

Case Studies in Employee Share Ownership

David Craddock is a recognised authority in the UK and worldwide on employee share schemes. In his book, *The Tolley's Guide to Employee Share Schemes*, David shares his expertise drawn from over 30 years as a practitioner in the subject to explore and expound upon the many aspects of employee share ownership with practical application that is grounded in a comprehensive understanding of the relevant laws and regulations and a profound insight into how to maximise the employee share scheme initiative to the benefit of the company.

In this article, David explains through real-life case study examples how companies have in practice succeeded in introducing an employee share scheme initiative. These examples illustrate the methodology that a company needs to follow in order to determine the most appropriate employee share scheme or combination of employee share schemes required to support the corporate objectives of the business. Always the employee share scheme is a corporate incentive which must be focused on the motivation and incentivisation of employees. The case studies show how it is necessary to work with an understanding of the law alongside an appreciation of the human behaviours within the business.



UK Case Study 1: A Light Engineering Company

1. The Objective

The objective is to establish a succession plan for the shareholding of the company, thereby enabling the existing shareholders to diversify their investment portfolio and pave the way for a management buy-out.

2. The Facts

The company is a private company and has grown steadily over many years. The existing shareholder directors are in their late 50s and are contemplating retirement. The company operates an engineering business that has a long history of successful initiatives in the

UK market and overseas. The directors recognise that the company has strong potential for new product development and the capture of new markets. The existing shareholder directors have identified successors within the business, existing managers who as responsible individuals will be able to lead the workforce of some 220 employees into this new era for the business. The directors are, therefore, planning for both shareholder succession and management succession. The existing shareholders want to retain some shareholder interest. However, they also want to realise value for at least some of their shares with a view to diversifying their investment portfolio.

3. The Solution

The company establishes an employee share trust, initially with a view to enabling the shareholder directors to sell 24% of their combined shareholding and realise actual cash for investment elsewhere. The company grants EMI share options to key management team members with top-up tax-unapproved share options to take the shareholding of the new management team to 40% in five years' time and to 75%

in 7 years' time. The company has taken deliberate steps to train and to develop its new management team to the level of management that is required to run the company.

4. The Particular Commentary Features

The existing shareholder directors realise their actual cash return through a capital gains tax transaction with the employee share trust, based on an anti-avoidance clearance from HMRC. The existing shareholder directors have in the short-term retained control of the company, even control of special resolutions, whilst at the same time ensuring that their investment portfolio is not restricted to shares in their own company. The statutory corporation tax deduction is a particular attraction to the directors with the company benefiting from relief within its corporation tax computation based on the gain realised by the employees at exercise. The new management team can envisage a future with their shareholding escalating over time and their own opportunity in time for a realisation of value through selling to the same employee share trust.





UK Case Study 2: A Specialist Management Consultancy Company

1. The Objective

The objective is to protect the value of the existing shareholders while at the same time introducing a growth shares model to motivate and incentivise all employees to generate further value for the company.

2. The Facts

The company is a private company, currently worth £10 million, with five shareholders who are resolved to drive the company forward towards high growth in order to realise the company's potential. The company operates in a specialised management consultancy field with a dynamic

set of products and services that have unlimited potential in the UK and worldwide. The existing shareholders want to preserve for themselves the existing whole company value that exists at the date of the commencement of the employee share scheme so that only they have a claim at any time on that value. Additionally, though, they are resolved to involve the whole workforce of 140 employees in a growth shares model as the impetus for the company to grow and develop in the UK and overseas.

3. The Solution

The directors resolve to reclassify the existing ordinary share capital into a new preference share capital to replace the existing ordinary share capital. The whole company value of the company at the date of the

reclassification is £10 million and it is this value that the directors resolve to freeze into the new preference shares. Alongside the new preference shares the directors resolve to create new ordinary shares as the growth shares which are allocated 80% to the existing shareholders and 20% to the new employee shareholders. This allocation policy ensures that the existing shareholders and the new employee shareholders benefit from the growth in the value of the company. The point is that all future growth from the date of the reclassification of the share capital attaches to the growth shares. On a sale of the company, say, for example, for £50 million, the first £10 million frozen value is paid to the preference shareholders while the remaining £40 million is paid to the ordinary shareholders, i.e. the owners of the growth shares.

4. The Particular Commentary Features

As the ordinary shares, operating as growth shares, grow from a value that is no more than the nominal value of the shares at the date of the reclassification, to attract all future growth following the reclassification, all the gain that attaches to the ordinary shares is treated as capital gain and, therefore, subject to the less punitive capital gains tax. The employee allocation of ordinary shares is

either allocated to the employees through an immediate new issue of shares or, alternatively, options are granted over the employee allocation of ordinary shares. In this case, EMI options were granted with the employees to benefit from the special form of Entrepreneurs Relief that was specifically created by statute for EMI. The EMI form of Entrepreneurs Relief delivers a 10% capital gains tax rate on the capital gain, provided a period of at least two years has elapsed from the date of grant of the option to the date of sale of the shares. However, when linked to the growth shares model, the 10% capital gains tax rate applies to virtually all the sale proceeds as the base cost of the shares is no more than the very low nominal value, say £0.0001 per share.

So, this article has set out two very different but equally fascinating case studies. In each case, the scheme is geared to motivating the workforce to higher levels of productivity and profitability. However, in each case also the aspirations of the existing shareholders are recognised and given practical expression within the structuring of the employee share scheme arrangement.

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