Promoting financial participation in the EU 27

ESOP Centre
May 2011
Workshop for ProEFP/Ecosoc, London

The Employee Share Ownership Centre

Spreading the Wages of Capital

London Workshop: May 20 2011

Organised by the Esop Centre at the request of the European Economic & Social Committee project: *'Promoting EFP in the EU 27'*

Opening

The London Workshop was opened by **Esop Centre chairman Malcolm Hurlston,** who said that in previous years the EU had been keen to look at employee share ownership (Eso/EFP) through the prism of multinational companies. EU projects in this sector had resulted in *round robin* messages and reports circulated to member states, but sometimes the results had been poorly collated. Another long-standing problem for Eso was that it had been pigeon holed within the Commission as a social and employment issue and had not really been linked with enterprise.

Multinationals, when asked, gave more coherent answers than SMEs (small and medium sized enterprises) about what to do with employee share ownership, so it was right to focus on the latter, as the EESC was doing. However, the Esop Centre, like everyone else, had found making progress (by getting Eso installed in SMEs) "extremely difficult." The tax aid packages provided by UK governments had never quite fulfilled their purpose. "Unless you have a formula which makes Eso attractive to company owners, it just won't happen – you'll end up with trade sales instead and that usually means the new owners cherry picking the sites they want to keep open" said Mr Hurlston. "That in turn means many closures in the regions – so Eso can be a very important in maintaining local work."

He was "delighted" that the Centre had been asked to participate in the EESC project, which was based firmly in the 'Enterprise' camp. The Committee had the power to make both the EU Commission and the Council of Ministers sit up, take notice and respond, said Mr Hurlston. He praised the role of Prof Jens Lowitzsch in the project, as Jens was "bridging the gap between the Anglo-Saxon concept and the more social and corporatist ideas which have held sway on the continent. Jens has encouraged me to think we are on a pathway towards something concrete and I have great hopes that this initiative will succeed," he added.

Lectures:

Adrian Bailey MP (Labour & Co-op) chairman of the House of Commons business innovation & skills committee said that although Eso had made great strides, it had not got the profile it deserved. Eso had been widely seen as an idiosyncratic element within the corporate financial structure, but was now seen by government as a driver of business productivity, better quality of service and ultimately better profitability. "I hope my committee in parliament will look at Eso and measure its progress and I hope the Esop Centre will contribute to our work, " said Mr Bailey. As for efforts to mutualise parts of the public sector, the new Mutuals Information Service, comprising Co-operatives UK, Local Partnerships and the Employee Ownership Association (set up in Nov 2010), had so far received 230 enquiries, mostly from local government, he said.

Prof Jens Lowitzsch, of the University of Frankfurt, said that the EESC project had adopted the *Building Block* approach in order to help spread the take-up of employee financial participation throughout the 27 member states. This project would restore the momentum, which had been lost since 2004. "EFP is not only social policy, it is also part of industrial and economic policy," said Prof Lowitzsch. "It's not just a give-away or a benefit – it's much more than that," he added. The EESC was ready for talks with the Commission and/or the Council of Ministers in order that they should take action on the project report's main recommendations. Despite the different names for elements of EFP in different countries, there were more or less the same features in place:

(1) Tax incentives, except in Germany. Tax harmonisation was difficult but why not have mutual recognition instead? Finance ministries should be asked to give the same or similar tax treatment for local employees of foreign companies. A working practice agreement between France and Germany about deferred taxation for certain French subsidiaries in Germany had defeated ten years of argument over legislative forms.

(2) EFP (Eso) was a source of capital participation in a crisis. Employee share ownership had helped save companies, even if wage cuts had sometimes been necessary.

(3) Business Succession could be helped by Eso, as an alternative to company liquidation or trade sales. Almost 700,000 companies within the EU were likely to have succession problems within the next few years. Even if EFP was used in one percent of these cases, almost seven thousand companies might be saved from the scrap heap.

(4) Better communication between company management and the workforce was often achieved through Eso, he said.

During the week of EFP in Brussels October 17-19, the project would be looking for EFP/Eso models. The challenge was to get everyone talking about EFP and how to install and operate it, he added.

Iain Wilson, of Computershare Plan Managers, spoke about the Computershare's online survey work with the National Institute of Economic and Social Research to examine Computershare employee participation in share plans and their attitudes and behaviour. The main results were: Eso participation is associated with:

- Motivational and productivity-enhancing behaviour
- Increased employee loyalty to the company
- Greater tendency for employees to feel like co-owners and to share company values than non-participants
- Lower average absence from work rates
- Less 'clock-watching'

These traits were more evident at high levels of EFP/Eso, but sometimes absent in units with lower levels of employee participation. No negative effects of EFP/Eso were identified. The survey work had helped raise participation levels by five percent among 'core' Computershare employees.

Mike Landon of MM & K spoke about the advantages and limitations of employee share ownership. ***The pros included***:

- Enabled companies to give valuable rewards to key people without exhausting their cash reserves (especially NB in small high tech companies)
- Long-term incentives were a good excuse for companies to communicate more with their employees
- State-approved Eso was tax advantaged for participating employees
- A source of new capital
- A means of trying to raise employee involvement and (hopefully) higher productivity

The cons included:

- Share schemes were usually more complex to administer than cash incentives, especially when international share plans were concerned
- They could be costly to set up
- The size of the rewards was unpredictable.
- No differentiation in basic share schemes for individual performance
- Eso needed strong and on-going communication to keep it alive

- Unwise for an employee to have a lot of cash locked up in employer's share scheme. Risk of loss if shares had to be bought by participating employees (eg Share Incentive Plan)

But 'society' could gain from Eso too:

- Good chance of better productivity and hence more wealth creation
- Improved industrial relations
- More social cohesion as employees feel they have a stake in capitalism
- The possibility of a fairer distribution of wealth

Successive UK governments had been good in giving employees tax reliefs on Eso participation, but not so good at removing regulatory obstacles, nor harmonising legislation. Recent Treasury draft legislation of disguised remuneration was a case in point, added Mr Landon.

David Craddock of Craddock Consulting described the various tax concessions for participating in HMRC 'Approved' share schemes:

The Share Incentive Plan, in which employees either (a) bought company shares – purchases which the employer could (b) match by giving employees shares - or (c) were given free shares, was a "beautiful scheme, under-estimated in the SME sector." ***Enterprise Management Incentives*** – a share option award scheme for key employees - was super advantageous tax-wise for qualifying SMEs, but there were many exclusions, including all subsidiary companies. EMI had been the product of very close collaboration between the Centre and the then Labour Government and had been "beautifully devised." It was one for the rest of the EU to study and perhaps implement.

SAYE – Sharesave - another share option scheme with operated through two contracts: the options award – often at a discount of 20 percent – contract and a savings contract, which committed participating employees to save monthly in order to have the necessary funds to buy the options (if they were in the money) when they matured thre or five years later.

Geoffrey Bond of RM2 Partnership spoke about avoiding the pitfalls of Eso. Companies, like one that had promised employees big equity rewards three years ago, but was then sold only months after the promise, could create unwittingly hugely inflated tax bills. There could be restrictions over employee shares; establishing an internal shares market was not always easy; employee benefit trusts had to be understood and set up and the company Mems & Arts had to be consulted, permissions obtained and so on. There were many hurdles to overcome before Eso could be installed in companies: there were accounting standards and other regulatory guidelines to adhere to, company, employment,

trust and tax law and Eso could be costly and was certainly dilutive. The company had to have, or create, quoted shares.
HMRC's valuation department had been very helpful in responding quickly to advisers' suggested values for about-to-be-issued company shares, said Mr Bond.

David Craddock also discussed the use of Eso as a succession planning tool. This had started with the Kelso Model from California in 1956 when a local newspaper group owner wanted his employees to takeover the business after his retirement, rather than have to sell it to a larger newspaper group. Louis Kelso had helped the owner achieve this by setting up the first Esop structure – allowing the employees to buy the owner's exit shares gradually, through a share trust mechanism, sometimes with a bank loan involved. The employee share trust arranged the progressive release/transfer of shares to employees, sometimes based on the achievement of performance conditions.

Employee share trusts also helped leading players in the company to buy it through an MBO (Management Buy-Out) usually with rank-and-file employees being offered smaller stakes in the equity – of the company owner wanted an exit. SME owners needed to understand that Eso did not necessarily mean the loss of control - provided employees' equity stakes in the business did not exceed 24 percent, added Mr Craddock.

Craig Dearden-Phillips MBE, founder MD of Stepping Out, discussed new UK public sector spin-out social enterprises and employee owned mutuals. The UK Coalition Government was pushing for social enterprise and staff-led mutuals to be formed from the public sector. Diversity of provision was on the agenda as local authorities were providing less and less. 14 Pathfinder Mutuals had already been announced and at least 14 more were being announced this year. These included several branches of local councils and health authorities. The aim was to set-up employee-led MBOs (management buy-outs) in the public services, said Mr Dearden-Phillips. The 'Right to Request' allowed NHS staff to request to take out their division from the public sector. NAVIGO, a company spun off from the NE Lincolnshire Care Trust Plus was one such. NAVIGO's chief executive officer had ensured that 'real' ownership was available for employees by issuing paper shares for staff and users. Employees had full rights to vote for both the member and main boards. It had a three year supplier contract with the NHS, but what would happen after that? By 2013, the forecast was that 60 or so NHS orgs would have become social enterprises. There was opposition from the trade unions to consider and lack of capability in some LAs to achieve this.
"Trying to create common endeavour in the UK public sector is a big problem. One is cutting away at the baggage. However, organisations and people change when they are put into a marketplace and asked to be responsible for their own futures," said Mr Dearden-Phillips.

Mahesh Varia, partner in lawyers Travers Smith, gave client two case histories of SMEs that had adopted employee equity (Eso) schemes.

One was a Start-Up, which used the Enterprise Management Incentive share options award scheme (which benefits from significant Government tax reliefs) because of its generous award limits – up to GBP 120,000 options per employee, within an overall limit of GBP 3m in outstanding options for each company. There is no income tax to pay provided the options are held for the required time period, but Capital gains Tax is payable on the growth in value of the shares. This small company was sold some years later for GBP 70m and each employee received an average pay out of more than GBP 100,000 after tax. But companies employing more than 250 employees and/or holding gross assets worth GBP 30m or more cannot qualify for this generous state-aided Eso/EFP scheme for SMEs. The EMI had been very, very successful, he added.

Mahesh's second case history involved an MBO (management buy out) backed by a private equity investor. This Eso plan could not be approved by HMRC (the UK tax authority) because more than half the equity was owned by the private equity investor. The Eso operated alongside an Employee Benefit Trust (EBT) which warehoused unallocated shares, acquired shares from leavers and funded bonuses. This Eso is working well and the PE owner + managers aim to exist after between three and five years, said Mahesh.

Paul Maillard, honorary president of FONDACT, (French Association for the Promotion of management and Employee Financial Participation) explained the three main French EFP systems:

1. INTERESSMENT - collective based cash distribution to employees on a voluntary basis. The contract states precise targets to trigger awards and criteria for distribution. Exempt from social contributions and from tax - if employee invests the proceeds in a savings scheme. The company is not taxed on the value of the awards to employees.

2. COLLECTIVE PROFIT-SHARING PLAN - compulsory for companies who employ more than 50 employees and who get good results. It can be used by smaller companies on a voluntary basis. A legal formula determines the basis for profit-sharing. Employees can invest the proceeds into mixed portfolios (eg mutual funds) or they can receive a cash bonus, which they must hold for five years.

3. PLAN D'EPARGNE - savings schemes, involving different mixed funds in which employee savings can be invested. The managing board of the fund contains employee reps.

Now other choices are available to companies – they can award stock options, free shares and they can offer a retirement plan called PERCO, said Mr Maillard.
At the end of 2008, more than 7.5m French employees were participants in one form of EFP or another. In the same year, €6.5bn was distributed under Interessement to 4.3m employees by 14,000 companies – an average of €1490 per participating employee. Almost € 8bn was distributed under profit-sharing to 5.5m employees by 12,000 companies. €1.6bn was distributed under matching schemes to 2.5m employees by 13,000 companies.
On June 30 2010, total employee participant assets managed in specific investment funds was €84.6bn, of which 61 percent was in diversified funds. Around €33bn was invested in single company shares by 11.7m employees and retired employees, he added.

Prof Jens Lowitzsch discussed what specific policy proposals might emerge from the EESC project. "It maybe that we need a Directive at the end of this," he told the workshop. Company constitutions might have to be amended to allow companies to provide financial assistance to their own employees and the constraint on them buying back their own shares could be lifted if the purpose was to give them to their employees within 12 months, he added. To date, the EU Commission's justification for investigating EFP had been "social improvement" but there was more to it than that. "We are re-formulating policies on this issue for 2020, especially for the SMEs" said Jens. What could the EU get out of EFP? - The answer was: a helpful aid in business succession; regionalism to preserve jobs, without being protectionist; an increase in purchasing power for millions of EU employees, plus improvements in productivity and competitiveness of EU based enterprises. "The ground for advancing the penetration of EFP must be prepared," he said. The EESC project would go online very shortly with its own website, so that SME owners and managers could find something about EFP availability in each of the 27 EU member states.