PENNINGTONS MANCHES COOPER

INCENTIVISING EXECUTIVES: GROWTH SHARE SCHEMES

Share schemes continue to play an important role in incentivising executives and employees.

Whilst there are a variety of methods by which executives can be offered a stake in the company for which they work, 'growth' share schemes are particularly useful for those who may prefer an immediate and tangible interest in shares as opposed to a share option, and where EMI options are not available, either because the company does not qualify or where an executive has exceeded his personal EMI threshold for options. Typically, growth share schemes are reserved for senior executives but there is no reason why they cannot be extended to the whole workforce.

This briefing note gives a general overview of growth share schemes for private companies, explains how they operate, and looks at the pros and cons of these schemes.

'GROWTH' SHARE SCHEMES – WHAT THEY ARE

There are a number of terms that are used interchangeably to describe growth share schemes, including 'flowering' share, 'blossoming' share, 'freezer' share and 'hurdle' share schemes. Whilst there are differences in these types of schemes, the essence of each involves creating a separate class of shares whose rights are such that they have little or no current value, but have the potential to benefit from future growth in value, or a realisation in value, of the company. The aim of such schemes is to deliver capital gains tax treatment for the executive on any gain on sale of those shares for a minimal up-front cost to the executive on subscription for those shares. In other words, the aim is to deliver the economic and tax benefits of an option structure for both the company and the executive, outside an option scheme.

HOW THEY WORK

There is no 'one size fits all' formula for growth share schemes – scheme provisions will need to be tailored to each particular company. However, a usual structure would involve the creation of a separate class of shares whose rights are such that they have little or no current value but have the potential to benefit from the future capital growth of the company. The growth shares' value on subscription is low because either they have no economic or other rights (growth shares will usually have no dividend or voting rights) until, or such rights only crystallise when, further growth in value occurs, or a certain hurdle event or conditions are met. Hurdle conditions are typically linked to the achievement of a minimum exit price on disposal or a commercial milestone of some kind.

However, there are many different approaches that can be taken when drafting growth share class rights. Companies may wish to provide that the growth shares:

- participate proportionately with the ordinary shares in the value of the company above the hurdle;
- have an entitlement to different proportions of specified bands of excess value above the hurdle;
- have very limited rights until the end of a vesting period of continuing employment or the satisfaction of other performance conditions.

The exact terms of the growth share scheme will need to be tailored to the company and the objectives of the incentive structure in question. The company's articles of association will need to be amended to set out the rights of the growth shares and other share classes. The articles of association will also usually be amended to include leaver provisions so that where a scheme participant ceases to be an employee the company will repurchase his growth shares at nominal value.

In addition to changes to the articles, the company may also adopt a growth share plan and/or a form of growth share subscription agreement setting out the terms of who can receive growth shares and the terms on which growth shares will be acquired.

WHY USE GROWTH SHARE SCHEMES?

- The main aim of growth share schemes is to secure capital gains tax treatment, rather than an income tax liability, on the growth in value of the shares during the executive's ownership. This potentially means that growth shares will be taxed at 20% (the current capital gains tax rate for higher-rate tax payers) rather than 40% or 45% (the income tax rates for higher income earners). In addition, the executive may be able to benefit from Business Asset Disposal Relief (formerly known as entrepreneurs' relief) on the first £1 million of any gain if certain conditions are met (including holding the shares for at least two years prior to sale).
- If properly structured an executive will only pay a nominal value to acquire the growth shares and will have no liability for tax or National Insurance contributions on acquisition. This requires the shares to be issued at their unrestricted market value (that is disregarding the effect of any restrictions on the shares).
- There is no limit on the number of shares that can be awarded under a growth share scheme. As such, growth share schemes are particularly useful for companies where EMI options are not available.
- There is no requirement to offer participation in such schemes to all employees and the company has discretion as to who participates.
- The shares are owned by the executive on day one which may help in aligning the executive's interests with those of other shareholders.
- There should only be a minimal outlay for the executive at the outset. Growth shares can have a relatively low market value at the time they are acquired, even if other shares in the company are quite valuable at the time. This reflects the negligible share of the company's current value which they represent and the possibility that the company will not achieve the growth required for the executive to benefit substantially from the shares.
- There is very little risk for the executive: if the share price falls he or she will have lost very little but if the share price rises they may make substantial gains.
- Growth share schemes allow the existing shareholders to continue to exercise voting control over the decisions of the company and can also protect, for the existing shareholders, the value created in the company prior to the date of the executive's acquisition of growth shares.
- Growth share schemes can be structured in order to meet a variety of needs of individual companies.
- They can be implemented 'back to back' with an option scheme which would only operate below the relevant hurdle.

WHAT'S THE DOWNSIDE?

- Growth share schemes do carry a degree of risk on the tax treatment - they rely on there being no change in the tax legislation to impose income tax on the shares' growth in value (which might be done retrospectively if HMRC considers that growth shares are being used for unacceptable tax avoidance). HMRC has previously commented that it is looking more critically at such schemes and so they do remain open to attack as avoidance arrangements.

- The benefits of a growth share scheme assume that the capital gains tax rate remains low relative to high earners' income tax rates (as it is now), right up to the time when the executive disposes of his growth shares.
- The revised articles of association and any allotment of shares will need to be registered at Companies House and therefore will be a matter of public record (and so potentially accessible to all employees). This means that such schemes are to a large extent 'public'. This is in contrast to more typical employee share option plans, where the terms are usually set out in a self-contained set of plan rules and individual option agreements which are not required to be filed on any public registry.

WHAT COMPANIES NEED TO DO

- Implementing a growth share scheme requires careful planning to avoid unwanted income tax liabilities arising. It is unwise to progress with a growth share scheme approach to incentivising executives without robust professional advice – early involvement of your solicitors at the planning stage is recommended.
- The shareholders themselves should also be encouraged to seek independent tax advice in relation to their own circumstances.
- The alteration of the company's articles of association will require shareholder approval.
- An independent share valuation expert, usually an accountant with relevant experience, will be needed to value the company and the new growth shares, growth shares are not part of a plan or arrangement approved by HMRC which means that it is not possible to obtain advance clearance from HMRC).
- Experienced solicitors will need to draft the share plan and associated documents including the necessary changes to the company's articles of association.

FURTHER INFORMATION

For further information, please get in touch with your usual Penningtons Manches Cooper contact.

FIND OUT MORE

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