White Paper - Nº 2

A slice of the action: How to set up an employee share scheme that works

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Life is simple when you own the business yourself. All your decisions are unanimous. There's no danger that you'll fall out with your business partners or find you can't reach agreement with them on an important issue. It's just you, making all the key decisions. If you don't know what to think about a particular business issue, get some good advice and sleep on it. You'll probably see things much more clearly in the morning.

But sometimes there's a compelling reason to bring another person into the business.

Share ownership schemes are a useful tool when you want to retain key staff and build loyalty. They are particularly effective if you want to ensure that the interests of your employees are well aligned with your own, as the owner of the business. If you want to incentivise your key staff, offering them shares in the company has a lot more impact than giving them a cash bonus.

It can be hard to find staff whose enthusiasm and commitment are as strong as your own. But offering them a slice of the business builds trust. Bringing them in as a shareholder helps them to start thinking more like you.

Share ownership schemes work well for companies where know-how is highly prized. They are especially valuable in an industry when there is a lot at stake if employees decide to jump ship and work for the opposition.

Corporations like Microsoft use sophisticated share ownership schemes to keep their key staff incentivised, working hard, and inside the tent.

But back to you. What if you'd like to offer shares in your own business to a few key employees? Perhaps you are thinking about smoothing the path to a management buy-out a few years down the track. Bringing your righthand man in as a shareholder is an excellent first step in your succession plan be it to either sell the business or retain it but retire from day to day involvement. But there are a few things to think about before you take the plunge.

Staying in control

First of all, consider how much control you'd like to give away. Twenty-five per cent is a key threshold. Once your employees own more than 25 per cent of the shares, they can block a special resolution of the Board. So when drawing up the company's constitution, make sure that 75 per cent of shares (not of shareholders) can pass a special resolution, and keep your employees' shareholding under 25 per cent if you can.

Do you want to offer your employees a directorship as well? If you do so, you need to remember that directors have one vote each at board meetings. If you don't want to be outvoted on your own board by a minority shareholder, offer them shares without a directorship and stay in control.

It can be hard to establish a price for the shares. My preference is to use a formula based on an agreed multiple of the company's net profit before tax. The formula should be based on the net profit at year-end of the last full year of trading. The multiple should be established by negotiation – around 3 to 4 is usual, though in some cases it could be as high as 6.5.

The formula has a lot going for it. It can be applied whenever a minority shareholder buys in, and again when they leave and wish to sell their shares. The alternative approach is to obtain an independent valuation of the value of the shares – but that will mean going to your accountant for a formal valuation. But it's less desirable. Using the formula means that everyone knows exactly where they stand at any given point, and that shareholders enter and exit on the same basis.

Now, think about the shareholders' agreement. Here is what it should cover. First, it should set out the relationship between the parties, include a warranty (by you) that there are no unrecorded liabilities (e.g. for tax payments), describe the mechanism for resolving disputes, and outline what happens when one of the shareholders wants to leave the company or sell their shareholding.

And now it starts to get a bit more complex. What about guarantees given to the bank and to your customers? Is the minority shareholder going to indemnify the majority shareholder, say on a pro rata basis? If not, the company should pay a guarantee fee to the majority shareholder, since he is the only one providing the guarantees.

The nuts and bolts of the share deal

How will the employee pay for the shares? There are several options. They may, of course, simply hand over a cheque in return; but it is more likely that they will need a loan. If you are planning to offer the employee a loan from the business, interest on the loan will be payable, unless it can be structured as an employment-related share purchase loan, to avoid having to pay FBT on the interest that has been foregone.

Generally, if the shares are sold to an individual (rather than to a trust), the loan can be interest-free. In fact, selling the shares to a trust is not recommended, since it means you will have to deal with the other trustees, not simply your shareholder-employee. Not what you wanted to achieve in this exercise.

But how will the loan be repaid? You will need to have a policy on dividend payment. If there are dividends paid, then most of the dividend (say 66 per cent to 75 per cent) should be used to repay the loan. If not, the debt will never be paid off.

That takes us to dividends more generally. You may wish to distinguish between majority and minority shareholders, so that if you wish you can pay dividends at a different rate to different share classes. This is straightforward to do. The minority (employee) shares can be issued as a separate share class, and you can decide whether they are to be voting or non-voting.

You may also wish to keep the employee's shareholding in the company confidential, so that other staff cannot see that they have shares in the company. This can be achieved by having a nominee hold the shares on behalf of the employee, rather than showing the share ownership in the employee's name.

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Heading for the exit

First of all, let's consider the employee's exit options. Once the deal is done, things may go well for a few years.

But suppose circumstances change, and your minority shareholder decides he or she wants out. What happens then?

The shareholders' agreement should lay out the process in detail. Essentially it needs to cover two cases: the 'good leaver' and the 'bad leaver'. In the 'good leaver' situation, after a certain minimum time period (which will be specified in the shareholders' agreement – typically three years), the shareholder wishes to sell their shares and move out of the company. In that case, they should get the market price for their shares. Anything else comes under the 'bad leaver' situation. Perhaps the employee is leaving under a cloud (which should be defined in the agreement), or wishes to get out within the minimum time period. In that case, they should receive the price they paid for their shares, not the current market value.

But what if the value of the firm has dropped? There are two ways to handle this – either the employee never suffers a loss and sells the shares back at cost, or they do suffer a loss and will end up indebted to whoever loaned them the funds to purchase the shares. The former is more normal, as otherwise many employees will be scared off by the potential downside.

Now, let's think about your exit strategy – after all, that's why you are considering bringing your employee into the company. Are you thinking about selling after a certain period of time has elapsed – say, five years from now? Do you want to sell up when you reach a certain age? And is your incoming shareholder likely to have enough money to be able to buy you out when the time comes?

If your overall strategy was not to facilitate a management buy-out, then the shareholder's agreement needs to address the exit arrangements for both of you. Generally we use 'drag along/tag along' provisions, to ensure that when the majority shareholder wants to sell, the minority shareholder has to sell out too, on the same terms and conditions. So the employee-shareholder will benefit from the increase in value if the agreed multiple being used to value the shares for the purchaser is now 6, not 3.

Finally, timing. When the company has been doing well, the prospect of buying in looks more attractive, but the share price will be higher. If, however, sales are declining, then the share price will be lower. But your employee may not find the prospect of buying in quite so attractive, unless they are confident they can turn things around.

Lots of things to think about! But it's nothing too complex. And there are real advantages in thinking through your exit strategy well in advance, and then bringing your right-hand man or woman into the company to facilitate a smooth management buy-out when you're ready to step out.

Every business owner needs to obtain advice on his or her particular situation. But if you'd like to talk it over to see what it could mean for you, please don't hesitate to call me on 09 301 1777. Nigel Smith

About Covisory

The Covisory Group specialise in International and Domestic Tax Services, Trust Management, Succession Planning, Strategic and Business Planning, Accounting Services and Business Valuations.

Established in 2007, The Covisory Group has grown from one business to four with a diversity of clients. Covisory clients are owners of family businesses, operating both in New Zealand and globally. Our team of specialists work either one-on-one or alongside our clients' team of professional advisers to develop appropriate short- and long-term solutions.

We build strong relationships with our clients based around trust, accessibility, and responsiveness. There is no 'one size fits all' about our services. Our solutions are bespoke to each client, drawing on our up-to-date specialist knowledge and our years of experience. providing one-on-one expert advice.

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