sector but few UK businesses have not been significantly affected. Some face an existential crisis (we believe around 30% of SMEs have serious concerns as to whether they will be able to survive). Many have not been so adversely affected but still face a potentially long road to full recovery. A lucky few have been pretty much unaffected or have even thrived.

As the restrictions are lifted, any business contemplating life after lockdown will be asking what they can do to maximise their recovery prospects. Clearly the answer has several facets. We believe one of these to be **employee ownership**, in which a substantial part of a company becomes owned by its employees.

'the reasons for considering employee ownership will for many be stronger than ever…'

In the world before Covid-19, a growing number of companies were already embracing employee ownership. Attracted by its potential to build employee engagement and collaboration, improve productivity and performance and – for founder owners wishing to retire – maintain their company's independence, over 400 companies had become wholly or majority owned by an employee ownership trust or **EOT**. These span a diverse range of sectors (from construction to consulting, manufacturing to architects) and include such household names as Aardman Animations (Wallace & Gromit) and Richer Sounds.

That was then…and this is now. But we believe the reasons for considering employee ownership will for many be stronger than ever and may have progressed from a *"nice to have"* to a *"must have"*. This note explains why and sets out practical *"how to do it"* ideas for employee ownership to be part of your company's recovery plan, providing a new deal for the employees on whom you will rely to turn things around.

The greater the support a business can enlist from its people, the better its chances of making a strong and sustained recovery. Companies' recent experiences will include:

- Sacrifices made by owners, leaders and employees alike. Some businesses will have handled the crisis well by retaining (or even building) the trust of their employees and so will have a stronger platform for recovery. Others may not have handled things so well and lost employee trust, which will require rebuilding
- Many have had cause to rethink their purpose, accepting the importance of putting their people first. Some business owners have a strong sense that doing well here is now a key measure of success
- Many employees will be traumatised/disorientated/exhausted, as will some business owners and leavers
- Revenues that have plummeted or even disappeared, with continued restrictions posing challenges to a quick bounce back
- Dwindling cash

Whatever your experience, if you are confident your business continues to have long term potential, employee ownership can both help the healing and build a new and stronger foundation for future success.

2 The role of employee ownership

The potential benefits for a company of creating an employee ownership plan include:

- Showing you have a clear plan for how your employees will benefit from the effort they devote to business recovery
- Simply providing a stake in the upside of any recovery
- Acknowledging that owners, leaders and employees alike have made big sacrifices and future ownership should recognise this – *"from now, all of us together"*
- As furlough comes to an end, helping you retain the skilled people you'll need as your business goes back into growth
- Creating a shared purpose
- As new working practices develop (to manage continuing restrictions and/or make good use of efficiencies developed out of necessity in recent months), ensuring that your employees share in the resulting benefit
- Where necessary in some cases, reducing operating costs by exchanging an agreed pay reduction for shares (or share options)

'employee ownership can both help the healing and build a new and stronger foundation for future success'

If your company is already employee-owned, you will arguably already be in pole position to bounce back. If your company has not yet introduced employee ownership, the good news is that you can choose an approach that matches your needs from a range of tried and tested solutions.

3 Some ways to do it

Here we briefly look at *what can you do?* This is aimed at companies which do not already have employee ownership.

What you can go is going to depend on what you want to achieve. Here are some ways of creating employee ownership and the goals that each may help you achieve. These are suggestions and are not exhaustive, so if you do delve into this further you may find that there are others.

HOW EMPLOYEE OWNERSHIP CAN BE CREATED	GOALS IT CAN HELP ACHIEVE
You transfer shares in your company to an employee ownership trust (EOT). Any future financial benefits (profits attributed to those shares or growth in their value) are then shared between employees Alternatively, you award your employees free shares. If this is done under a Share Incentive Plan (SIP), employees are not taxed and any further growth is free of capital gains tax (CGT) *Each of these is risk free for employees*	Providing all your people with a stake in the benefit of any recovery By making free shares conditional on staying with the company for three years, this may (but will not on its own) also encourage employee retention Encouraging employees to embrace smarter working If you have had to reduce your staff costs, the EOT approach is a way of giving something in return With clear communication, a listening culture and openness about your company's performance, creating a stronger foundation for employee engagement and common purpose
Transferring all (or a majority of) the company to an EOT *This is also risk free for employees*	By making your company wholly or majority employee-owned, you are creating the strongest possible seedbed on which to grow employee engagement, enterprise, resilience and commitment Retiring from the ownership in a way which keeps your company independent
Share options. You grant your senior leaders/key people a right (option) to acquire shares in your company at a fixed price equal to today's value (which may be suppressed by the impact on your business of Covid-19). As business recovers, share value should grow. After (say) three years, the employee can take up that right and become a shareholder (if they wish to), paying what is now a discounted price *This is risk free for any participating employee*	Helping retain your senior leaders/key people (by making it a term of their option that they lose it if they leave) and rewarding them for longer term performance

4 How to do it

We take each of the ideas above and briefly explain for each how to do it. *These are summaries only and there will be more detail to think about.*

HOW EMPLOYEE OWNERSHIP CAN BE CREATED	HOW YOU DO IT	HOW THE TAX WORKS
You transfer shares in your company to an employee ownership trust (EOT)	Your company establishes an EOT under a trust deed, people are appointed to run the trust (trustees) and shares in your company are then transferred to it. This can be done at no cash cost to the company. Alternatively, if the trust purchases its shares it will often pay in instalments funded from the company's future profits	Current shareholders If you transfer less than 50.1 % of your company's shares to an EOT, you will pay CGT on your gains but you can require the EOT to take this over (so they will pay instead if they ever sell the shares) If your goal is simply to place shares in a SIP, the simpler approach may be for the company to create (issue) new shares Employees Pay tax on any value received from the EOT (but with careful planning, not before then) Company If company funding is required it won't be corporation tax deductible
Transferring all (or a majority of) the company to an EOT	As above, save that if the EOT is to acquire a majority of shares, the current shareholders are more likely to wish to be paid for them so there will be cash cost on the company albeit spread over future years	Current shareholders No CGT on your sale proceeds Employees Can be paid an annual profit share free of income tax (financial limits apply) Company If company funding is required it won't be corporation tax deductible

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HOW EMPLOYEE OWNERSHIP CAN BE CREATED	HOW YOU DO IT	HOW THE TAX WORKS
You award your employees free shares under a Share Incentive Plan (SIP)	Your company establishes a SIP (*requires rules and a trust deed*) and trustees are appointed to run the trust who will hold shares on behalf of named participating employees, Shares in your company are then transferred to it. This can be done at no cash cost to the company	Company Any cost of providing free shares is corporation tax deductible Employees Receive something of value (shares) without a tax liability. No CGT on any growth. Current shareholders Can defer any CGT liability on selling to a SIP (if it acquires at least 10 %)
Grant of options to your senior leaders/ key people	Your company establishes a share option plan (rules required) and then grants options to selected employees under an individual option agreement	For employees, either: • when option is exercised, income tax is payable on difference between price paid by employee and value at date of exercise, or • tax is payable only when option has been exercised and shares sold. Tax will be CGT. This tax treatment applies to EMI and CSOP options which have favourable tax status

5 What should we do if our company is already employee-owned?

You should already have that platform for building employee commitment and engagement. If you are concerned that it needs to work better, this will often involve a greater focus on relationships within the company rather than tinkering with the ownership structure.

That said, there may be things about the current situation that, unanticipated as it was, that in some cases justify considering adjustments to how your employee ownership structure works.

For example, if you company is wholly owned by an EOT, you might – if you wished to give your company an adrenaline injection – consider moving to a hybrid arrangement involving some personal ownership of shares by employees whilst the EOT continues with a majority holding. That would give each employee a more tangible stake. This would be a big step for many employee-owned companies and may be suitable only rarely.

6 The people side

Contributed by: **Garry Davis**, Associate, J Gadd Associates

The Government launched Covid lockdown with the message that 'we're all in it together'; seeking to create the sense of a shared experience and common purpose, rallying resourcefulness and motivating us to work together to overcome adversity. Interestingly, there are few expressions that so aptly convey the benefits that businesses seek to leverage from being employee owned. In the 'VUCA' (volatile, uncertain and complex and ambiguous) world that we face, leaders will need agile and empathetic people strategies to ensure this mantra holds true for all in the organisation. A few thoughts, based on my experience and observations:

- You have an opportunity to engage your people in realigning, refreshing and recentring vision and values. Businesses that are **purpose driven** with their employees at the heart tend to be more resilient and have that competitive advantage
- Ensure, indeed insist, **all in Leadership model the way**. As we have observed, in times of change and adversity the expectation for senior leadership to model organisational values and 'walk the talk' is magnified. *"Begin with self"*.
- **Get into your employees' shoes.** Easy to say *"we're all in it together"* but as we know many have had starkly differing experiences of Covid lockdown ranging from traumatic personal loss, economic hardship to lockdown to being a relaxing sun-filled break learning new hobbies and interests. Many successful employee-owned businesses have empathetic leadership at their core and senior leaders need to ensure that this is at the heart of their dealings with employees. I am reminded of the Stephen Covey saying *"seek first to understand before seeking to be understood"*.

> *'You have an opportunity to engage your people in realigning, refreshing and recentring vision and values'*

- **Invest in resilience training**. Employee-owned businesses are traditionally more resilient, but this should not be assumed automatically to happen. Now is the time, if you haven't done so already, to invest in training. Can you do more to build individual resilience? It will be valued way beyond its cost with its potential to impact on work and home life (the lines being already blurred for many) giving individuals valuable tools to collaborate with those around them. We know that *"bouncebackability"* is key in challenging economic circumstances.
- **Communication:** be real, be honest, be timely, be transparent. Whether it's uncertainty about the *"new normal"*, or the challenges facing the business, organisations that have engaged and educated their employees in business literacy will be well placed to land key messages and get the desired traction.
- **Review profit sharing arrangements.** Employees will more readily share the difficult times and share if there is a tangible sense of fairness about how the gains will be shared in better times.
- Check your organisations' **'emotional bank account'**: employee-owned businesses tend to be more open with the information given out and the extent to which they place trust in their employees as co-owners. Make necessary deposits to build or indeed rebuild trust. That's an article in itself but starting with the foundations of listening, admitting mistakes and building rapport will take you someway along the path.

- Take further steps to **devolve responsibility and inspire shared leadership**. Employee ownership encourages leaders, teams and individuals to feel that sense of ownership, to be more agile and take more creative decisions.

A recent McKinsey Covid report suggested that the time is right for employers to shift a degree of emphasis presently placed on increasing shareholder value towards organisational resilience and the 'preservation of lives and livelihoods' (McKinsey & Co 2020). Perhaps that's why so many employee-owned businesses are better positioned in their people policies and strategies to embrace the challenges and opportunities whatever the *"new normal"* may bring.

7 Legal issues

Contributed by: **Jane Wheeler**, Keystone Law

Few companies will wish to consider reductions in pay and benefits unless this is essential to help reduce operating costs to increase survival prospects. As we have mentioned, if this has to be done then a company can provide something in return – in the form of an employee stake in future growth.

How can a company putting in place a pay reduction minimise the risk of a legal claim from the employees who are affected?

The only legally effective way to impose a pay reduction is by individual, specific employee consent. If this is not obtained, there is a risk of the employee bringing a breach of contract/unlawful deduction from wages claim (for the difference in pay) or even resigning and claiming constructive dismissal.

In practice, a pay reduction will have an immediate effect on each affected employee, so if they continue to work they may be deemed to have accepted the change which will make it harder for them to bring a claim. If a pay reduction is agreed with a trade union, this can demonstrate the reasonableness of any change such that if an employee brought a constructive dismissal claim it should be easier for an employer to defend (as the thrust of a constructive dismissal claim is that the employer has acted in a way calculated to destroy the employment relationship).

A pay reduction will be easier to achieve if the employee is getting something positive out of the situation in terms of employee ownership.

There are no different rules, or specific exemptions, if the employer is in difficult financial circumstances – although an employer in this situation may simply not be able to wait to obtain employee consent and may go ahead and impose the pay reduction, betting that the employee won't bring a breach of contract claim or walk out, given that in the current climate they may feel fortunate to have a job.

8 Wider issues

For any company emerging from our Covid-19 lockdown, employee ownership will only be part of the picture. Amongst other things, it is likely also to be thinking about:

- Ensuring employees and leaders alike are rested

- Updated business planning
- Cashflow planning
- Whether new finance is needed
- New safe working arrangements
- Contingency planning for the next crisis

9 Contact us for further information

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