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Incentivising staff with shares

By Andrew Skinner – Martelli McKegg

Despite some economic headwinds, New Zealand is still experiencing a tight labour market.

Many employees are now in a position where they can "shop around" as there are more opportunities available to them. As well as these options, post Covid employees are looking for more than just a pay cheque. Employees now want long-term opportunities in which they can grow with a business and reap the rewards of the company's success. As a result, an increasing number of employers are looking at different options for staff holding shares as a retention tool. This article looks at the different options available and highlights that careful legal and tax advice needs to be sought.

The main reasons for staff holding shares from an employer's perspective is to hopefully make them less likely to leave the business and contribute more when their efforts are linked to the company's profits. The main benefits are:

- Assist retention
- Encourage and increase productivity with existing employees
- Offer flexible remuneration
- Attract new employees
- An exit strategy for the owners

Of course, with staff holding shares there is a lot to think about. If staff hold shares then normally those staff will have voting rights and will be able to see a lot more financial information about the business.

Employee Share Schemes

An employee share scheme is an arrangement where employees are given the opportunity to acquire shares in the company. The shares are issued by the company (as opposed to transferred by the existing shareholders) either up front to the employee or the issue of the shares can be linked to certain events or performance (known as options).

How can employees acquire shares in an Employee Share Scheme?

If the company wishes to create an employee share scheme then certain employees can be invited to take part. A key decision will be whether the shares are issued for market value or below market value. If the shares are issued for below market value then the employee receives a taxable benefit and tax advice needs to be considered. The employee will need to use their own personal funds to acquire the shares or the company can loan the employee the funds required to acquire the shares (subject to complying with the rules around financial assistance).

What are the potential issues with Employee Share Schemes?

As mentioned above, when an employee becomes a shareholder in a company the shares usually have certain rights (such as dividends, voting and information). For smaller private companies, the employer may wish to restrict the power that employee shareholders can exercise over the company and this is often done by creating different classes of shares. A company can have different classes of shares that confer different rights to different classes of shareholders (e.g. class A shareholders shall have the full rights afforded to shareholders whilst class B shareholders will not have voting rights).

Aside from the rights attaching to the shares, having employees holding shares can present its only challenges if an employee leaves the company (for good or bad reasons). Usually the employee is required to sell their shares when leaving and so then the question becomes who buys them and for what price? The shares could be offered to the other shareholders or they could be acquired back by the main founding shareholders or by the company and cancelled. The share value can be determined by a valuer or an accountant but this can get expensive each time so sometimes companies adopt a formula that can be re-set every few years.

Whenever a company issues shares, the directors need to consider the information disclosure requirements of the Financial Markets Conduct Act. Even though employees may have more knowledge of the company than a member of the public, the investor disclosure requirements still apply unless the employee meets one of the investor exemptions or the specific requirements of the exemption for employee share schemes are met (which limit the volume of shares annually that can be issued in any class and have specific lower information disclosure requirements).

Employee Option Schemes

An alternative to issuing the shares up front to staff is to provide them with options to acquire shares in the future if certain events or performance thresholds are met. The issue price for the shares is usually the price at the time the options were granted (which may be different to the market value at the time the shares are issued). Options can create an incentive to stay with the company but employees need to understand that there is a potential tax liability for the difference between the exercise price the shares are issued for and the current market value.

Selling shares to key staff

Along with retaining staff, an increasing number of business owners contemplating retirement may want to consider whether any key senior staff may want to acquire the shares in the company. This could be done in one transaction or staged over a number of years. Key to this exit strategy is to consider the valuation of the business, the stages for investment and a shareholders agreement to govern the management of the business.

Shareholders Agreements

If employees hold shares (whether they are issued by the company or transferred by existing shareholders) then the employee shareholders will have rights as highlighted above. In order to govern the operation of the company and also restrict how those shares can be traded, it will be very important for the company to have a shareholders agreement.

A shareholders agreement is a contract between all the shareholders of a company that regulates the relationship between the shareholders and sets out the rules for governing the company. Each shareholders

agreement needs to be prepared and tailored to the specific business. Some of the key provisions a shareholders agreement should address are:

- **Board composition:** provisions around who is on the board of directors and how decisions are to be made (i.e. unanimous, majority etc). In the absence of these specific provisions, the standard rules in the Companies Act prevail, which may not be appropriate

- **Reserved matters for board or shareholder approval:** shareholder agreements usually reserve certain important decisions for the board or shareholders

- **Funding and operational responsibilities:** funding may be by way of capital contributions, shareholder loans or other bank loans and should be set out in the shareholders agreement

- **Restrictions on the transfer of shares:** shareholders' agreements will usually contain restrictions around how shareholders can dispose of shares (known as pre-emptive rights). Pre-emptive rights give existing shareholders the first right to purchase shares from departing shareholders

- **Dispute resolution, default and deadlock processes:** as disagreements may arise, the shareholders agreement should address how to deal with and resolve disputes, defaults and deadlocks. It is important that a clear process is set out so that parties can follow this process rather than let their issues fester to the detriment of the company

As you can see, whilst at first glance offering shares to employees may be considered a great retention tool, there are many practical, legal and taxation consequences to consider. This article summarises some of those issues but it is very important that you seek appropriate advice before implementing an employee share strategy.

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