

ADDLESHAW GODDARD



Employee Incentives Group

Remotivating management
in private companies

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There are an increasing number of private equity-backed companies that have no equity value due to high levels of debt in the company and the downturn in economic activity. During the last 12 months we have seen a number of restructuring mandates from private equity firms, investee companies and bank lenders alike. In many situations the private equity and/or bank funders will capitalise some or all of their debt investments into equity instruments to recognise the difficulties of the present position, and strengthen the investee company's balance sheet.

The proportion of the equity held by management (whether in the form of shares or share awards) following a debt to equity swap will often be greatly reduced. Whether there is a restructuring proposed or not, investors need to consider how their management teams should be incentivised going forward, as any existing arrangements are unlikely to remain fit for purpose.

New management share plans will play an important role in incentivising key employees. A carefully designed share plan can help underpin the financial performance of the business or set the groundwork for an exit strategy, delivering value to other stakeholders and investors. When designing a share plan the fact that the shares have very little built-in value can be an advantage, enabling companies to put in place tax efficient arrangements (particularly following the income tax and national insurance contribution increases recently announced) which would be more complex and costly for a company with a higher share valuation.

Types of arrangement

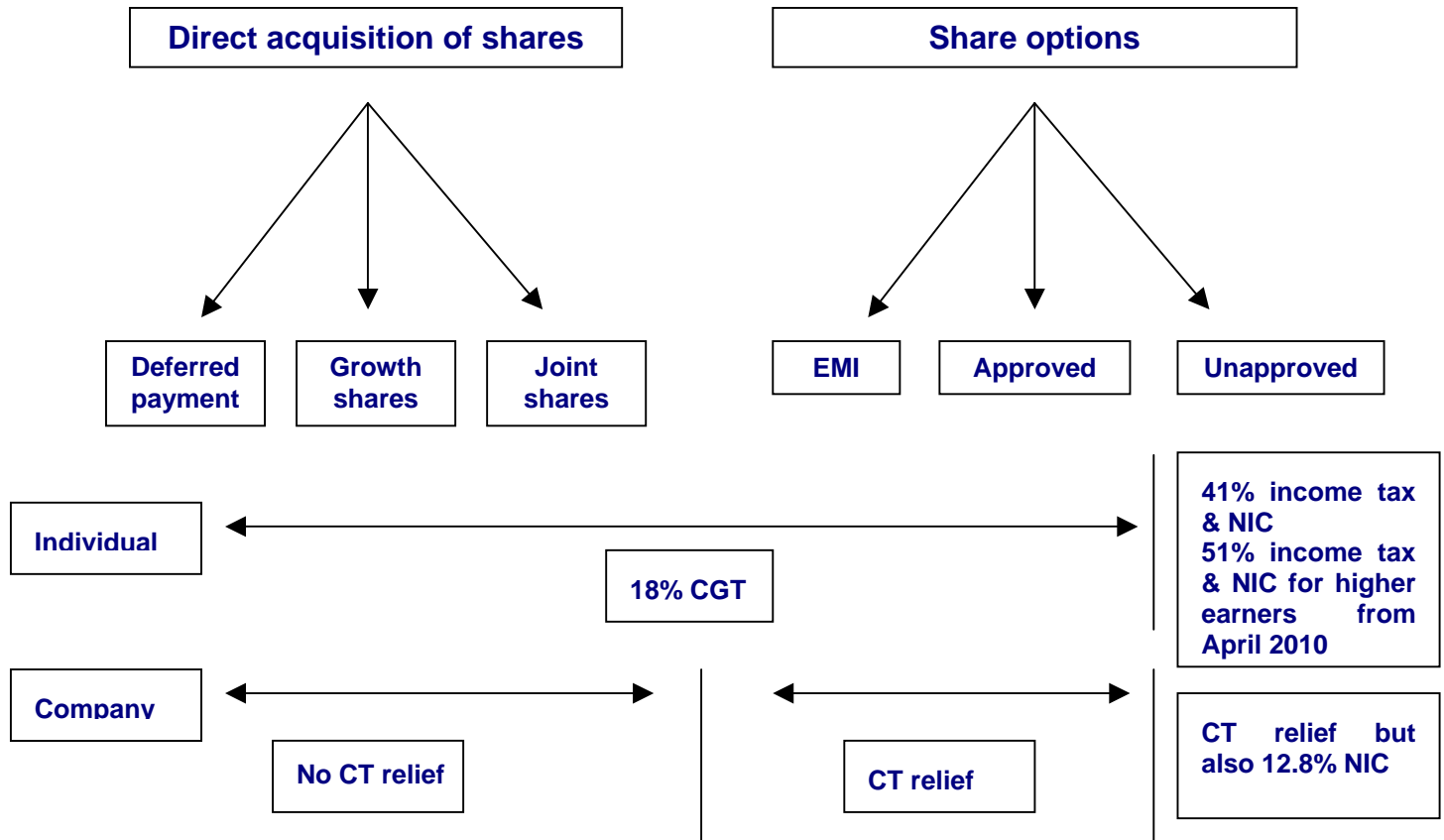
The new incentive arrangements could feature the direct acquisition of shares, share options, or a combination of the two. Each such arrangement will have particular tax implications (the diagram below highlights the key features of each arrangement) when finalising proposals for management teams.

In designing a successful share plan, whilst tax implications invariably dominate the structure, the investors and the company need also to ensure that:

- it is transparent and can be understood by participating employees
- management "buys in" to the arrangement and can see a clear attractive benefit
- it is affordable for the company
- it offers attractive payouts so that total reward is competitive within the market place
- the plan fits with the other elements of the participating employee's remuneration package.

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The tax implications of different arrangements



So what are companies doing?

Following a debt for equity swap, the low value of the company's share capital often favours a direct acquisition by management of shares that could not be facilitated in more successful investments. These awards can be made subject to the usual good leaver and bad leaver provisions. However, if the shares still have an upfront value, albeit perhaps only a tax value, then this may be less attractive to management. There are a number of alternative structures:

Deferred shares

This would typically involve the issue or transfer of shares on a deferred payment basis. The obligation is typically deferred until exit or the manager is a leaver. This can be relatively straightforward and tax efficient, as it again would seek to ensure that the proceeds of sale are subject to capital gains tax (CGT), which is currently charged at 18%, rather than income tax (which rises to 50% for higher income employees from April 2010).

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Growth shares

It is also possible to structure a growth share plan so that management only benefits from the growth in value of the shares once a predetermined value is achieved on any future exit.

The key features of such a growth share arrangement are:

- employees subscribe for a new class of shares
- the rights attaching to the class of shares as set out in the company's articles of association mean that employees are only entitled to a share in disposal proceeds over and above a predetermined valuation of the company on an exit
- the aim is to get the initial valuation of the shares as low as possible to minimise any upfront income tax (and possible NIC) charge
- the proceeds of sale of the shares on an exit should be subject to CGT at 18% and not income tax and national insurance contributions.

A slightly different variation to growth shares is a joint shareholder approach, where management acquire shares jointly with an employee benefit trust. On a sale of the shares the manager would receive proceeds equal to the growth in value of the shares (again subject to CGT at 18%) and the trust receives the balance.

Share options

Whilst many private equity-backed companies cannot qualify for tax approved plans, such as Enterprise Management Incentives (EMI), they should be considered; if you do qualify they provide a tax efficient and relatively straightforward solution, subject to having to comply with a number of legislative limits.

Cash

The use of long term cash bonuses focused on payout at exit, or following an appropriate orderly handover period, should not be ignored. Whilst clearly not tax efficient they are very easy to understand, have clear line of sight with management and can be drafted in whatever way is most desirable, without having to be restricted with the current articles of association of the company.

Entrepreneurs' relief

With the removal of taper relief for CGT, the opportunity of reducing the CGT rate to 10% by utilising entrepreneurs' relief is often overlooked. Where a member of the management team is to be issued shares which represent at least 5% of the ordinary share capital (and which allow him to exercise at least 5% of the voting rights), it may be possible for the employee to benefit from entrepreneurs' relief. Provided certain conditions are met, the growth in value of shares which qualify for entrepreneurs' relief are taxed at an effective CGT rate of 10%.

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Similarly, where an employee has pre-existing underwater options over at least 5% of the ordinary share capital, the company may wish to consider asking the employee to waive the options in exchange for a direct issue of shares which potentially qualify for entrepreneurs' relief.

In addition to the level of shareholding (and associated voting rights), the main requirement to qualify for entrepreneurs' relief in these circumstances is that the taxpayer has been an officer or employee of the company throughout the period of one year before disposal. There is a £1 million lifetime cap on the amount of qualifying capital gain that can benefit from entrepreneurs' relief.

It would be unusual for junior management to have a sufficient shareholding to qualify for entrepreneur's relief. However, in the case of senior managers, it is possible that the 5% requirement will be met. In those cases, it is important that incentive arrangements involves ownership of shares and the underlying voting rights (which would not be the case under option arrangements, for example) if managers are to benefit from the relief.

Getting it right

Incentivising key management in these difficult times is one of the essential issues which stakeholders will need to focus on in the coming twelve months. There are a number of ways in which companies are dealing with this, but each company is different. Investors and managers should not simply resort to a pre-packaged solution, nor should they necessarily let the tax tail wag the dog: choose the right incentive that motivates management to focus on the right things going forward.

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