Field Fisher Waterhouse

Equity incentives – strategies for challenging times

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Introduction

Notwithstanding ongoing economic uncertainty, employers continue to use equity incentives to retain and recruit staff. Now is a good time to revise existing arrangements, or implement new ones.

In addition, from 6 April 2010, employees earning more than £150,000 face a 50% top rate of income tax. There will also be an increase in national insurance contributions ("**NICs**") from April 2011 for all employees and employers. Minimising tax and national insurance costs in relation to remuneration will therefore be an objective for many businesses and individuals in the coming years, and equity incentives, if properly structured, provide a means to achieve this.

This briefing guide looks at ways in which incentive plans can be designed or revised to take account of current market conditions, covering a wide range of subjects from how to tackle underwater options to making best use of lower market valuations in relation to HM Revenue & Customs ("**HMRC**") approved share plans. The guide also explains tax and compliance issues and potential tax savings.

Strategies for underwater options

Many options remain underwater due to falls in share prices of those companies listed on stock exchanges, or private companies who have experienced reduced levels of financial performance.

Options are referred to as being "underwater" or "out of the money" when their exercise price is higher than the current market value of the underlying shares. Options have little or no incentive value while they remain underwater, although this can depend on how far underwater the option lies, and the chances of the option coming back into the money within the option exercise period.

A company can seek to deal with underwater options in a number of ways including:

- amending the terms of the existing options by reducing the exercise price (often referred to as option repricing);
- asking option holders to surrender their old options and grant new options with a lower exercise price;
- granting new options leaving the underwater options alone;
- granting "parallel" options which, to the extent exercised, trigger the lapse of the old options; or
- doing nothing and waiting for the share price to rise and the options to come back into the money.

Companies that have their shares listed on the Main Market and the AIM Market of London Stock Exchange plc need to be aware that option repricing or cancelling underwater options for new options that are in the money is contrary to the guidelines on executive remuneration published by the Association of British Insurers ("**ABI**") which state that such behaviour is "not appropriate". The ABI is concerned to ensure that option holders are in no better position than shareholders when it comes to the rise and fall of the company's share price.

Whatever choice a company makes in seeking to deal with underwater options, it should always consider the rules of the relevant plan governing the options, and ensure that if shareholder approval is required, this is obtained. If the relevant plan is approved by HMRC, then it is important to ensure that any proposed course of action does not jeopardise its approved status and therefore the tax reliefs on exercise. There may also be additional accounting charges if changes are made to the terms of existing options.

Adjusting performance conditions in long term incentive plans

Long term incentive plans or LTIPs are frequently structured as free share awards or nil cost options, so that they deliver as much value to participants as possible, provided that specific performance conditions connected to the vesting of the awards are satisfied within defined time periods.

Performance conditions are typically based on increases in share price or earnings per share linked to above inflation targets, or relative targets such as outperforming peers based on total shareholder return (a combination of share price movements plus dividends reinvested over a stated period to give an indication of a company's general performance).

These performance conditions may be more difficult to achieve due to the economic downturn. It may be possible to revise the targets or extend the performance periods so that the awards retain their incentive for the individual. Where the ABI guidelines are relevant, any changes to the terms of existing LTIP awards should be made in light of the ABI's comment that retesting of performance

conditions is unnecessary and unjustified, highlighting the view that "rewards for failure" are no longer acceptable.

Shareholder approval may also be needed if changes to LTIP rules are necessary and there may be accounting implications to consider. Companies may wish to revise performance conditions for future awards only, and adopt a policy of making smaller individual awards on a more frequent basis.

Option grant tied to salary sacrifice

Companies implementing salary sacrifice schemes or temporary reductions in salary may wish to consider offering share options with favourable strike prices, vesting or performance conditions. DSE International plc, the owner of Currys and PC World, recently received shareholder approval for such a scheme. This allowed executives to receive market value share options with no performance conditions in exchange for a pay cut of up to 25%. Normally executive options would be expected to contain challenging conditions, based on a mix of group wide and personal performance targets.

Making use of lower share valuations

The credit crunch and worldwide downturn have inevitably led to sustained falls in some share prices. Private company business valuations are now also, on the whole, lower than before the credit crunch as M&A activity has reduced, finance remains harder to obtain and redundancy rounds impact on overall profits.

For tax purposes, lower share valuations can provide an opportunity to extend and maximise the use of equity incentive plans approved by HMRC (these are the Company Share Option Plan, Save As You Earn, Share Incentive Plan and the Enterprise Management Incentive arrangement). All such plans have financial limits on the number of shares that can be held under option or awarded to individuals. These financial limits are imposed by reference to the market value of the shares on the date of grant or award. A lower valuation means more options or shares can be brought within an individual's limit. It also means that the opportunity to realise a gain on exercise of an option should be greater, as the market valuation is also used as a basis for the exercise price of the option. As the plans are approved by HMRC, the gains on exercise should be free of income tax and NICs.

Companies may find it difficult to communicate a positive message to employees if shares have fallen in value, but the potential upside for employees in receiving an award based on a lower valuation can be explained using clear briefing guides and other forms of communication (for example, internal seminars, help lines and information placed on an intranet). Recent share price rallies help promote this message.

Motivating employees alongside other investors

Many private equity deals have been financed using significant amounts of debt and equity finance raised by the target company. Distressed sales and sales out of administration will often involve a restructuring of existing debt in the business as part of the acquisition, with the result that the debt remains repayable for some years to come. Venture capital-backed companies that have taken significant amounts of venture capital funding now find that valuations have fallen, and exits are hard to achieve.

What all three of these scenarios have in common is that, against the backdrop of the economic downturn, the levels of debt and the specific liquidation preferences associated with private equity and venture capital money are likely to exceed any reasonable valuation of what the company is worth. As a result of this, the ordinary share capital (and therefore any options to acquire ordinary shares) may effectively become worthless, meaning that equity based awards for management and other employees will have limited or no incentive value. The position of those holding ordinary shares can weaken further if the company raises further venture capital or convertible debt at a lower price than previous funding rounds (as the issue of further shares can severely dilute the ordinary shareholders and cause existing incentives to be underwater).

Companies may wish to consider ways in which their employees can regain a meaningful equity stake in their employers. Several solutions exist including:

Grant of new options: following a down round of venture capital finance, a company could grant further options over ordinary shares, at a lower exercise price equal to or perhaps at a discount to the price paid by investors at that round. This may deal with the potential dilution issue, but does not deal with the problem of the ordinary share capital being "underwater", as all ordinary share capital will be subject to the liquidation preference held by investors.

Modify the liquidation preference "waterfall": a company could seek to amend the rights of investors holding preference shares so that ordinary shareholders participate earlier in the distribution of proceeds on sale of the company (so moving higher up the distribution waterfall). This distribution could be up to a specified amount, following which any balance is distributed to preferred shareholders in accordance with the normal liquidation preference.

Create a bonus pool: a company could establish a bonus pool or ratchet mechanism so that employees receive further shares or investor shares convert to a worthless class of share in the event of a sale of the company above a specified valuation or internal rate of return ("**IRR**"). As an alternative solution the company could create a separate class of "growth" share specifically for employees, which has limited or no economic rights until a sale of the company is achieved above a pre determined valuation or IRR. The rights attaching to the shares are likely to be conditional on continuing employment with the company, so that only those employees who are employed at the time of sale can participate in the bonus arrangement. If structured properly, creating a class of "growth" share can be more tax advantageous for employees than receiving an additional issue of shares immediately prior to an exit event.

There may be other solutions available to a company facing problems with underwater ordinary share capital (including the use of options over preferred shares, or deferred share purchase plans).
None of these proposals are easy to structure or implement, and a company should always seek specialist advice on the tax and other implications connected with these potential solutions before adopting them.

Our service

We advise on all aspects of equity-based remuneration, with particular expertise in creating and sustaining genuine employee ownership solutions.

We provide targeted, commercial advice based on the needs of your business, from start-ups and spin-outs to AIM and Official List companies in a broad variety of sectors.

Through our overseas offices, affiliates and contacts, we advise on international share plans, including advice on local tax and securities laws, regulatory issues and how best to communicate the plan to participants.

Contacts

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