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Sharing is caring? An introduction to workforce equity incentive schemes

Given the increased need to retain talent in a candidate-driven market, Harneys' transactional team in the BVI has seen a considerable uptick in requests for equity incentive schemes in both the start-up and listed company market.

George Weston, Corporate Partner, and Charlotte Allery, Employment Associate, consider some of the different options and the practical and legal pitfalls a business should consider before introducing such a scheme.

What is an equity incentive scheme?

Although there are multiple types of schemes, a basic principle at the heart of most of them is to give staff some or all of their compensation in the form of an interest in the company that they work for.

The idea is that if the company performs well, partly due to the efforts of its workers or management, the value of that interest will increase. Scheme participants may also benefit from distributions or a buyout on the occurrence of a liquidity event such as a merger.

Why have a scheme?

There are many reasons why companies choose to implement equity plans, which often depend on the size of the company and its specific objectives.

Common reasons for utilising share schemes include:

- Recruiting, retaining and motivating staff
- Improving and incentivising performance
- Nurturing loyalty
- Supplementing low salaries and/or replacing cash bonuses
- Reducing employment costs
- Aligning interests of owners and the workforce
- Alleviating cashflow issues and sharing risk
- As a tool for succession or exit planning

Schemes are generally best used where the company is expecting to increase its value over the medium term, and where there is likely to be liquidity in its securities. This means they are typically seen in either listed companies or those that expect a listing or potential sale in the future, for which companies the BVI has for a long-time been a natural home.

Different types of equity incentive scheme

The traditional and still perhaps most common scheme is the employee share option plan or "ESOP". In essence the employee receives a number of options every year that allow them to purchase (or be awarded) shares in the future when the options become exercisable (vest). The idea is that as the shares become more valuable, the ability to buy them at a historic price becomes itself valuable.

There are however countless variations to traditional share option schemes, which include employee benefit trusts (where a trustee holds securities on behalf of employees), 'phantom' plans based on the value of shares and even trendy token option schemes. A business has several choices when deciding what type of equity-linked incentive to offer. Each type of scheme comes with its own advantages and disadvantages, and much will depend upon the aim of the incentive and the scale of the company.

For example, with "phantom or synthetic options providing cash awards, participants are never truly shareholders. This reduces complexity because there is no need to follow the formalities of issuing shares, encourages performance (particularly in the lead up to exit), and maintains the balance of power between owners and the workforce because participants do not have the benefit of voting rights or minority protection. However, the issue of shares or tokens can have a greater incentive effect on staff (who receive a genuine 'piece' of the company), leading to longer-term retention, and can create cashflow benefits.

At an early stage, it is worth seeking counsel on the options available, including the benefits of each route.

Key commercial aspects

When granting an award, the fundamental commercial factors that a business will need to consider include:

- **Participants –** Who do you want to offer the incentive to? Is this for senior management or your whole workforce? Is this just your employees or will your non-executive directors or consultants be offered the scheme?
- **Vesting –** Do you want all of the shares (or future options to purchase shares) to be available straight away, or do you want participants to receive their awards little by little over time?
- **Exercise –** If granting an option-based scheme, when should participants be able to exercise their option (i.e. purchase the shares or release the cash value)? Do you wish to tie this to a set timeframe, or on a particular event (such as an exit, or achieving a particular financial or performance target)?
- **Impact of termination –** What should happen to a participant's award in the event that they leave the business? Does the business wish to differentiate between 'bad' leavers, and those who are 'good'?
- **Effect of change of control –** In the event that there is a change of control, do you wish to protect the future acquiror's interest by allowing termination of the scheme entirely, or afford the participants the ability to accelerate exercise?
- **Tax –** is it necessary to structure the scheme in a particular way to ensure it is tax efficient for both employees and the company?

Key corporate factors

Aside from the commercial issues at play, the introduction of an equity-incentive scheme raises several corporate and constitutional queries:

- **Impact on future transactions –** A badly drafted incentive scheme can torpedo an M&A transaction or potential listing. While it is never entirely possible to anticipate all scenarios, a well drafted scheme gives participants the ability to benefit from those transactions without complicating or frustrating them.
- **New class of share –** The company (and indeed its current shareholders) may wish to introduce a new class of share to be granted under an option, to ensure differentiation between original shareholders and those who join by way of workforce option scheme, and to control dilution.
- **Voting and other rights –** If introducing a new class of shares, the rights attached to that class will need to be considered and reflected in the company's articles of association. Will you allow the new shareholders to have voting rights? What will their rights to dividends and/or capital be, for example?
- **Constitutional documents** – The constitutional documents of the company (in the BVI, the memorandum and articles of association) may require some amendment. This will always be the case when the scheme is over a new class of shares. If the company still has boilerplate documents from incorporation which are designed for a single shareholder, they are highly likely to need updating.

- **Shareholders agreement –** On the award of shares, it is usually sensible to ask the new staff shareholders to enter into a Shareholders Agreement (or a Deed of Adherence to a current Agreement), dealing with operational items such as reserved matters, transfers of shares, and death.

- **Minority shareholder protections –** Where an equity incentive scheme involves the issue of actual shares to participants, it is sensible to consider that, although BVI legislation is generally company and/or director friendly, minority shareholders are able to avail themselves of certain protections.

Offshore considerations

Whilst the BVI is a tax neutral jurisdiction, for offshore entities introducing an equity incentive scheme, the first step to take will be to seek **tax advice** on the local tax implications of both the grant and exercise of an equity award (whether option-based, phantom or otherwise). Onshore tax laws may be applicable depending on where the company's base of operations and management are and where employees are located.

Whilst we can build in protective provisions in the documents, such as tax indemnities in the business' favour, it is important to understand the tax impact of the scheme for both the business and participants alike. This may affect which participants are included and indeed the type of scheme offered.

Although the BVI is also a very flexible jurisdiction, when the incentive scheme involves a BVI company, it is important to seek advice to ensure that not only have the factors mentioned above been thought through, but that all relevant corporate law formalities have been followed. For example, BVI law requires specific wording in board resolutions where shares are being issued for non-cash consideration.

When offering an incentive to non-employees, it is also sensible to consider **applicable employment law**, to establish whether the grant of the scheme may create an employment status risk. Just because the issuing company is incorporated offshore, this does not mean that the employees are not entitled to employment law protections in their usual place of work.

The content of this article intends to provide a general guide to the subject matter, and each scheme will depend on your business' size and objectives. **If you require further information on introducing a scheme, or you would like to complete our equity incentive scheme questionnaire so we can identify the best arrangement for you, please contact George or Charlotte for more details.**

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