# EMPLOYEE SHARE OWNERSHIP PLANS IN OWNER MANAGED BUSINESSES

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**An employee share ownership plan ("ESOP") (also known in many cases as an employee stock option plan) is an arrangement under which an employer permits participating employees, or a trustee on behalf of participating employees, an opportunity to purchase company stock at a fixed price which is less than the market value of the shares at the time of the purchase. This can be a reward for past performance or an incentive for the future. The benefit to the employee comes from buying shares at less than market value.**

**Most ESOPs are "option based". Employees or their trustee are granted options to buy stock at some time in the future but for a purchase price equal to the value of the stock at the time the options are granted. The benefit to the employee comes from helping building company value between the time the options are granted and the day they decide to exercise those options.**

**There are many reasons to implement an ESOP. However, and in any situation, developing and implementing a successful ESOP in a private, owner managed business is a challenge that must be handled in a strategic and professional manner.**

*Please note that this article has been written from the perspective of the owner/manager of private business in Ontario with sales in excess of $3,000,000.00 and more than five employees whose strategic goal is to build the value of the company, although some of the thoughts expressed can apply to other situations.*

*This article was written as an introduction only to a complex strategic, human resource, tax and legal issue. Generalizations can never be applied to any specific situation, and appropriate tax, legal and human resource advisors should be consulted before any specific employee stock option plan is implement.*

## Uses of ESOPs

There are a number of recognized uses for ESOPs in owner managed businesses. These include:

- Raising money for the company, especially a new or struggling business.
- Reducing wage demands by providing an equity based incentive that justifies an employee accepting a lower base compensation package.
- Rewarding long term employee loyalty that has created significant wealth for the owner.
- Providing a retirement strategy for the owner manager who prefers to see his or her employees buy the business instead of a competitor.
- Focusing employee attitude and behaviour on building shareholder value.

## Benefits and Pitfalls to the Employer and the Employee

The potential benefits to an owner manager include:

- Improved financial performance. (A 1987 Toronto Stock Exchange study found that ESOP companies performed substantially better than non-ESOP competitors in every economic category measured.)
- Improved employee performance.
- Increased employee loyalty.
- Increased employee commitment to the company.
- Increased access to employee ideas for improving the business.
- Reduced labour/management conflict.
- Reduced salary and benefit demands.
- Source of investment capital.
- Potential retirement strategy.
- Increased share value over time.

The potential benefits to an ESOP employee include:

- Greater access to information about the company.
- An opportunity to have a say in how things are done.
- Greater job security.
- An opportunity to participate in company profits and increase company value.
- Reduced labour/management conflict.
- Access to investment opportunity.
- Access to tax deferred or tax sheltered investment opportunity.
- Increased personal wealth.

Potential pitfalls to an owner manager include:

- Having to provide financial disclosure.
- ESOP employees seeking a say in how the business is run.
- The complexity, cost and time required to design, implement and maintain an ESOP.
- Having to consider minority shareholder rights.
- Being subject to greater employee scrutiny.
- Having your company subject to greater employee scrutiny.
- Being accountable to employee/partners.

Potential employee pitfalls include:

- Never really getting the chance to have an impact on the business.
- Hitching your star to a vehicle that never takes off, leaving you worse off if the company does not grow in value while you are accepting lower than usual personal compensation.
- Investing hard earned money in a high risk venture that does not pay off.
- Not achieving the vesting requirements.
- Not having the resources to buy the shares.
- Not being able to sell the shares when you want to cash out.

## Particular Concerns for ESOPs in Owner Managed Businesses

Private, owner managed businesses, by their very nature, are not easy candidates for ESOPs. I say this for several reasons:

Control: Most owner managed businesses stay small enough that the owner can control all major decisions, and many not so major ones as well. Most owner managers are not used to taking advice from their employees or giving them a say in how important things are done. There is nothing wrong with this management style for a privately owned business. However, this approach does not work well with ESOPs. For an ESOP to work well in building company value participating employees must believe and experience how what they do and how well they do it impacts company value. Participating employees must have some say in how things are run. If the owner manager is making all the decisions and directing how everything is done, this feeling of connection will be lost and the employees will not value the ESOP as something worthwhile they can contribute to.

Sharing of Information and Dialogue with Employees: Most owner managers are very private people when it comes to sharing of information. This is an extension of that control-oriented personality. Yet for an ESOP to work the employees must have intimate knowledge of the company's financial situation. Without true understanding of how the company makes money, how much the company is making, and how this drives company value, employees will never be connected to the ESOP and will not adopt the spirit necessary for the plan to succeed in the long run. Most owner managers are extremely reluctant to provide this kind of education and information to their employees, and even more reluctant to allow their employees to have a say in how best to improve company value.

Providing Liquidity: Liquidity is an essential component to any ESOP. Participating employees must eventually buy and then sell their shares if they are to realize the financial rewards the plan promises. In public companies participating employees rely upon the stock market to provide the liquidity they need to fund the purchase price of the stock, and to allow them to cash in their gains, when they decide the time is right to do so. However there is rarely any market for the shares of a private, owner managed business. Many owner managers plan to provide a market by taking their company public or selling it within the five year horizon. However there is no certainty such plans will materialize. Therefore the owners of the business should provide liquidity, by way of loans or other assistance to participating employees who want to buy stock, and by way of buy-back plans for employees who wish to cash in their stock or options for profit taking purposes. These are added complexities which owner managers wishing to implement an ESOP must address. Many are not willing to do so, which severely restricts the plan's ability to create enthusiasm, loyalty and extra effort in the participating employees.

Presenting a Growth Opportunity: Most ESOPs have a vesting period of three to five years and termination date of ten years. Most employees want to be able to reap rewards within five years. In addition, many ESOPs have performance targets that must be met for the options to vest. Unless the option price is significantly below market value at the time the options are granted, then the company has to grow significantly in value for the options to be of real, after tax value to the participating employee. Many owner managed businesses are not positioned for significant growth, and therefore do not make good candidates for ESOPs based upon growth in future value.

## Some Basic ESOP Concepts

<u>*Options*</u> generally refers to the number of shares the employee is entitled to purchase in accordance with the ESOP and the *Grant* that is made to that employee.

Under the umbrella of the overall plan, a participating employee is <u>*Granted*</u> an *Option* to buy a certain number of *Optioned Shares* at a fixed price called the *Option Price.* This becomes a contract between the employee and the company and forms part of the employee's employment contract with his or her employer. The employer is required to make the *Optioned Shares* available to the employee at the *Option Price*, but the employee is not required to buy them.

The <u>*Option Price*</u> is the purchase price the employee must pay for the *Optioned Shares*. It is determined at the time the option is granted. It is usually equal to the fair market value of the shares in question at the time the *Option* is granted, but does not have to be. It can be more or less that that fair market value.

The <u>*Optioned Shares*</u> are the number and type of shares the employee can buy at the *Option Price.* The number and type of *Optioned Shares* are determined by the plan and the *Grant*. They do not have to be same kind of shares held by the owner manager. For example, they do not have to be voting shares.

<u>*Vesting*</u> requirements are things that must occur before the employee is entitled to exercise his or her *Options*. Some times the *Options Vest* immediately, which means that nothing more must occur and the employee can exercise the *Options* whenever he or she wants to. On the other hand, it is quite common for *Vesting* to be linked to employee loyalty. For example, an *Option* to purchase 100 shares might *Vest* at the rate of 20 shares per year in arrears, so that the employee must stay with the company for five years before he or she is entitled to purchase the full 100 shares provided for in the *Grant*. In other situations *Vesting* is tied into meeting defined performance targets, such as increased sales or profits.

After the *Options* have been *Granted*, and after any *Vesting* requirements have elapsed, the employee has the option to purchase the *Optioned Shares* that have *Vested* for the *Option Price*. This is called <u>*Exercising*</u> the *Option*. The plan may or may not impose limits on when or how often the *Options* may be *Exercised*, or how many *Optioned Shares* must be purchased each time the *Option* is exercised.

Most companies do not want to have un-*Exercised Options* remaining outstanding indefinitely. Therefore the employee must "use them or lose them" within a certain time frame. If the employee does not *Exercise* the *Vested Options* before a defined "drop dead", the right to buy the shares is terminated. This "drop dead" date is called the <u>*Termination Date*</u>. The employee is not allowed to buy the *Optioned Shares* after the *Termination Date*.

## Issues to Be Managed in Developing and ESOP for an Owner Managed Business

A significant number of issues must be considered in developing a plan. Some of them will become matters of contract between the participating employees and the company, and some will become a matter of policy subject to change in the discretion of the company. This is a very unregulated area, and there is a great deal of flexibility available to the owner manager and his advisors. This permits a great deal of creativity to be brought to bear. In the end, no two plans are identical. A summary of the issues to be managed includes:

The Development Team: No ESOP should be developed without knowledgeable professional advisors being involved. In particular a tax specialist and a business lawyer should be involved. A human resource professional can also be useful. Finally it may or not be appropriate to involve the potential participating employees, or a representative of the participating employees, in the project team.

The Strategic Purpose: An ESOP is a strategic tool. It should be developed as an integral component of a five to ten year plan for the company. The owner manager should have a clear understanding of why he or she is developing and implementing an ESOP, and clear objectives for the company and the ESOP. In particular, the owner manager should decide upon the extent the purpose of the ESOP is to be a reward for past effort, an incentive for the future of the company, and a "golden handcuff". If performance standards are a key part of the plan, the participating employees should share this vision and should agree that the objectives are reasonable and achievable. The purpose of the plan should be well expressed, and known and agreed to by the owner manager and the participating employees.

Company Valuation: The issue of valuation will come up again and again. The owner manager and participating employees must know the value of the company at the time the plan is established, so that opening option prices can be established and the owner manager and the participating employees can appreciate what is being given up or offered for sale. The owner manager and participating employees must also know how the company is valued, as this will be the yardstick by which the success of the company is measured and will come into consideration if new options are granted or new employees join the plan. Valuation also comes up when the liquidity event occurs, whether it is an initial public offering, sale of the business or company funded buy-back. Finally, valuation issues affect how the benefits and rewards of the plan are taxed in the hands of the participating employees who exercise their options. The services of a Chartered Business Valuator are often essential at this stage in the process.

Investment Opportunity: In creating an ESOP a company is holding itself out as a potential investment which justifies employee participation. If the ESOP is not perceived as having good investment potential, it will not be well received by the participating employees. Therefore the business must be assessed for its investment potential, and a case must be developed for why it represents a good investment for its employees. Then the interest of the employees to "invest" in the business must be assessed. If the employees in question are not motivated by the ESOP, or do not appreciate the company's investment potential, than an ESOP may not be a good idea for that company at that time with those employees.

Participating Employees: The owner manager must decide what employees, either specifically or by position or by class, will participate in the plan. It may be possible to include all of the employees, just some employees, or just selected senior managers. In any case the owner manager must be aware of the fact that most employees do not value share ownership as highly as they value salary and bonus. Most employees are not equity oriented, which is why they are not owner managers themselves. This issue must be considered in the context of the class of employees which will be included in the plan, and the specific employees the owner manager is trying to motivate. For some employees it may make sense to find another financial incentive plan, such as a bonus structure or employee profit sharing plan.

Number, Type and Attributes of Participating Shares: Most ESOPs call for common shares to be issued to participating employees. However the owner manager must decide what percentage of the company will be made available to the plan, and what the attributes of those shares will be. In particular, it must be decided whether or not the participating employees will get voting stock. Non-voting shares solve many potential “control” issues as mentioned above.

Granting of Options: The owner manager must decide how many options will be granted to each participating employee or class of employees. It is not unusual for a certain percentage of the company to be made available to specific employees based upon position (e.g. 2.5% VP Sales, 2.5% VP Operations, 2.5% VP Finance, etc.) or by class (2.5% Operations and Administration, 2.5% Sales and Marketing, 2.5% Engineering, etc.).

Option Price: The initial option price for the original granting of shares must be set. In addition, policies, formulas or principles for the option price for future grants must be established. Fair market value at the time of the grant as determined by the board of directors is a fairly typical approach. However, options are sometimes granted at more or less than current fair market value, depending on the strategic purpose of the plan (e.g. reward for past performance or service could result in options being granted at less than fair market value).

Vesting Requirements: Vesting defines the conditions which must be satisfied before the relevant participating employee can exercise their options. There is a great deal of flexibility when it comes to vesting. Vesting can occur at the time of granting, or may happen in stages over a period of time conditional upon ongoing employment. Vesting can also be tied into certain pre-determined performance criteria, including sales, profits or value issues. This is a key issue. The owner manager must decide what combination of vesting (some immediately, some over time, some tied into company performance, some tied into personal performance, etc.) that best meets the strategic purposes of the plan.

Termination Provisions: The grant of options does not require the employee to buy the shares. It is an “option” in the true sense. However the options can not exist forever. Therefore various termination issues need to be addressed in the plan, including simple passage of time (five to ten years after granting or vesting is typical), failure to meet performance criteria, disability, death, leaving the company, termination for cause and termination without cause all have to be considered. In addition what happens to the options and exercised shares upon the occurrence of each potential termination event (e.g. an employee quits or is fired) needs to be considered and spelled out, including a potential company buy back of the options or exercised shares.

Acceleration/Drag-Along Provisions: Plans change. The owner manager must consider what will happen to outstanding options, both vested and unvested, in the event that an opportunity to do an initial public offering occurs before planned, or in the event he or she receives an offer for the company that can not be refused, or should the owner manager die or become disabled. In these circumstances vesting may or may not accelerate, or unvested options may terminate, or the employee may be given a brief period of time to elect to exercise vested or unvested options. Most plans allow some percentage (up to 100%) of the unvested options to accelerate. It is also typical for the exercise of the shares to be timed to the closing of the IPO/sale/liquidity event, so that the participating employees can use their share of the sale proceeds to pay the exercise price for their shares. In any case, most plans allow the owner manager to sell the company and to force the participating employees to participate in the sale or event in question.

Anti-Dilution Issues: Similar concerns arise with respect to financing the company. Most ESOPs contain provisions preventing the owner manager from diluting the participating employees' percentage interest in the company (vested or unvested) in the event that that the owner manager wants to issue new shares to himself, a new partner, or another source of financing. This must be balanced against the owner manager's need to adequately capitalize and finance his or her business. For example, the plan could call for any dilution to be borne pro rata by all share and option holders, or on some other basis, or might call for unexercised options to be bought out at an agreed or formula based price using the proceeds of the financing. There is a great deal of flexibility in this area.

ESOP Liquidity Issues: As mentioned above, the plan should be clear as to whether or not the company will provide financial assistance to participating employees to exercise their options, and when and how the participating employees get liquidity of their options or exercised shares. The usual methods for ultimate liquidity or an initial public offering, sale of the company, a company funded buy back program, or some combination of all three. This is extremely critical. Without the guarantee of liquidity at some reasonable time in the future, the plan will not generate the enthusiasm and commitment the owner manager is looking for.

Tax Planning: Tax planning issues must be considered. These can be complex. For example, the plan may call for shares to be purchased from company treasury, or from the existing shareholders. An ESOP can be one way for an owner manager to obtain the benefit of the $500,000.00 exemption for capital gains on the shares of qualifying small business corporations.

In addition, the tax consequences for the participating employees need to be considered.

The general rule is that no tax is triggered to the employees when the options are granted, but capital gains tax is triggered when the options are exercised, and must be paid whether or not the employee holds or immediately sells all or some of the exercised shares. In most cases the difference between the option price and the fair market value of the shares at the time the options are granted is taxed as employment income (i.e. any gain realized from the fact that the employee received grants at less than the then current fair market value of the shares is considered employment income). In addition, another general rule is that the difference between the option price paid for the shares and the fair market value at the time the option is exercised is taxed as a capital gain (i.e. the "gain" in value from the option price to the value at the time the option is exercised is taxed as a capital gain).

There is an important exception to these general rules. If the company remains a Canadian controlled private corporation ("CCPC") under the ITA then the capital gain is deferred by the participating employee until he or she actually sells the exercised shares.

In addition, the employee's right to use the $500,000.00 life time exemption for capital gains on qualifying small business corporations must be considered. However this can be difficult to capture as the participating employee must hold the shares in question for two years after he or she exercises their options for this exemption to be available. This may not be possible, depending on the nature of the liquidity event and management of liquidity and tax issues.

There are other specific adjustments that the participating employee may be able take advantage of, which can be explained by an experienced tax professional.

However, any ESOP should take into account the tax participating employees will have to pay, when they will have to pay it, and how they will fund the payment of that tax. If it does not, the ESOP may lose much of its attractiveness due to negative tax consequences to the employee, including the inability of the employee to exercise the options because he or she can not cash flow the resulting tax liability.

<u>Interim Profit Sharing, Dividends and Year End Management Bonuses</u>: Most small, private companies in Ontario “bonus down” their year end profits to obtain the small business tax rate on profits less than $200,000.00. Others distribute dividend income to its shareholders. These issues must be considered with respect to the optioned shares, especially when (as is often the case) the money ends up being loaned back to the company anyway.

Bonuses and dividends are one way for the “value” of the company to be regularly diluted prior to the options being exercised. This would frustrate the ability for the employees to really increase the value of the company for their eventually gain.

After the options are exercised, employee shareholders will expect to receive dividends and management bonuses on a pro rata basis based upon their exercised shares. However, it would not be unusual participating employees to be excluded from bonusing for tax purposes when the after tax amount of the bonus is simply loaned back to the company as operating capital.

<u>Securities Law</u>: As a general rule there are no *Securities Act* issues that arise in a typical private company ESOP. However, if the plan is to take the company public, and the ESOP is intended to survive the initial public offering, then the plan should take *Securities Act* and stock exchange requirements into account so that the ESOP will meet regulatory requirements after the company goes public.

<u>Plan Management</u>: It must be decided who will manage the plan. The company board of directors is fairly typical, provided the owner manager remains in control of the board. Generally speaking the board will be empowered to determine who participates, how many options they are granted, what the option price will be, and what conditions are required for vesting, within initial guidelines set down by the owner manager in the plan document or a policy statement at the time the plan is established. In addition, if shares are being made available to a class of employees, the plan may call for an independent trustee to act as trustee of the optioned shares on behalf of the members of the class.

<u>Employee Connection</u>: Employee “connection” is important to securing value for the owner manager from the ESOP. By “connection” I am referring to the extent the participating employees feel they have a genuine opportunity to influence company value. If the employees do not feel that they have an opportunity to make and implement decisions that affect company value, either because of the nature of their position (e.g. company receptionist) or because of owner manager interference (see comments on Control, above), then the perceived value of the ESOP to

that employee will decrease dramatically and the existence of options may not affect employee loyalty or performance. This is a critical concern. Businesses can not be democracies. If the employees are given too much say in how things are done, decision making can suffer. On the other hand, if the participating employees are given no say, then they will not be motivated to try and drive company value, which undermines the very purpose of the plan. Important issues of authority, chain of command and management style must be considered.

Integration with Other Employee Compensation Issues: The granting of options is clearly a benefit from employment, although the value of the options is speculative and uncertain. The impact of the options on other compensation issues, such as the salary, commission, bonus, benefits, termination packages, and perquisites offered to the participating employees must be addressed. Most owner managers expect their employees to be less demanding in these areas as a result of the options. Most employees consider the options speculative and something independent of their basic compensation. This conflict can be a difficult one to resolve, but will help reveal the extent to which the employee in question really "values" the ESOP, which will also tell the owner manager something about the employee or the ESOP or both.

Fairness: As a final check on all of the above, the issue of "fairness" must be considered. A successful ESOP is perceived by all concerned as "being fair" between the participating employees and the owner managers, and being "fair" as among the employees themselves.

Documenting the ESOP: Finally, the ESOP needs to be appropriately documented. This will usually involve: a plan document that sets out legally binding details of the plan for the company as a whole; a policy or series of policy documents that apply to the whole plan but are not "contractual" and may be varied by the directors or owner managers or plan administrators in the future; articles of amendment and supporting shareholders' and directors' resolutions setting up the class of shares to be optioned; directors' resolutions granting specific options in accordance with employee specific factors (such as number of shares, vesting conditions, option price, etc.); and a granting document signed by the company and the employee that incorporates elements of all of the foregoing and forms part of the employee's employment contract with the company. Finally, depending on the circumstances, a shareholders agreement between the owner manager and the participating shareholders (or an independent trustee on their behalf) may be required.

Communicating the ESOP: After the plan is fully developed and documented it must be communicated to the participating employees in a manner which is simple, clear, convincing and motivating. Failure to properly plan and implement this critical step could make all the previous work meaningless.

## Closing Thoughts

For owner managers looking to get industry leading loyalty, productivity and commitment out of its key employees, an ESOP is an alternative to discretionary bonuses that should be considered. However, a successful ESOP in a private, owner managed business will generally depend upon the existence of a unique combination of business opportunity, owner manager enlightenment, and motivated employees who not only value the principle of share ownership but also value the share ownership opportunity as set down by the owner manager in the plan itself.

*Note: Please see a companion article written by Phil Thompson on Employee Profit Sharing Plans (EPSPs)* *and Employee Gain Sharing Plans (EGSPs) in Owner Managed Businesses.*