

Employee Share Option Plans The Good. The Bad. The Ugly. Practical Suggestions

By Bruce Duggan

The Good

If you want "over-and-above" results, reward productivity. If you want to attract special talent, provide something more than a base salary.

At any level in business, results oriented incentives payback handsomely. Cash payouts always seem to be the most successful.

Sometimes key employees may want or expect rewards that the founding entrepreneur shareholder may not be able to immediately afford. Share options, or the right to participate in the future profits of the company, are a way of providing a financial opportunity that may not only successfully replace the lack of immediate cash, but may also create a tremendous incentive for those key employees to push the extra mile in making certain the company succeeds. It's amazing what can happen when one has a stake in the outcome!

The Bad

Issuing shares as well as making promises to issue shares to senior employees can, all by itself, create circumstances down the road that can frustrate your later plans to deal with your business.

The Ugly

No Sale: Prospective purchasers of a private corporation usually demand 100% of the outstanding shares of a corporation.

Significant planning and strategy development is required to minimize taxes on the share sale of a business. But minority shareholders or senior employees who have been promised shares can easily frustrate this effort, and your desire to sell the business. Without the consent of minority shareholders or people who have received promises to be issued shares in the future, the prospective purchaser will usually walk away from the deal.

Corporate Decisions: In making any decisions, you as a majority shareholder must consider whether your actions might be considered oppressive (unfair) on the minority shareholders.

The Ontario Business Corporations Act provides a flexible system of remedies to minority shareholders where majority shareholders have undertaken a course of action or decision that is unfair with respect to the interests of minority shareholders;

Minority Shareholder Rights: The right of veto.

By law, minority shareholders individually or together with at least 33% of the issued shares have what amounts to a right of veto on fundamental changes to the corporation. This would include: mergers and amalgamations, selling substantially all of the assets of the corporation, changes to the number of directors or amending the articles of incorporation. Even where minority shareholders own less than 33% of the issued shares, legislation protects their interests in the face of fundamental changes to the corporation. They are provided with a right of dissent and a right to be bought out by the corporation at fair value.

The Ex-Employee Shareholders: They continue to own part of your company, including the right to receive financial information about your company.

If an employee who owns shares resigns to work for a competitor or other company, dies or becomes disabled, they or their heirs retain the right to receive financial information about your company, being legitimate part owners. Obviously you do not want to have a non-employee still owning shares and exercising rights. Without the ability to re-acquire these shares you are left with a shareholder who is not participating in the company, but who can materially affect business decisions you may wish to make.

Employee Share Option Plans *(continued)*

Some Practical Suggestions

Phantom share options: Rather than issue shares or grant options to buy actual shares in the future, you can use a program sometimes called “phantom share options”.

These are not real shares but are notionally the same thing as far as the company's value is concerned. The value of the company is fixed at the date that the “phantom share options” or “phantom shares” are issued. The employee does not have any shareholder rights, but has an opportunity to receive cash bonuses related to the profits or the increased value of the company at predetermined events. A fixed formula determines profits and valuations in advance. This will have an impact on the future cash flow of your company, but you will know that the cash flow is coming out of the company's increased value.

Issuing actual shares and share options: These shares can be issued without any voting rights, and a shareholders' agreement addresses problems regarding the future sale of the business and unfairness implications. This shareholder agreement gives you an opportunity to introduce certain rules and rights that allow you, the majority founding shareholder to control the sale of the business, as well as a host of other matters.

Employee share ownership plans (ESOP's): These are more complicated solutions. ESOP's permit the transfer of shares in the company to key employees by way of a trust that you can still control. There are advantages and disadvantages with ESOP's.

- i) take-along rights – *these specifically require the minority shareholder to be “taken along” by the majority shareholder when a prospective purchaser requires that 100% of the shares of the company be sold. The minority shareholder agrees in advance to receive his pro rata share entitlement of the share sale proceeds.*

- ii) shotgun provisions – *there are an unlimited variety of shotgun provisions and formulas that essentially allow shareholders to force the purchase or sale by the other shareholder(s).*
- iii) first rights of refusal and call options – *these can be used either together or individually. The first right of refusal would require the minority shareholder to purchase the majority shareholder's shares on the same terms as the prospective purchaser had offered to buy the majority shareholder's shares. A call option is an agreement where the minority shareholder has agreed in advance to permit the majority shareholder to buy out the minority shareholder's shares at a predetermined formula.*
- iv) exit from the company on pre-agreed terms – *Although planning in advance for oppression remedy defences is not possible, there are shareholder agreement mechanisms that provide rights for the minority shareholder to exit from the company on pre-agreed terms.*
- v) mandatory buy-back option – *Where an employee leaves, dies or becomes disabled, you can only require the sale of those shares back to the company or to yourself if a mandatory option for that purpose is inserted, in advance, into a shareholders' agreement.*
- vi) *additionally, restrictions always should be built into the articles of incorporation of a privately held corporation to restrict the opportunity of shareholders to transfer their shares for a variety of reasons. They should also include the opportunity for the majority shareholder to veto the sale of shares to any other person not approved of by the majority shareholder.*

The Right Incentive

Encourage those entrepreneurial qualities that have made your business dynamic and successful. Provide key employees with the same type of financial incentive that you have, and make a dramatic impact on productivity and forward momentum for your company.

Simmons da Silva & Sinton provides legal services to entrepreneurial business clients and individuals. At a personal level, we assist clients with all matters relating to family law, including mediation, collaborative law and court-contested proceedings. We also advise as to the preservation of wealth, Wills and estates. Since 1969 our reputation has been built on being astute problem solvers and providing common sense solutions to the legal issues confronting our clients.

Bruce Duggan is a partner in the firm and practices business law, with particular emphasis on the needs of entrepreneurial ventures, small and large privately held companies and family businesses. In addition to providing general counsel and advice on ongoing legal issues that impact their business, Bruce works with clients to develop and facilitate realistic growth strategies, and is able to connect them, where appropriate, with other expert resources.

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